Forged Check Endorsement Losses Under the UCC: The Role of Policy in the Emergence of Law Merchant From Common Law

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I. INTRODUCTION

This paper discusses the allocation among innocent parties of losses incurred in connection with the collection and payment of checks bearing forged indorsements.\(^1\) The discussion covers, in various degrees of emphasis, (i) jurisdictions that have adopted a statute modeled on the English Bills of Exchange Act (BEA),\(^2\) conveniently, though not always accurately, sometimes referred to throughout this paper as common law jurisdictions,\(^3\) (ii) the United

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1. Generally speaking, a forged indorsement is an unauthorized indorsement other than by an agent who exceeded his authority. For forged drawer's signature losses, which are outside the present discussion, see Benjamin Geva, *Allocation of Forged Cheque Losses—Comparative Aspects, Policies and a Model for a Law Reform*, 114 L.Q.R. 250 (1998).

2. 1882, 45 & 46 Vict., ch. 61 (Eng.).

3. Jurisdictions covered are Canada (Bills of Exchange Act, R.S.C., ch. B-4 (1985)); Israel (Bills of Exchange Ordinance [New Version], 1957, 2 L.S.I. 12; South Africa (Bills of Exchange Act 34 of 1964); and Australia, where checks were excluded from the coverage of BEA 1909 and are currently governed by the Cheques Act, 1986, ch. 145 (Austl.). Strictly speaking, Israel, South Africa, and
States where the Uniform Commercial Code (UCC) Articles 3 and 4 apply to checks, and (iii) civil law jurisdictions where a statute modeled on the Geneva Uniform Law on Cheques (UCL) governs checks. This paper has several objectives. First, it is designed to place the UCC scheme in a broader comparative global context. Second, it will be demonstrated that worldwide developments were not arbitrary; rather, they responded to competing and often conflicting policies, so that local differences tend to reflect decisions based on conscientious policy preferences. Third, this paper will examine the interaction between policy and doctrine and the role of law merchant in the evolution of the law in this area.

It will be observed that among the major global systems, the Anglo-American one is far more complex than its Continental counterpart. Nevertheless, this paper concludes it is the Anglo-American scheme which implements the better policies. Additionally, statutory exceptions to the basic scheme reinforce the desired policies under the UCC but weaken or undermine these policies under the BEA. Finally, concrete proposals to revise the UCC provisions are made with the view of enhancing the implementation of the desired policies. Specifically, these proposals are concerned with (i) the restriction and some other modifications in the application of the conversion remedy, (ii) the revision of the negligence regime, particularly by the elimination of the comparative negligence rules, and (iii) the encouragement of voluntary codes of conduct prescribing standards of ordinary care.

In the past, I expressed the view that "[a] sound scheme

the Province of Quebec in Canada are not common law jurisdictions.

4. Article 3 governs negotiable instruments and Article 4 governs bank deposits and collections. The current text of Article 3 was enacted in 1990. Its enactment was accompanied by the passage of conforming and miscellaneous amendments to Article 4.


7. See infra Part IV.C.
allocating forgery losses should be aimed at achieving loss reduction and loss distribution while not undermining the fundamental policies underlying the use of negotiable instruments as payment devises.\textsuperscript{8} Such fundamental policies were identified as "the free circulation of commercial paper and the finality of payment."\textsuperscript{9} The present study confirms that loss prevention or reduction and free circulation are competing policies; yet, while historically, with respect to forged indorsement losses, a response to each one developed so as to be exclusionary of the other, these policies are reconcilable, and the objective of formulating a sound scheme accommodating both policies is, indeed, attainable. However, in the final analysis, this paper concludes, benefits from risk prevention or reduction substantially outweigh any potential benefit from free circulation. This result is because, in practice, checks seldom circulate or are negotiated other than to a depositary bank. Hence, the protection of free circulation and finality of payment to an indorsee neither outweighs nor ought to be reconciled with the policies of risk prevention or reduction and loss distribution that underlie the basic scheme of the Anglo-American system.

On a jurisprudential sphere, this paper observes that in the Anglo-American system, the evolution of the law relating to forged indorsement supports the view that commercial law is not a distinct and separate body of legal doctrine but rather the adaptation of general law doctrines and processes to meet the needs which arise in commercial transactions. This allows a more integrative view of commercial law in the context of the broader legal system as a whole and does not serve to demote commercial law in history or in practice.

\textsuperscript{9} \textit{Id.}
II. THE BASIC SCHEME IN THE MAJOR SYSTEMS OF THE WORLD

A. Forged Indorsements Under the UCC

The starting point of UCC section 3-403(a) is that "an unauthorized signature is ineffective."\(^\text{10}\) "Unauthorized" signature is defined in the UCC as "one made without actual, implied or apparent authority and includes a forgery."\(^\text{11}\) Since under section 3-204, "[i]ndorsement" requires "a signature,"\(^\text{12}\) it follows that a forged indorsement constitutes a breach in the chain of title to the check; it passes neither title nor lawful possession. Title and the right to possession remain with the original (ex-)holder whose signature has been forged.

A transferee who derives title, directly or indirectly, through a forged indorsement is not a "holder" in relation to parties whose signatures on the check preceded the forgery. This is because no transferee can become a "holder" without the "negotiation" of the check to him,\(^\text{13}\) and it is the holder's indorsement which negotiates a check.\(^\text{14}\) While being in possession of the check, the forger is neither its named payee nor indorsee, and thus, is not a "holder."\(^\text{15}\) Consequently, the taking from the forger, even by indorsement, is

\(^{10}\) U.C.C. § 3-403(a) (1999). This rule is stated to be subject to two enumerated exceptions and to exist "[u]nless otherwise provided in this Article or Article 4." Id. The enumerated exceptions pertain to ratification and the effectiveness of the unauthorized signature to bind the signer. The other exceptions are discussed infra Part IV.B.

\(^{11}\) U.C.C. § 1-201(43) (1999).

\(^{12}\) U.C.C. § 3-204(a) (1999).

\(^{13}\) See U.C.C. § 3-201(a) (1999). "Negotiation" is the mode of transfer constituting the transferee "the holder" of the instrument. This paper aims at maintaining a gender neutral language. It will use "he," "him" and "his" to equally denote "she," and "her" as well as "it" and "its."

\(^{14}\) See U.C.C. § 3-201(b) (1999). Strictly speaking, the provision speaks of "an instrument payable to an identified person" rather than to order. See id. However, under section 3-109(b), a promise or order payable to order "is payable to the identified person." U.C.C. § 3-109(b) (1999).

\(^{15}\) U.C.C. § 1-201(20). A holder of a check payable to order is defined as the identified person in possession of the check. See id.
not "negotiation;" hence, while being an indorsee in possession of the check identifying him, neither the taker from the forger, nor any transferee deriving title from him is a "holder." 16

By definition, a "holder in due course" must be a "holder." 17 Because the acquirer of a check payable to order through a forged indorsement is not a holder, no one who takes a check subsequent to a forged indorsement can be a holder in due course in relation to parties whose signatures preceded the forgery. A holder in due course obtains clear title to the check, free from claims to it, such as "a claim of a property or possessory right in the instrument or its proceeds." 18 This definition would allow a person from whom a check was stolen and whose signature was forged to claim ownership. But, as indicated, a forged indorsement precludes holding in due course, without which forgery could not have been overcome.

B. Forged Indorsements Under the BEA

The basic scheme of the UCC is modeled on that of the BEA. In BEA jurisdictions, a forged indorsement constitutes a breach in the chain of title to the check—"no right to retain the bill" 19 or to give a discharge therefor or to enforce payment thereof against any party thereto can be acquired through or under [a forged] signature." 20 A forged indorsement passes neither title nor lawful possession. 21 Title and the right to possession remain with the

16. Notwithstanding the statutory definition. See id.
19. Other than in Australia (where checks are excluded from the BEA), a check is a species of a bill of exchange.
20. See section 24 in the U.K., section 48(1) in Canada, section 23(a) in Israel, and section 22 in South Africa. In Australia, an indorsement of a check is not effective unless the indorser signs it. See Cheques Act, 1986, § 41(1)(a) (Austl.). Unless otherwise indicated, all statutory references are to the BEA in the United Kingdom, South Africa, and Canada; to the BEO in Israel; and to the Cheques Act in Australia.
21. This is also true for a collecting bank in Canada, notwithstanding BEA
original (ex-) holder whose signature has been forged.

A transferee who derives title, directly or indirectly, through a forged indorsement is not a "holder" in relation to parties whose signatures on the check preceded the forgery. This is so because no transferee can become a "holder" without the "negotiation" of the check to him, and the negotiation of a check payable to order is by "the indorsement of the holder." While being in possession of section 165(3), providing that "[w]here a cheque is delivered to a bank for deposit to the credit of a person and the bank credits him with the amount of the cheque, the bank acquires all the rights and powers of a holder in due course of the cheque." BEA § 165(3). In Boma Manufacturing Ltd. v. Canadian Imperial Bank of Commerce (1996), 140 D.L.R. 4th 463, 489 (SCO), after noting the broad language of the provision, but recognizing its underlying purpose and speaking on that point for a unanimous court, Justice Iacobucci held that "the 'person' in section 165(3) must mean a person who is entitled to the cheque," such as "the payee or the legitimate endorsee." Id. paras. 74 & 76; see generally paras. 69-85. Justice La Forest ultimately agreed. See id. paras. 107-09. For an earlier authority in the same direction, see Morguard Trust Co. v. Bank of Nova Scotia (1982), 40 O.R.2d 211 (H.C.J.), aff'd (1983), 44 O.R. 2d 384 (C.A.), where Justice Maloney rationalized this rule by stating that

[section 165(3)] refers to the "delivery" of a cheque. Section [39] of the Act states that delivery "in order to be effectual must be made either by or under the authority of the party drawing, accepting or endorsing..." In this case there was no delivery of the cheque within the meaning of this section and therefore there was no delivery of the cheque within the meaning of [section] 165(3).

Id. at 217. For a contrary view on the effect of section 165(3), see Ian F.G. Baxter, A Non-Negotiable Crossing, 7 CAN. BUS. L.J. 141 (1982-83). Note that strictly as a matter of technical statutory interpretation, Justice Maloney's explanation is not convincing because the quoted provision requires the "endorser" to authorize "delivery," not the last "endorsee." Justice Iacobucci's policy-oriented explanation in Boma is thus far more convincing.

22. "Negotiation" is the mode of transfer constituting the transferee "the holder" of the instrument. See Cheques Act § 40(1) (Austl.); BEA § 59(1) (Can.); BEO § 30(a) (Isr.); BEA § 29(1) (S. Afr.); BEA § 31(1) (U.K.).

23. See section 31(3) in the U.K., section 59(3) in Canada (where "endorsement" substitutes "indorsement"), section 30(c) in Israel, and section 29(3) in South Africa. See also Cheques Act § 40(2) (Austl.).
the check, the forger is neither its named payee nor indorsee, and thus is not a "holder." Consequently, the taking from the forger, even by indorsement, is not taking by "negotiation;" hence, while being an indorsee in possession of the check, neither the taker from the forger nor any transferee deriving title from him is a "holder." 

By definition, a "holder in due course" must be a "holder." Because the acquirer of a check payable to order through a forged indorsement is not a holder, no one who takes a check subsequent to a forged indorsement can be a holder in due course in relation to parties whose signatures preceded the forgery. A holder in due course obtains a clear title to the check "free from any defect of title," including all adverse claims, which would have covered the claim of ownership of the person from whom the check has been stolen, and whose signature has been forged. But as indicated, a forged indorsement precludes holding in due course, without which forgery could not have overcome.

24. A holder of a check payable to order is defined as the payee or indorsee in possession of the check. See Cheques Act § 3 (Austl.); BEA § 2 (Can. and U.K.); BEO § 1 (Isr.); BEA § 1 (S. Afr.).

25. Notwithstanding the statutory definition. See id.


27. Consequently, the preclusions of a party from raising forgery against a holder in due course, discussed infra Part II.D., do not benefit a claimant through a forged indorsement.

28. Cheques Act § 49(2) (Austl.); BEA § 73(b) (Can.); BEO § 37(2) (Isr.); BEA § 36(b) (S. Afr.); BEA § 38(2) (U.K.).

29. "Defect of title" is the statutory equivalent of the common law "equity attaching to the bill." Alcock v. Smith, [1892] 1 Ch. 238, 263. Corresponding to the duplex nature of the negotiable instrument as both a chattel and a chose in action, such an "equity" is either as to liability on the instrument or as to its ownership. Equity as to ownership is an adverse claim. See Zechariah Chafee, Jr., Rights in Overdue Paper, 31 HARV. L. REV. 1104, 1109 (1918).
C. The Dispossessed Owner’s Remedies Under the BEA and the UCC

1. The Payee/True Owner’s Remedy

In the common law BEA jurisdictions, the "true owner," namely the one from whom the check has been stolen and whose indorsement has been forged, may sue either in conversion or in money had and received, any person through whose hands the check passed subsequent to the forgery. Each post-forgery indorsee, and possibly, the drawee who paid the bill, fall into this category. In both actions, the defendant need not necessarily be the one in possession of the check at the time of the action. Furthermore, under the BEA, having provided an indemnity against any possible adverse claim, the true owner may sue on the lost check prior parties liable thereon.

30. Ownership of an instrument (other than that of a holder in due course) is established under general principles governing ownership in chattels. See, for example, in South Africa, First National Bank v. Quality Tyres, 1995 (3) SA 556, particularly 567-70 (AD), and in Israel, C.A. 144/62, Kupat Aliya v. Kirstein, 17 P.D. 2282, 2286. Kirstein held that a voidable title to an instrument acquired under a rescindable contract that has not yet been rescinded is nevertheless ownership. At the same time, the South African case should not be taken to suggest that in the common law, the transfer of ownership of a chattel requires the transfer of possession. Anyway, in the facts of that case, and notwithstanding the court's view to the contrary, it is hard to see why there was not a constructive delivery of the instrument.

31. In BEA jurisdictions, both actions in conversion and money had and received are not statutory based. They are thus inapplicable in South Africa and the Province of Quebec in Canada, which are civil law jurisdictions where the BEA applies. For a review of the South African position, see, for example, C. Hugo, The Negligent Collecting Bank: Recent Decision Introduce a New Era, 3 Stellenbosch L.R. 115 (1992). In Quebec, the leading authority for the inapplicability of the conversion action to checks is Norwich Union Fire Insurance Society v. Banque Canadienne Nationale [1934] 4 D.L.R. 233 (SCC). Conversion (with regard to chattels in general) is, however, statutory-based in Israel under section 52 of the Torts Ordinance [New Version], 1968, 10 L.S.I. 266, as amended. In contrast to the conversion and money had and received actions, BEA sections 69-70 in the U.K., sections 155-56 of the BEA in Canada, sections 69-70 of the BEO in Israel, sections 67-68 of the BEA in South Africa,
Similarly, under the UCC, two options are available to the dispossessed owner ex-holder of the check. First, he may call on prior parties liable on the check. Alternatively, he may sue subsequent parties on the basis of their unlawful interference with his possession or property right. The former action is governed by UCC section 3-309. The later is governed by section 3-420.

Under both the BEA and the UCC, I re-examine the role of conversion, side-by-side with the action for money had and received in BEA jurisdictions, in implementing of the Anglo-American basic scheme. In my view, the true owner’s action on the lost instrument provides him with an adequate remedy. Any action against post-forgery parties unnecessarily adds lawsuits. In providing for additional defendants, the availability of such an action improves the true owner’s position compared to that which would exist in the absence of forgery. In any event, there seems to be no difference in the true owner’s burden in proving his entitlement, whether he sues prior parties on the check or subsequent ones in conversion (or money had and received); hence, no extra hardship is involved in limiting his remedy to prior parties. As well, in most cases, the true owner cannot be said to suffer loss due to the disappearance of the benefit of negotiability, because regardless of negotiation, he remains responsible for any defect in his own title.\(^3\)

It thus seems that the true owner’s remedy from a post-forged indorsement party ought to be limited to the physical return of the instrument. There appears to be no justified grounds for any monetary claim. The availability of conversion (or money had and received) under present law can be viewed as an obsolete remnant

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3. True, when the true owner is an indorsee, who is not a holder in due course, and who would have managed to transfer the instrument to a holder in due course, upon the recovery by the latter from the drawer, the true owner is not exposed to any liability. Yet, this is not the typical situation; usually the true owner is the payee. Second, use of such a scenario as a basis for an action in conversion (or money had and received) is tantamount to recognizing a right of a holder not in due course to the full value of the check. Such a right, however, does not exist.
from the archaic rule attributing to an instrument all qualities of a chattel. It would have followed from such a rule that the physical loss of the instrument necessarily entails the forfeiture of its entire economic value in the form of a loss of the right to recover on it. This, however, is not the law, at least anymore, so that the conversion (or money had and received) action of the true owner against a post-forged indorsement party does not appear to be justified and seems unnecessary in the implementation of the Anglo-American scheme.

However, upon further reflection, this is true only with respect to the pre-payment situation, which could arise, for example, in connection with the left of post-dated checks, whose payment is thus delayed. After payment for example, in the case of embezzlement by an employee of the true owner of several checks payable to the true owner by the true owner’s debtors, it may be more efficient for the true owner to bypass the action against the various drawers, whose accounts have been already debited, and sue directly the taker from the forger, usually the forger’s bank acting as a depositary bank, thereby avoiding circuity of action. Indeed, there is no policy ground to support the involvement in the litigation of the drawer of a check stolen from the payee, whose account has been already debited; in this sense, the true owner’s direct remedy against the taker from the forger eliminates wasteful litigation. I am inclined to propose that conversion (and money had and received) be limited to post-payment situations, and be available only against the actual taker from the forger, and not against anyone deriving title from him. On the other hand, a true owner to whom conversion (as well as money had and received) is so available, ought to be required to invoke this remedy first, before becoming able to pursue any remedy against any prior party.

2. The Drawer’s Remedy

Where a complete check payable to order has been stolen from the drawer and paid over a forged indorsement, the drawer may sue the drawee in breach of contract for paying the check contrary to
the drawer's instructions. Such instructions, embodied in the 
drawer/customer's order which constitutes the check, were to pay 
the check to the payee or to someone deriving title from the payee. 
Payment to one claiming through a forged indorsement, that is, to 
someone other than to the one who derives title from the payee is 
wrongful; it does not discharge the drawer from liability on the 
instrument. 33 Being contrary to the drawer's instructions, such 
payment constitutes a breach of the banking contract between the 
drawer/customer and his bank.

In this respect, there is no difference between the UCC and the 
basic scheme of the BEA. To some extent, Article 4 of the UCC 
codified the point in section 4-401(1), by permitting a bank to 
"charge against the account any item which is otherwise properly 
payable from that account . . .," thereby implicitly indicating that 
a bank may not charge to the account an item which is not 
"properly payable." 34 The provision goes on to state that 
"[a]n item is properly payable if it is authorized by the customer and is in 
accordance with any agreement between the customer and bank." 
The official comment to the UCC clarifies that 
"[a]n item containing a forged drawer's signature or forged indorsement is not 
properly payable." Accordingly, a drawee bank which pays a check 
over a forged indorsement is in breach of duty.

The drawer's remedy under the UCC is only against the drawee 
bank. Section 3-420 of the UCC specifically settles a pre-1990 
Article 3 as well as a BEA controversy by denying the drawer a 
conversion action against parties who handled the lost or stolen 
check, such as the depository bank or anyone else deriving title 
through the forged indorsement. 35 Under the BEA, the prevailing

33. UCC section 3-602(a) states that discharge by payment requires payment 
"to a person entitled to enforce the instrument." U.C.C. § 3-602(a) (1999). 
Similarly, the Canadian BEA provides that discharge by payment requires 
payment to the "holder." BEA § 138 (Can.). One claiming through a forged 
indorsement is thus excluded from both definitions.

34. See generally JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM 

view is to the contrary, namely, that the drawer from whom a complete check payable to order was stolen and whose bank paid over a forged indorsement, may sue a post-forgery party, such as the depositary bank, in conversion.\(^\text{36}\)

In denying the drawer's remedy against the depositary bank, and to that end, in explicitly following the pre-1990 Code-leading case of *Stone & Webster Engineering Corp. v. First National Bank & Trust Co.*,\(^\text{37}\) Official Comment 1 to UCC section 3-420 explains that "[t]here is no reason why a drawer should have an action in conversion." As a matter of doctrine, "[t]he check represents an obligation of the drawer rather than property of the drawer." To the same end, as a matter of policy, "[t]he drawer has an adequate remedy against the payor bank for recredit of the drawer's account for unauthorized payment of the check." This double rationale is quite convincing; on this point the departure from the dubious contrary prevailing view in common law BEA jurisdictions, facilitating a conversion action by the drawer, is fully justified. Indeed, being the drawer's bank, the drawee may be in a better position than the depositary bank to defend against the drawer's action by invoking defenses based on the drawer's course of business. Hence, the avoidance of circuity of action by allowing the drawer remedy against the depositary bank is not convincing.

**D. Post-Forgery Parties' Remedies Under the BEA and UCC**

Under the BEA, one who derives title through a forged indorsement is entitled to sue on the check any prior indorser who took the check subsequent to the forgery. The BEA precludes an indorser of a check from denying (i) "the genuineness and regularity . . . of . . . all previous indorsement" as well as (ii) that "at the time

\(^{36}\) For a critical analysis of case law, see Benjamin Geva, *Conversion of Unissued Cheques and the Fictitious or Non-Existing Payee—Boma v. CIBC*, 28 CAN. BUS. L.J. 177, 186-92 (1997) [hereinafter Geva (Boma)].

\(^{37}\) 184 N.E.2d 358 (Mass. 1962). Pre-1990 Article 3 did not specifically exclude the drawer's conversion action.
of his indorsement... he had a good title."\(^{38}\) The former preclusion runs in favor of a "holder in due course." The latter runs in favor of an "immediate and subsequent indorsee." In relation to prior parties who indorsed the check subsequent to the forged indorsement, the possessor of the check is an "immediate or... subsequent indorsee" as well as, depending on his compliance with required statutory conditions of good faith and taking the check for value,\(^{39}\) a "holder in due course." Effectively then, the two enumerated statutory preclusions run in favor of all transferees subsequent to the taker from the forger. On the strength of these preclusions, "the person in possession of a bill bearing a forged indorsement is considered a holder against every party who signed the bill after the forgery of the indorsement."\(^{40}\) Being precluded from asserting the forgery, a post-forgery party is thus liable on the check to a subsequent indorsee as if the endorsee claims through a flawless chain of title to an impeccable instrument bearing only genuine signatures.

No similar provisions exist in the UCC. Nevertheless, a similar result, namely liability of a post-forged indorsement party to any subsequent transferee, is achieved by means of an altogether different technique, the "vendor’s warranty."\(^{41}\) The theory is that a check is a chattel whose vendor warrants title, uninterrupted by any forged indorsement. Unlike under the BEA, a post-forged indorsement transferor is not liable to a subsequent transferee on the check; the transferor is, however, liable to a subsequent transferee on the breach of warranty.\(^{42}\)

\(^{38}\) Cheques Act § 74(1)(b) (Austl.); BEA § 132(b)-(c) (Can.); BEO § 55(b)(2)-(3) (Isr.); BEA § 53(2)(b)-(c) (S. Afr.); BEA § 55(2)(b)-(c) (U.K.).

\(^{39}\) The precise conditions to be complied with are set out in Cheques Act § 50(1) (Austl.); BEA § 55(1) (Can.); BEO § 28(a) (Isr.); BEA § 27(1) (S. Afr.); BEA § 29(1) (U.K.).


\(^{41}\) This technique is available under the BEA for an instrument payable to bearer, on which the transferor is not liable. See, e.g., BEA § 137 (Can.).

\(^{42}\) See Barak, *supra* note 40, at 180-90.
Among other matters, the transferor warrants that "[he] is a person entitled to enforce the [check]." that "all signatures on the [check] are authentic and authorized," and that "the [check] has not been altered." This warranty covers the authenticity and validity of each indorsement and the title to the check. Under UCC section 3-416, this warranty is made by any "person who transfers an instrument for consideration . . . to the transferee and if the transfer is by indorsement, to any subsequent transferee." Under UCC section 4-207, this warranty is made by any "customer or collecting bank who transfers an item and receives a settlement or other consideration . . . to his transferee and to any subsequent collecting bank." Indeed, this is a vendor’s warranty of title, given by each transferor for value not only to the immediate transferee, but also to any subsequent indorsee or collecting bank, up to the last indorsee or collecting bank in the chain, and regardless of whether the claiming beneficiary gave value for the check. With respect to checks, these warranties cannot be disclaimed.

Transfer warranties under the UCC do not benefit the drawee of the check, who is neither a transferee, nor a collecting bank, targeted under sections 3-416 and 4-207. This is quite similar to the position under the BEA, where the statutory preclusions do not

43. The other enumerated warranties relate to the freedom of the warrantor’s entitlement from any adverse claim or defense and to the warrantor’s lack of knowledge of insolvency proceedings against the drawer.

44. Both provisions are substantially identical. While UCC section 3-416 applies to "instruments," section 4-207 applies to "items." A check is both an "instrument" under Article 3 (section 3-104) and an "item" under Article 4 (section 4-104(a)(9)).

45. In theory, a pre-forged indorsement party will give this warranty to the ultimate transferee, except that the former is not in breach and thus not liable to the latter. As under the BEA, a forged indorsement does not trigger any liability by a pre-forgery party to a post-forgery one.

46. This is fair, because a transferee by way of gift (donee) is able to sue on an instrument.

47. See U.C.C. §§ 4-207(d), 3-416(c) (1999). "Transfer warranties may be disclaimed with respect to any instrument except a check." U.C.C. § 3-416 cmt. 5 (1999).

48. See U.C.C. §§ 3-416, 4-207.
run in favor of the drawee. However, in BEA jurisdictions, other than in Canada, the general law of restitution and mistake governs the remedy of the drawee bank which paid to one claiming the check through a forged indorsement. In Canada, the BEA provides recovery.\(^{49}\) At first blush, the UCC combines these two approaches. First, it provides in section 3-418(b) for the recovery of a mistaken payment made over a forged indorsement.\(^{50}\) Second, such recovery is stated in UCC section 3-418(c) to be subject to defenses based on either taking the check in good faith and for value, or making a good faith change of position in reliance of payment. However, irrespective of such defenses, and in departure from the position in all BEA jurisdictions, the drawee or payor bank benefits under the UCC from specific presentment warranties running in its favor and facilitating recovery on a strict liability basis.

Relevant provisions are UCC sections 3-417 and 4-208.\(^{51}\) Thereunder, when a check is presented for payment, the presenter and any prior transferor warrants to the drawee\(^{52}\) that "the warrantor is, or was, at the time the warrantor transferred the [check], a person entitled to enforce the [check] or authorized to obtain payment . . . of the [check] on behalf of a person entitled to enforce the [check]."\(^{53}\) This amounts to a warranty of good title by virtue of lack of any forged indorsement. The mere presentment of the check does not trigger the warranty by itself, but rather, it must be coupled with the drawee's ensuing payment or acceptance.\(^{54}\)

To assert the warranty, the drawee must have paid the check in

\(^{49}\) See BEA § 49 (Can.).

\(^{50}\) See U.C.C. § 3-418(b) (1999).

\(^{51}\) For checks, both provisions overlap. Effectively, remedies under section 3-417 supersede those for mistaken payment under section 3-418(b). See U.C.C. § 3-418(c) (1999).

\(^{52}\) "There is no warranty made to the drawer under subsection (a) when presentment is made to the drawee." U.C.C. § 3-417 cmt. 2 (1999).

\(^{53}\) U.C.C. §§ 3-417(a)(1), 4-208(a)(1) (1999). Other presentation warranties enumerated in subsection (a) pertain to the fact that the check has not been altered and to the lack of knowledge as to the fact that the drawer's signature is unauthorized.

\(^{54}\) See U.C.C. §§ 3-417(a), 4-208(a) (1999).
good faith though not necessarily without negligence. A defendant against whom recovery is made may invoke the transfer warranties all the way down to the taker from the forger on whom the loss ultimately falls.

E. Forged Indorsement Under the UCL

The basic scheme under the UCL is diametrically opposed to that of the BEA and UCC. Under UCL Article 19, "[t]he possessor of an endorsable cheque is deemed to be the lawful holder if he establishes his title to the cheque through an uninterrupted series of endorsements. . . ." Nonetheless, under UCL Article 21, where a person has been dispossessed of a check, notwithstanding the lack of an uninterrupted series of indorsement on the check, "the holder in whose possession the cheque has come is not bound to give up the cheque unless he has acquired it in bad faith or unless in acquiring it he has been guilty of gross negligence." Such holder defeats the title of the previous "lawful holder," who has been dispossessed of the check, and effectively becomes its new lawful holder. As such, he is entitled to enforce payment on the check against all parties who became liable on it, whether before or after the forgery, so that the loss falls on the dispossessed previous lawful holder or dispossessed owner. Consistent with Article 21, UCL Article 35 provides that "[t]he drawee who pays an endorsable check is bound to verify the regularity of the series of endorsements, but not the signature of the endorsers." Stated otherwise, a drawee bank is released vis-à-vis the drawer, when it pays to the holder claiming under what appears to be an uninterrupted series of indorsement, even when in fact it is interrupted. Effectively, then, the combined effect of UCL Articles 21 and 35 is to put a bona fide purchaser of an endorsable check on similar footing with a bona fide purchaser of a check payable to bearer.

55. See id.
56. See id.
Thus, in contrast to both the BEA and the UCC, the UCL provides for the effectiveness of a forged indorsement. Because it passes title, no remedies are available to the dispossessed owner, whether against prior parties on the check or against post-forgery parties on the basis of any possessory or proprietary right that has been forfeited under the UCL.

III. THE EVOLUTION OF EACH BASIC SCHEME TO RESPOND TO A COMPETING POLICY

As the preceding discussion demonstrates, there is a fundamental difference between Anglo-American (common law) and Continental (civil law) jurisdictions in their basic attitude toward the effect of forged indorsements on negotiable instruments, including checks. In the Anglo-American legal systems, the starting point is that, subject to specified exceptions which are not uniform throughout the various jurisdictions, a forged indorsement is wholly inoperative and may not pass title of an instrument, even to a bona fide purchaser. Conversely, in the Continental legal systems, a forged indorsement may pass title of an instrument so that a holder acquiring an instrument in good faith and without gross negligence through an uninterrupted series of indorsements has good title even when the instrument was lost or stolen and one of the indorsements it bears, is forged.

Consequently, unless a recognized exception is involved, a drawee bank in an Anglo-American jurisdiction is not discharged if it pays to someone claiming the check through a forged indorsement, and the drawee bank may not effectively debit the drawer customer account with the amount of a check bearing such a forged indorsement. Conversely, in civil law jurisdictions, the drawee bank is discharged if it pays the check in good faith to a holder who can establish his title through an uninterrupted series of indorsement, even where one is forged; the drawee bank may

57. See supra Part II.A.–B.
58. See supra Part II.E.
then lawfully debit the account of the drawer customer for the amount of the check.

The Anglo-American basic rule favors the purported indorser whose signature has been forged, or more generally, the true owner of the instrument from whom it was stolen at the expense of the bona fide purcahser of the instrument bearing the forged indorsement. This rule promotes a policy of property protection—a thief may neither forfeit nor pass title, or more generally, no one can pass property to something, including a negotiable instrument, not owned by that person. The "true owner" who lost the instrument or from whom it was stolen, retains his ownership in the instrument to the exclusion of anyone else, including a bona fide purchaser, and remains the only one entitled to both sue and give discharge on it. Among innocent parties, loss ultimately falls on the taker from the forger.

At the same time, the Continental rule favors the bona fide purchaser of the instrument bearing a forged indorsement, at the expense of the purported indorser or true owner, on whom the loss ultimately falls. This promotes negotiability or currency, namely, the smooth transferability of instruments from hand-to-hand, free from adverse claims of ownership, as if negotiable instruments are money. With respect to stolen instruments, Anglo-American law effectively preserves this policy, only as to instruments payable to bearer whose transferability does not require an indorsement.

In providing discharge to a drawee who in good faith paid an indorsee claiming under a forged indorsement, Continental systems promote finality of payment. To some extent, these systems encourage creditors, as potential indorsees, to accept indorsed bills in payment of debts due to them. True, for a creditor holder of a check, the loss of the instrument may be tantamount to the loss of actual money. Yet, once a bill bearing a forged indorsement has been paid, neither the drawee nor the bona fide indorsee is exposed to any action. Conversely, in denying discharge from a drawee who paid over a forged indorsement, Anglo-American law does not shield the indorsee from the drawee's subsequent restitutionary claim, thereby undermining finality, and leading to multiplicity of
remedies: the drawee must re-credit the drawer’s account and sue the recipient, who has recourse from each prior indorser subsequent to the forgery. Yet, the Anglo-American scheme encourages debtors to draw and issue bills in payment of debts because the debtor is protected in case of theft of the bill on its way from the drawer to the payee. Finally, arguably, the taker from the forger is typically a more appropriate loss bearer than the innocent owner from whom the bill has been stolen, as the taker from the forger needs to be vigilant in scrutinizing the identity of his own indorser. Consequently, in imposing the risk of loss on the taker from the forger, compared to its Continental counterpart, Anglo-American law is more consistent with the policy of risk reduction. In addition, insofar as the taker from the forger is not infrequently a bank, the Anglo-American system implements risk distribution policy; a bank can pass on to customers and distribute among them in the form of charges, the cost of both risk reduction measures and insurance against remaining losses.

These fundamental distinctions between the two major systems have evolved over the years. The original position in both Continental Europe and England was uniformly along the lines of the basic present Anglo-American approach. Thereunder, forged indorsement passed no title; thus, the law protected the true owner’s property at the expense of the bona fide indorsee so that the currency of instruments payable to order was not promoted. In the course of the eighteenth century, this position was reinforced in England and commenced to disintegrate in Continental Europe.

The leading English case, decided in 1790, is that of Mead v. Young. It concerned a bona fide indorsee of a bill who acquired it


60. For an excellent discussion, on which the ensuing analysis draws, see Friedrich Kessler,Forged Indorsement, 47 YALE L.J. 863, 863-71 (1938).

through a forged indorsement. The court dismissed his action against the drawee/acceptor of the bill. According to Kessler, "[t]he most interesting aspect of the case is that the judges did not confine themselves to the conventional legal arguments, but talked for the first time in practical terms and weighed the interests of an indorsee against those of the other parties." Speaking for the majority, Justice Buller rationalized the protection of the true owner's property on the basis of promoting loss prevention or at least minimization, finding that

if the [bona fide indorsee] cannot recover on this bill, he will be induced to prosecute the forger; and that would be the case even if it had been passed through several hands, because each indorser would trace it up to the person from whom he received it, and at last it would come to him who had been guilty of the forgery: whereas if [the bona fide indorsee] succeed in this action, he will have no inducement to prosecute for the forgery; the drawer, on whom the loss would in that case fall, might have no means of discovering the person who committed the forgery, and thus he would probably escape punishment.

The Chief Justice, Lord Kenyon, did not agree. In his dissent, he could not "distinguish this case . . . from that of Miller v. Race, where the innocent holder of a note [payable to bearer], which had been taken when the mail was robbed, was held entitled to recover." In his view, "if the [bona fide indorsee] cannot recover, it will put an insuperable clog on this species of property. . . . it would throw too great a burden on persons taking bills of exchange to require proof of an indorsee that the person from whom he

63. See id. at 878.
64. Kessler, supra note 60, at 867.
received the bill was the real payee."68

Effectively concurring with Justice Buller, Justice Ashhurst thus pronounced the ultimate rule, finding "no title can be derived through the medium of fraud or forgery" so that "[i]n order to derive a legal title to a bill of exchange, it is necessary to prove the handwriting of the payee."69 The underlying prevailing policy is thus that by inquiring into the indorser's title, the indorsee will be able to eliminate or reduce fraud and resulting losses.

In the same period that the old doctrine was rationalized and solidified in England, doubts and challenges steadily gained a foothold in Continental Europe, ultimately leading to the doctrine's reversal. First, a more limited line of attack emerged in France in the middle of the eighteenth century.70 This attack did not challenge the ineffectiveness of the forged indorsement to pass title; rather, it sought to protect the drawee who paid in good faith to one claiming over a forged indorsement.71 It was pointed out that a rule requiring the drawee to satisfy himself with the validity of each indorsement puts a heavy burden on a conscientious drawee and enables a recalcitrant one to gain time.72 "It was felt that this result would completely paralyze the use of bills of exchange, the utility of which depended upon their prompt liquidation at maturity."73 Thus, France passed a specific law in 1787, three years before Mead, which provided a discharge to a drawee who paid in good faith to an indorsee claiming under a forged indorsement.74 This rule remained effective in France until it adopted the Geneva Uniform Laws75 in the 1930s, which enlarged it further to protect the bona fide indorsee.76
A second challenge to the traditional doctrine as to the ineffectiveness of forged indorsement has developed in Germany. As of the beginning of the eighteenth century, this challenge was broader in its scope and proved to be more formidable. It was argued that a transferee of a bill of exchange "could only be expected to examine the external regularity of the chain of indorsement," and not to go beyond investigating the title of his own transferor. To enhance their role as instruments of commerce, bills of exchange ought thus to circulate like money. This currency theory is in fact no different from the dissenting view of Lord Kenyon in *Mead*, except that in Germany, it fared better and became law by the middle of the nineteenth century. According to Kessler,

[under the new theory the title of a bona fide indorsee is not in the least derivative, that is, dependent upon the previous indorser's title, but is completely independent. If the indorsee is bona fide, i.e., not grossly negligent, he always acquired title even if his predecessor had none, provided there is an indorsement to him plus delivery. With the title he acquires the rights incorporated in the instrument against all prior parties whose promises are binding, irrespective of whether there are nonbinding promises in between, because the individual promises are independent of each other.]

This currency theory took over and became part of the Geneva Uniform Law regime. It was thus adopted in Continental Europe, including France, and spread worldwide, other than in the United

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77. See id. at 870.
78. Id.
79. See id.
80. See id.
81. Id.
82. See id.
States and BEA jurisdictions.\textsuperscript{83}

The UN Convention on International Bills and Notes, which the United Nations Commission on International Trade Law (UNCITRAL) prepared and the United Nations General Assembly adopted, advanced an interesting compromise position that purported to bridge the gap between the basic Anglo-American and Continental approaches.\textsuperscript{84} Strictly speaking, the Convention does not apply to checks; its scope, is rather, confined to international promissory notes and bills of exchange other than checks.\textsuperscript{85} Nevertheless, in so far as it purported to accommodate policies underlying the laws of both major systems, the particular forged indorsement rule is of interest to us.\textsuperscript{86} The Convention adopted the Geneva Uniform Law rule but added a cause of action in favor of the "true owner" as against the taker from the forger.\textsuperscript{87} By protecting the bona fide purchaser, the Convention follows the Continental rule, thereby enhancing the free circulation and finality policies.\textsuperscript{88} At the same time, the true owner's cause of action against the taker from the forger secures the policy of loss reduction that Justice Buller pronounced in \textit{Mead}, and adopted in Anglo-American law. The scheme undermines finality only in so far as it allows the true owner to recover from the forger. It encourages creditors to accept bills in payment of debts due to them as well as encouraging drawees to pay such bills because both good faith indorsees and

\textsuperscript{83.} See \textit{id.} at 871.


\textsuperscript{85.} See \textit{id.} at 4.

\textsuperscript{86.} For the position under the Convention, in comparison with both Anglo-American and Continental laws, see, for example, Carl Felsenfeld, \textit{Forged Indorsements under the United Nations Negotiable Instruments Convention: A Compromise Between Common and Civil Law}, 45 BUS. LAW. 397 (1989); William C. Vis, \textit{Forged Indorsement}, 27 AM. J. COMP. L. 547 (1979); see also DENIS V. COWEN & L. GERING, COWEN THE LAW OF NEGOTIABLE INSTRUMENTS IN SOUTH AFRICA 126-27 (5th ed. 1985).

\textsuperscript{87.} See Vis, \textit{supra} note 86, at 560.

\textsuperscript{88.} See \textit{id.}
drawees are protected. Compared to the Continental system, some protection is also accorded to a debtor/drawer who, when the instrument was stolen in transit to the payee, may sue the taker from the thief.\textsuperscript{89}

In the final analysis, compared to its Continental counterpart, and even to the UNCITRAL compromise, it is the Anglo-American system which implements the more desired policies. This is so because, in practice, checks seldom circulate or are negotiated other than to a depositary bank.\textsuperscript{90} Hence, the protection of free circulation and finality of payment to an indorsee neither outweighs nor ought to be reconciled with the policies of risk prevention or reduction and loss distribution, which underlie the basic scheme of the Anglo-American system. Ironically, however, in a post-payment situation, my proposal to require the true owner to sue first the taker from the forger, prior to pursuing his recourse from any pre-forgery party liable on the instrument, and to eliminate any other remedy in conversion or money had and received, though motivated by the avoidance of circuity of action,\textsuperscript{91} appears to produce a substantially similar result as that under the UNCITRAL proposal.

\section*{IV. Exceptions to the Basic Scheme and the Implementation of the Underlying Policy}

The implementation of the free circulation policy has never

\textsuperscript{89} Evidently, the origin of the scheme, and the basis of the discussion here, is BARAK (NATURE), \textit{supra} note 59, at 154-55, and Barak (Forgery), \textit{supra} note 59, at 461-65. Aharon Barak co-authored the Draft of the UNCITRAL Convention and advised the Commission in the ensuing drafting process.

\textsuperscript{90} A payee who does not deposit the check to a bank account typically obtains payment through a check cashing facility not operated by a bank. But even this is not a case of indorsing a check in payment of a debt the payee owes to the indorsee. For a view defending each of the UCC and the Continental systems, in its own context, see Eric Wallenbrock, \textit{Forged Indorsements under French Negotiable Instruments Law and the U.S. Uniform Commercial Code: A Comparative Study}, 28 UCC L.J. 393 (1996).

\textsuperscript{91} For this proposal see \textit{supra} Part II.C.1.
been taken to require the protection of one acting without good faith. In further requiring a purchaser to act without gross negligence, the UCL should not be taken to add a considerable imposition so as to undermine its free circulation policy. Neither good faith nor absence of gross negligence constitutes a real exception in the implementation of the free circulation policy underlying the UCL.

As indicated, the policies underlying the Anglo-American scheme are those of loss prevention or reduction and loss distribution. The allocation of losses to the one who deals with the forger implements loss prevention or reduction. Loss distribution is achieved due to the fact that, typically, the one who dealt with the forger is a bank.

The ensuing discussion will consider the role that exceptions to the Anglo-American basic scheme play in relation to their underlying policies. It will be observed that while the exceptions under the UCC reinforce the underlying policies, the exceptions under the BEA actually undermine these policies. It is perhaps in this context that it can be properly said, but only in connection with the BEA and not the UCC, that the allocation of forgery losses is determined according to "a set of mechanical doctrines" making it inadequately responsive to consistent and coherent policy considerations.

A. Exceptions Under the BEA

No general duty to prevent or detect forgeries exists in BEA jurisdictions. The absence of such an exception based on negligence, and the resulting automatic loss allocation to the one who dealt with the forger even when in the facts of the case it is the fault of another that caused or could have prevented the loss, is by itself a setback to the loss prevention or reduction policy. Other setbacks exist in the form of statutory exceptions or the way they have been

conventionally understood to operate.

1. Checks Payable to Fictitious or Non-Existing Payees

Legislation in most BEA jurisdictions contains a provision stating that where the payee is a "fictitious or non-existing person, the [instrument] may be treated as payable to the bearer." Hereinafter, this provision shall be known as "the fictitious payee provision." In the allocation of forgery losses, the fictitious payee provision operates to disregard the forgery of the payee's indorsement on the basis that such indorsement was not required in the first place. Where the provision applies, its effect is twofold. First, a bona fide taker for value of the instrument, including a collecting bank that dealt with the thief, acquires good title. Second, payment in good faith, even to the thief, is payment in due course and thus discharges the drawee bank so as to entitle it to credit the drawer’s account. As in the case of theft of an instrument payable to bearer, and unlike in the usual situation of a theft of an instrument payable to order, loss thus falls on the person from whom the instrument was stolen. The provision is of particular importance in Canada, where in effect, no specific broad protections against forged indorsement are given to banks collecting and paying checks.

In Bank of England v. Vagliano Bros., shortly after England...
enacted the BEA, the House of Lords understood the fictitious payee provision to mean that "whenever the name inserted as that of the payee is so inserted by way of pretence merely, without any intention that payment shall only be made in conformity therewith, the payee is a fictitious person within the meaning of the statute." The objective of the provision has thus become the protection of banks from fraud exercised on the drawer by a third party, particularly, internal fraud within the drawer organization. Indeed, the general rule under the BEA is that a forged signature is not operative, so that the drawer does not usually bear the risk forged indorsement incurs. Conversely, where the fictitious payee provision applies, namely when an insider in the drawer organization defrauds the drawer by generating instruments intended to be misappropriated, the loss falls on the drawer who is in a better position to minimize losses and obtain insurance. It is with the view of implementing this rationale that the fictitious payee provision ought to have been construed.

However, the technical rules generated in the course of the judicial interpretation of the fictitious payee provision do not always meet this challenge successfully. In interpreting the provision, courts have focused on the meaning of "fictitious" and "non-existing." In this context, particular attention was given to the relevance of intention for the application of the provision. Particularly, courts have been seeking to define "non-existing," as well as to ascertain whose intention determines whether the payee is a "fictitious or non-existing person." In thus focusing their attention on the language of the provision, and thereby overlooking

97. Id. at 153 (Lord Herschell). According to Chalmers, "[d]uring the controversy [as to the meaning of the provision] the draftsman of the [fictitious payee provision] must have felt much like the professor of Divinity who was asked by a student to explain some passage he had written in a theological tractate. 'My dear friend,' said the professor, 'when I wrote that passage, only God and I knew what I meant, and now only God knows.'" MacKenzie D. Chalmers, Vaglione's Case, 7 L.Q. REV. 216, 218 (1891). Yet, Chalmers continued, "I venture to think that Lord Herschell's judgment ... puts the matter on a sound and intelligible basis." Id.
the basic policy behind it, courts have failed to see the forest for the trees.

According to a classic statement of Falconbridge, "[w]hether a named payee is non-existing is a simple question of fact, not depending on anyone's intention. The question whether the payee is fictitious depends upon the intention of the creator of the instrument, that is, the drawer of a bill or cheque or the maker of a note."\(^98\) In connection with this statement, a payee who is either a creature of imagination or a dead person is "non-existing."\(^99\) A payee who is a real person, namely, one who is neither imaginary nor dead, is "existing." When the drawer inserts the latter's name by way of pretense, with no intention that he will receive payment, such a person, though "existing," is nonetheless "fictitious"\(^100\) so as still to fall within the ambit of the provision. However, a payee who is a real, that is, an "existing" person, who was not intended by the drawer to receive payment, but who becomes payee because of a third person's fraud of falsely representing to the drawer that the drawer is indebted to such payee, is neither "fictitious" nor "non-existing." Thus, this type of payee falls outside the provision. The intention of the drawer determines whether the payee is "fictitious," but not whether he is "non-existing."\(^101\) In the quoted language from Falconbridge, while fictitiousness "depends upon the intention of the . . . drawer," existence or nonexistence "is a simple


\(^99\) Obviously, this interpretation is broader than "a person not having capacity to contract," as the South African fictitious provision states. BEA § 5(3) (S. Afr.). Hence, the impetus for an amendment. In any event, a check payable to the estate of a deceased person ought not to fall under the fictitious payee provision. See Denis V. Cowen & Leonard Gering, Cowen on the Law of Negotiable Instruments in South Africa 70 (4th ed. 1966).

\(^100\) For the exclusive relevance of the drawer's intention, see Vinden v. Hughes, [1905] 1 K.B. 795.

\(^101\) For the objective nature of "nonexistence," the leading authority is Clutton v. Attenborough & Son, 1897 App. Cas. 90 (appeal taken from Eng.).
question of fact, not depending on anyone's intention." The two categories are thus mutually exclusive. First, the "nonexistence" of the payee is determined objectively. Next, and upon failing to find the payee to be "non-existing," the "fictitiousness" of the "existing" payee is settled subjectively, from the point of view of, and as intended by, the drawer. Otherwise, the provision does not apply.

In some situations, this interpretation leads to results which are consistent with the underlying policies of the provision. Thus, the fictitious payee provision applies when a signing officer defrauds her corporate employer and draws a check payable to a real creditor of the company intending to misappropriate the check and its proceeds. The result will not change when the payee's name was the product of the signing officer's imagination. The result is however less straightforward when the fraud perpetrator was an employee of the drawer company who did not sign the check, as for example in "payroll padding."

A leading case in Canada is Royal Bank of Canada v. Concrete Column Clamps (1961) Ltd. In their judgments, members of the supreme court dealt with the situation of a fraudulent insider who was not the signer, but rather the one who either supplied the payees' names to, or prepared the checks for signature by, the authorized signing officer. The majority held that in such

102. See supra text accompanying note 98.
103. This is true only because the provision expressly specifies these two categories. In South Africa, where the "non-existing" category is not provided for, and notwithstanding a South African authority to the contrary, see Nedbank v. Window Press, 1987 (3) SA 761 (SE). I am attracted by Cowen and Gering's argument, see supra note 99, at 71, according to which there is nothing to preclude "fictitious" from being broad enough to include "non-existing." Undoubtedly, apart from language, there is no policy ground to support the exclusion of the check payable to a "non-existing" person from the coverage of the South African provision.
106. See id. at 43:
circumstances, the fictitious payee provision did not apply to checks made out to "existing" past employees. The ensuing loss thus did not fall on the drawer. While the fraudulent clerk was truly not "the creator of the instrument" within Falconbridge's summary, inasmuch as the fraud was internal to the drawer organization, this interpretation is a clear victory of form over substance which fails to bring the interpretation of the provision in line with its rationale. This becomes particularly obvious in light of the fact that in the facts of the case, checks payable to "non-existing" persons, whose names the fraudulent clerk equally supplied to the signer, were held to fall within the ambit of the provision because "existence" is an objective fact determined irrespective of anyone's intention.

It is clear, then, that the current interpretation of the fictitious payee provision, as correctly reflected in Falconbridge's summary, is less than a perfect tool to allocate internal fraud losses on the drawer. Efforts ought to be made for judicial improvement, if not

107. See id. at 44.
108. See supra text accompanying note 98.
109. See supra text accompanying note 98. In the facts of the case, the distinction between "non-existing" and "fictitious" became even somewhat surrealistic as some of the "non-existing" persons were names taken from the telephone book. See supra text accompanying note 98. It is hard to see why such names are of "non-existing" persons while names of past employees were of "existing" persons who failed to be "fictitious" only due to the absence of fraudulent intent by the signer. Unless, of course, "existence" requires some actual dealings with the defrauded company so that names randomly picked from the telephone book, and belonging to persons with no past or present contact with the company, cannot be of "existing" persons.

110. In this context, note Chief Justice Laskin's dissent in Concrete Column Clamps, concluding that the named former employees were "fictitious," since due to the purely mechanical role of the authorized signer, it is the intention of the dishonest clerk, and not the authorized signer, that the court should attribute to the drawer company. See Concrete Column Clamps (1976), 74 D.L.R.3d at 38-43. Supporting the result, Justice Spence added in his dissent that in the facts of the case, the bank was not "guilty of any negligence whatsoever," while for the drawer, "it would have been quite easy in proper office management to have designed sufficient methods of checking and verifying to have defeated [the
for a legislative amendment. Regrettably, at present, courts focus their attention on the language of the fictitious payee provision rather than on the provision's underlying policies.

A further unjustified departure from both policy and jurisprudence took place in Boma Manufacturing v. Canadian Imperial Bank of Commerce. In Boma, a bookkeeper/payroll clerk with signing authority for two associated companies, fraudulently prepared checks, ostensibly on behalf of her corporate employers, intending to misappropriate their proceeds. The clerk made some checks payable to existing employees and other checks payable to an imaginary person. She signed some checks herself, but procured on other checks the signature of an innocent, unsuspecting shareholder/officer who also had signing authority. The clerk collected all such checks for her own use.

It seems, that inasmuch as internal fraud caused the loss, the companies should have borne it entirely. Speaking for the majority of the Supreme Court of Canada, Justice Iacobucci nevertheless thought that the fictitious payee provision did not apply to any of the checks, and he shifted away the entire loss from the companies. In his view, for the provision to apply, a fraudulent intent by a guiding mind, and not a mere employee of the company is required. Stated otherwise, in reference to Falconbridge's summary, it is only a guiding mind of the company, and not any authorized signer, that could truly be described as "the creator of dishonest clerk's] scheme." See also Peter E. Salvatori, Vagliano's Case Revisited, 3 CAN. BUS. L.J. 296 (1978-79); Michael Yong Haron, Revisiting Section 7(3) of the Bills of Exchange Act 1882: An Economic Analysis, 29 CAMBRIAN L. REV. 53 (1998) (both effectively arguing for the application of the provision in connection with "fictitious" transactions, that is where the corporate customer has not intended any valid business transaction).

111. Such a legislative amendment could be similar to pre-1990 UCC section 3-405, as set forth in Chief Justice Laskin's judgment in Concrete Column Clamps. See Concrete Column Clamps (1976), 74 D.L.R.3d at 39. The current UCC provision is UCC section 3-404.


113. See id. at 467-68.

114. See id. at 479-81.
the instrument."

In the final analysis, by allocating forgery losses to the organization from which they emanated, the fictitious payee provision is designed to promote loss prevention or reduction. It is, however, its interpretation side-by-side with the absence of any complementary provision allocating losses to a negligent party, that has effectively undermined, or at least failed to fully implement, loss prevention or reduction policies.

2. Specific Protections to Drawee and Collecting Banks

A limited application of the French rule protecting the drawee who paid in good faith over a forged indorsement, applicable to checks only, crossed the English Channel and was incorporated into the English Stamp Act of 1853.\textsuperscript{115} This application has remained a feature of English law to this very day as the most prominent exception to the dogma under which the forged indorsement does not pass title. While spreading to other BEA jurisdictions, at least in the Anglo-American context, this rule has never crossed the Atlantic, and has not found its way to North America. It is not law in both the United States and Canada. The latter may in fact be the only BEA jurisdiction not to have any variation of such a rule.

Accordingly, in connection with a check paid over a forged indorsement, so far as the protection of the drawee is concerned, the Anglo-American system may be divided into the English and American variants or subsystems, with Canada being the only BEA jurisdiction to adhere to the American subsystem. Between the two subsystems, it is the American subsystem that faithfully follows the Anglo-American orthodox approach by not providing for any protection to a drawee who paid over a forged indorsement.

Like the American or the Anglo-American orthodox approach, the English variant initially allocates the loss to the taker from the

\textsuperscript{115} 1853, 16 & 17 Vict. 59, § 19 (Eng.). See also JAMES M. HOLDEN, \textit{History of Negotiable Instruments in English Law} 222-29 (Wm. Gaunt & Sons 1993) (1955).
forger. Notwithstanding the discharge of the check by the drawee’s payment over the forged indorsement, the taker from the forger remains liable to the true owner.\textsuperscript{116} However, in departure from the American variant, the English model does not shield the drawer from the paying drawee’s action or from debiting the drawer’s account. Consistently, and thus unlike the American variant, the English model provides for the discharge of the check by the drawee’s payment, so as to release the drawer from his engagement on both the check and the contract for which it was given. As under the Continental scheme, following the payment of the check, the drawer under the English variant is not exposed to an action by a subsequent party.

Arguably, where the check was stolen from the drawer, the drawer may, under the English variant, pursue his recourse from the taker from the forger.\textsuperscript{117} Regardless, when the taker from the forger was the drawee bank, loss may fall under the English variant, as in the Continental scheme, on the person from whom the check was stolen. Because the check was discharged by the drawee’s payment to the thief, the theft victim has no cause of action on the check. Where the theft victim is the drawer, the loss thus falls on him.

Compared to the current Continental scheme, the English variant provides only limited encouragement to creditors to accept indorsed checks in payment of debts due to them. Under the English variant, as under the Anglo-American orthodox position, an indorsee through a forged indorsement is not protected from the true owner’s action. Nor does the indorsee through a forged indorsement have a cause of action against parties who signed the bill prior to the forgery. Indeed, unlike the American variant, the English subsystem bypasses the drawer’s action to have his account re-credited, as well as the drawee’s ensuing restitution claim against

\textsuperscript{116} Obviously, the true owner may recover from the person who the drawee bank paid, and in fact, from any prior indorsee, from the taker to the forger, against whom each has recourse.

\textsuperscript{117} Presumably, this would be the bank’s action for payment made under a mistake of fact for which the drawer is subrogated.
the recipient. However, compared to the Continental scheme, the English variant does not eliminate the true owner's action. The principal benefit accorded by the English variant is the encouragement given to the drawee to pay, because as under the present Continental scheme, having paid a check bearing a forged indorsement, the drawee is shielded from both the drawer's and true owner's actions.¹¹⁸

In the United Kingdom, the principal provision currently giving special protection to a bank drawee of a demand draft is BEA section 60 providing that,

when a bill payable to order on demand is drawn on a banker, and the banker on whom it is drawn pays the bill in good faith and in the ordinary course of business, it is not incumbent on the banker to show that the indorsement of the payee or any subsequent indorsement was made by or under the authority of the person whose indorsement it purports to be, and the banker is deemed to have paid the bill in due course, although such indorsement has been forged or made without authority.¹¹⁹

This provision has a parallel in BEA jurisdictions other than Canada.¹²⁰ In the United Kingdom, it succeeded, and so far as

¹¹⁸. See Barak (Nature), supra note 59, at 154.
¹¹⁹. BEA § 60 (U.K).
¹²⁰. In Australia, BEA section 65(1) corresponds to BEA section 60 in the U.K. For checks, however, Cheques Act section 94(1) supersedes BEA section 65(1). Section 94(1) substitutes "without negligence" for "in the ordinary course of business." In South Africa, it is BEA section 58 which corresponds to BEA section 60. However, the South African provision adds a qualification—no protection is given to a drawee bank that paid over a forged indorsement that purports to be that of a customer at the branch on which the bill of exchange is drawn. That is, a banker is conclusively presumed to know the signature of his customer, not only as a drawer of a check drawn on an account held with the banker, but also as an indorser on someone else's check. It is currently proposed to delete this proviso. Finally, in Israel, BEO section 23(c), which corresponds to English BEA section 60, is not limited to a bill payable to order on demand.
checks are concerned, superseded\(^{121}\) section 19 of the Stamp Act of 1853.\(^{122}\) Effectively, BEA section 60 turns the drawee bank’s payment of a check over a forged indorsement, "in good faith and in the ordinary course of business," into "payment in due course." Such payment releases the drawer from his engagement on the check and the debt paid by it.\(^{123}\) Accordingly, it authorizes the drawee to debit the drawer’s account, irrespective of the fact that payment was not made to the holder, but rather, contrary to the drawer’s instructions, to someone claiming under a forged indorsement. As discussed, this provision does not affect the true owner’s remedy against any party subsequent to the forged indorsement, and hence, the ultimate loss allocation to the taker from the forger when such a person exists.\(^{124}\) Its effect is merely to

drawn on a banker. Rather, it applies to any type of bill exchange, whether or not drawn on a bank, and whether payable on demand or at a fixed or determinable future time.


122. See English Stamp Act, 1853, 16 & 17 Vict., ch. 59, § 19 (Eng.). Thereunder,

any [d]raft or [o]rder drawn upon a [b]anker for a [s]um of [m]oney payable to [o]rder on [d]emand which shall, when presented for [p]ayment, purport to be endorsed by the [p]erson to whom the same shall be drawn payable, shall be a sufficient [a]uthority to such [b]anker to pay the [a]mount of such [d]raft... to the [b]earer thereof; and it shall not be incumbent on such [b]anker to prove that such [e]ndorsement, or any subsequent [e]ndorsement, was made by or under the [d]irection or [a]uthority of the [p]erson to whom the said [d]raft or [o]rder was or is made payable either by the [d]rawer or any [e]ndorser thereof.

Id. Unlike that of its successor, BEA section 60, the quoted language does not appear to require the bank claiming the protection to have acted in good faith and in the ordinary course of business.

123. See Charles v. Blackwell, 2 C.P.D. 151 (1877). See also Kessler, supra note 60, at 879.

124. See Arnold v. Cheque Bank, 1 C.P.D. 578 (1876); Ogden v. Benas, 9 C.P. 513 (1874); see also BARAK (NATURE), supra note 59, at 120. Consider the following example: a check payable to order is stolen from the payee and ultimately paid to thief’s indorsee. As the true owner of the check, the payee may recover from thief’s indorsee, regardless of whether section 60 exits.
insulate the drawee bank from any involvement in the dispute concerning the forged indorsement. At the same time, in the absence of an innocent indorsee from the forger, the provision may shift losses away from the drawee bank, as the person who dealt with the forger, to the dispossessed owner. Due to the discharge of the check under the provision, the dispossessed owner is left with no cause of action.

BEA section 60 does not specifically require the drawee bank to act without negligence. It is, however, disputed whether the bank's "ordinary course of business" does not require it anyway to act without negligence.²¹²

For crossed checks requiring payment solely to a bank account,¹²⁶ banks in BEA jurisdictions enjoy additional protection. In the United Kingdom, BEA section 80¹²⁷ states that,

Alternatively, in the absence of section 60, the payee may sue the drawer, who will then be able to resist the debit to his account, in which case, the drawee will recover from the thief's indorsee. Either way, the loss falls on the thief's indorsee.

125. See E.P. ELLINGER & EVA LOMNICKA, MODERN BANKING LAW 378-79 (2d ed. 1995); HOLDEN, supra note 115, at 227-29. Both disapprove of Justice Slesser's dicta in Carpenters Co., [1938] 1 K.B. at 534, under which "[n]egligence does not necessarily preclude the protection of [section] 60." But see M. Gottesman, FORGED INDORSEMENTS AND BANKERS' LIABILITY, 7 IS. L. REV. 65, 92-96 (1972), in whose view, ordinary course of business and lack of negligence are "[c]learly... two concepts which can each be given independent content." For the "ordinary course of business" requirement, see MARK HAPGOOD, PAGET'S LAW OF BANKING 383-84 (11th ed. 1996).

126. A crossed check is a check bearing across its face two parallel traverse lines, with or without between them the word "bank," either with or without the words "non-negotiable." It must be paid solely into a bank account. The UCC does not provide for check crossing, and it is not practiced in Canada. Elsewhere, namely in UCL, as well as in BEA jurisdictions other than Canada, cheque crossing is a quite common practice.

127. To whom correspond BEO section 80 in Israel and BEA section 79 in South Africa. In Australia, Cheques Act section 92 is to substantially the same effect. In Canada, English BEA section 80 is reproduced almost verbatim as BEA section 173. This may be one reason why check crossing is uncommon in Canada, where in the absence of a counterpart to English BEA section 60, crossing will give the drawee bank protection to which it is not entitled.
[w]here the banker, on whom a crossed cheque . . . is drawn, in good faith and without negligence pays it, if crossed generally, to a banker, and if crossed specially, to the banker to whom it is crossed, or his agent for collection being a banker, the banker paying the cheque, and if the cheque has come into the hands of the payee, the drawer, shall respectively be entitled to the same rights and be placed in the same position as if payment of the cheque had been made to the true owner thereof.129

The provision substitutes "without negligence" for "in the ordinary course of business." As indicated, the latter may include the former, so that for crossed checks, the defenses may overlap. There is, however, an Australian authority130 suggesting that there may be circumstances where a bank acts without negligence outside the ordinary course of its business.131 For crossed checks, the defense of BEA section 80 may thus be broader than that of BEA section 60.132

In any event, payment against an absent or irregular indorsement is arguably both outside the ordinary course of business as well as negligent, so as to provide no protection to the drawee bank under either section 60 or section 80. In the United Kingdom, section 1(1) of the 1957 Cheques Act133 added otherwise.

128. For the view that in connection with crossing "the expression ["true owner"] bears a specialized meaning derived from the context of the legislative enactment in which it occurs and its historical origin," see First National Bank v. Quality Tyres, 1995 (3) SA 556, 567-69 (AD). Nonetheless, in my view, the better position is the one stated in C.A. 144/62, Kupat Aliya v. Kirstein, 17 P.D. 2282, under which also in this context the term "true owner" ought to be defined by reference to general property law.

129. BEA § 80 (Eng).


131. See id.

132. Note however, that while the drawer is explicitly protected only under BEA section 80, it is effectively equally protected under BEA section 60.

133. 5 & 6 Eliz. 2, ch. 36 (1957) (Eng.) This statutory section corresponds to Cheques Act section 94(2) in Australia and BEA section 83 in South Africa. No
complementary protection, covering cases of irregularity in, or absence of indorsement, providing that,

[w]here a banker in good faith and in the ordinary course of business pays a cheque drawn on him which is not indorsed or is irregularly indorsed, he does not, in doing so, incur any liability by reason only of the absence of, or irregularity in, indorsement, and he is deemed to have paid it in due course.134

"Irregularity" is not defined, and is broad enough to cover a forged indorsement. On the other hand, it was questioned whether protection is not limited only to situations where indorsement is not asked for, as the Act permits in connection with the deposit of checks, but nevertheless appears.135

In addition to the protection given to the drawee bank, BEA jurisdictions provide protections to collecting banks handling checks bearing forged indorsements and acting in good faith and without negligence.136 In the United Kingdom, the current provision is section 4 of the Cheque Act of 1957137 which provides, in its pertinent part, as follows:

(1) Where a banker, in good faith and without negligence
   (a) receives payment for a customer of [a check]; or (b) having credited a customer’s account with the amount of [a check], receives payment thereof for himself; and the

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135. For both points, see F.R. RYDER & A. BUENO, BYLES ON BILLS OF EXCHANGE 301-03 (26th ed. 1988).
136. In Israel, under BEO section 82, and in Canada, under BEA section 175, this protection is limited to crossed checks. Note that in Canada, the practice of check crossing does not exist.
customer has no title, or defective title, to the [check], the banker does not incur any liability to the true owner of the [check] by reason only of receiving payment thereof.

\[\ldots\]

(3) A banker is not to be treated . . . as having been negligent by reason only of his failure to concern himself with absence of, or irregularity in, indorsement of [a check].\textsuperscript{138}

Protections given to paying and collecting banks undermine the policies of loss prevention or reduction and loss distribution in several ways:

1) As indicated, it is not settled whether in order to benefit from the statutory protection, a drawee bank in the UK need have acted without negligence. Protection afforded to a negligent bank undoubtedly undermines the policy of loss prevention or reduction.

2) Fastening liability on banks regardless of their lack of negligence is likely to produce more stringent loss prevention policies than where liability is based on negligence alone.

3) The combined effect of protecting both collecting and drawee banks is to shift losses away from banks to customers. When the forger dealt directly with the depositary bank, loss is shifted to the dispossessed owner. Regardless, reallocation of losses from banks seriously undermines loss distribution. Furthermore, assuming both the dispossessed owner and the bank which dealt with the forger were not negligent, it is the bank which is capable of maintaining more rigorous loss prevention policies. Accordingly, to say the least, no gain in loss prevention or reduction is realized so as possibly to offset the erosion in the loss distribution policy occurring upon shifting losses away from banks.

\textsuperscript{138} Cheques Act, 1957, 586 Eliz. 2, ch. 36, § 4(1), (3) (Eng.).
B. Exceptions Under the UCC

1. Introduction: The Role of Negligence

As under the BEA, the basic UCC scheme is subject to exceptions. It is, however, in relation to the scope of such exceptions that major differences between the two sub-systems lie. First, unlike in BEA jurisdictions other than Canada, no special protections to collecting and drawee banks are provided for in the UCC. Second, to a large extent, fault principles supercede the UCC loss allocation scheme, fastening responsibility on negligent parties. A general provision to that effect is accompanied by a series of provisions, applicable in prescribed circumstances, allocating losses to parties in whose sphere of control or influence the fraud that generated the losses was precipitated. No similar provisions exist under the BEA, other than the one dealing with the fictitious payee.

Statutory exceptions to the general scheme, premised on fault or negligence, are enumerated in UCC sections 3-404 to -406.139 Their combined effect is to reinforce the loss prevention or reduction under the basic scheme.

Only "a person who, in good faith, pays the instrument or takes it for value or for collection" may invoke these exceptions.140 Stated otherwise, "good faith" is an indispensable pre-requisite for any variation in the basic scheme. "Good faith" is defined in section 3-103(a)(4) of the UCC as "honesty in fact and the observance of reasonable commercial standards of fair dealing."141 While this includes an objective component of "observance of reasonable commercial standards," the latter are stated to relate only to "fair dealing" and not the conduct in business in general.142

This is not to say, however, that the negligence of one who invokes a statutory exception premised on the negligence of

140. See U.C.C. §§ 3-404(a), -404(b)(2), -405(b), -406(a) (1999).
142. A point well made in WHITE & SUMMERS, supra note 34, at 572-73.
another is not pertinent. In each of the three provisions such negligence is relevant, though in a different way than the breach of the good faith requirement. It is relevant not as a complete bar to relying on the exception, but rather, merely for the purpose of ascertaining the amount of the loss to be allocated to each party. Accordingly, having failed "to exercise ordinary care in paying or taking the instrument" so as to substantially contribute to loss, a person who, in good faith, paid or took the check for value or for collection, becomes liable to the person bearing the loss to the extent the failure to exercise ordinary care contributed to the loss. The principle is then of comparative negligence, under which loss is apportioned according to the degree of fault substantially contributing to the loss.

Typically, the person dealing with the forger is a depositary bank or a check cashing facility. A failure to exercise ordinary care occurs, for example, when a check payable to a corporation is indorsed and/or deposited to an account of an individual, where the identity of an indorsee or account holder is not adequately scrutinized, and where suspicious account operation is overlooked. In such cases, compliance with reasonable commercial standards could have facilitated the detection of the forgery, and hence the prevention of the loss.

A forged indorsement that becomes effective under UCC sections 3-404 to 406 is a complete defense to a drawee's action for the breach of presentment warranties under UCC sections 3-417 and 4-208. While this is logical, the statutory language could, however, be improved by protecting the person invoking any of the former three Article 3 provisions only to the extent that he did not substantially contribute to the forgery, namely, only beyond his share in the loss under the comparative negligence rules that the

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143. See discussion infra Part IV.B.2.a. Both "ordinary care" and "substantially contributed" are discussed in connection with UCC section 3-406.
144. See U.C.C. §§ 3-404(d), -405(b), and -406(b) (1999).
146. See U.C.C. §§ 3-417(c), 4-208(c) (1999).
applicable provision provides.147

2. The Statutory Provisions

a. UCC § 3-406: Negligence Contributing to Forgery

The general fault or negligence principle is pronounced in UCC section 3-406(a):

A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.148

For a person engaged in business, "ordinary care" is defined in terms of the "observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged."149 The "substantially contributes" language is designed to preclude the application of strict proximation requirements between the

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147. See WHITE & SUMMERS, supra note 34, at 605-11. They correctly point out, for example, that when the drawee shared ten percent of the responsibility and the depositary bank was responsible for fifty percent of the loss (with the remaining forty percent being allocated to the customer of the depositary bank with whom the drawee bank settled), literal reading of UCC section 4-208(c) (and hence UCC section 3-417 as well) results in the depositary bank being fully protected against the drawee's breach of presentment warranty claim, thereby avoiding paying its share.


149. U.C.C. § 3-103(a)(7) (1999). For a bank, in connection with the automated collection and payment of checks, reasonable commercial standards may not require a physical examination of each check. This, however, is inapplicable to a depositary bank. Support for the latter proposition is implied in UCC section 3-103 comment 5. See also WHITE & SUMMERS, supra note 34, at 578.
negligent conduct and the causation of the loss. Negligent conduct substantially contributing to a forged indorsement could include the mailing of a check to a person with a name identical or similar to that of the intended payee, handling incoming as well as outgoing checks so as to facilitate unauthorized access and theft either by outsiders or unauthorized personnel, and hiring inappropriate staff for sensitive positions with inadequate scrutiny. Negligence could lead to the forgery of either one's own or of another's signature.

\[b. \text{Introduction to UCC §§ 3-404 and -405}\]

Provisions listing specific exceptions to the general scheme are UCC sections 3-404 and -405, respectively dealing with checks issued to impostors and to unintended or fictitious payees, and checks fraudulently indorsed by employees entrusted with responsibilities. In each case, the UCC provides for the effectiveness of the fraudulent indorsement in favor of a person who, in good faith, pays the instrument or takes it for value or for collection. Thereby, the UCC validates both title derived through the fraudulent indorsement and payment made over it. As discussed below, while an unintended or fictitious payee under UCC section

150. See U.C.C. § 3-406 cmt. 2 (1999).
153. For case law under the pre-1990 UCC, wherein courts considered whether particular acts constituted negligence substantially contributing to forgery, see Gary D. Spivey, Annotation, Commercial Paper: What Amounts to "Negligence Contributing to Alteration or Unauthorized Signature" under UCC§ 3-406, 67 A.L.R.3d 144 (1975).
154. By their terms, both provisions apply to all types of instruments. The official comments recognize, however, that they are primarily important with respect to checks.
3-404(b) is not substantially different from a fictitious or non-existing payee under the BEA, section 3-405 complements this provision because it covers instances of fraudulent indorsement by employees entrusted with responsibility with respect to checks which may fall outside section 3-404(b). There is no BEA parallel to UCC section 3-405.

For UCC sections 3-404 and -405 to apply, the fraudulent indorsement of the check, which these provisions render effective, ought to have been made in the name of the person to whom the check is payable. However, under both provisions, such indorsement includes (i) an indorsement in a substantially similar name, and (ii) the deposit of the check, whether indorsed or not, in a depositary bank, to an account in a name substantially similar to that of that person.\(^{155}\)

Loss is thus allocated under both UCC sections 3-404 and -405 to the best loss avoider within whose sphere of influence forgery was precipitated, so that it was either caused or not prevented due to the fault of that person.\(^{156}\) The principle underlying both provisions is that of fault or negligence substantially contributing to the forged indorsement and the resulting loss. In fact, both provisions state an irrebuttable presumption of such fault or negligence in each specific situation they delineate.

c. The Impostor Rule: UCC § 3-404(a)

UCC section 3-404(a) deals with the case where a fraudster either impersonates or poses as an agent for a legitimate payee and induces the issue, either to him in person or to a person acting in concert with him, of a check payable to the legitimate payee. The inducement may take place "by use of the mails or otherwise;" actual face-to-face impersonation is not required.\(^ {157}\) The provision extends also to the case where the impostor impersonates an agent

\(^{155}\) See U.C.C. §§ 3-404(c), -405(c) (1999).

\(^{156}\) See generally U.C.C. § 3-404 cmt. 2 (1999); U.C.C. § 3-405 cmt. 1 (1999).

\(^{157}\) A point elaborated in pre-1990 UCC section 3-405 comment 1, the predecessor of current UCC section 3-404.
of the legitimate payee, which is an expansion of the former UCC corresponding provision. The provision thus applies whenever the impostor impersonates a real creditor of the drawer, as well as when he impersonates an agent for such a creditor or for a charity to which the drawer wishes to pay. The former provision excluded a drawer, who having dealt with one impersonating an agent, nevertheless "[took] the precaution of making the instrument payable to the principal" and thereby became "entitled to have [the principal's] indorsement." The old provision thus shifted the loss in such a case to the taker from the forger. This rationale is specifically rejected and loss is reallocated to such a drawer, notwithstanding the precaution taken. No corresponding provision to the impostor rule exists under the BEA.

*d. The Fictitious Payee Rule: UCC § 3-404(b)*

UCC section 3-404(b) deals with a check issued to an unintended or fictitious payee, and it covers two situations. First, subsection (b)(i) applies to the case where "a person whose intent determines to whom an instrument is payable... or does not intend the person identified as payee to have any interest in the instrument." Second, subsection (b)(ii) applies where "the person identified as payee of an instrument is a fictitious person." In either case, anyone in possession of the instrument is its holder and any indorsement in the payee's name is effective as the payee's indorsement "in favor of a person who, in good faith, pays the instrument or takes it for value or for collection." Effectively

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158. The former provision was pre-1990 UCC section 3-405(1)(a).
159. Official Comment 2 to pre-1990 UCC section 3-405.
161. Arguably, however, a check payable to an imaginary charity, whose issue an impostor induces, could be characterized as a check payable to a "non-existing" person so as to fall under the BEA fictitious payee provision.
162. See U.C.C. § 3-404(b) (1999).
163. Id.
164. Id.
165. U.C.C. § 3-404(b) (2) (1999).
then, loss generated by the forger of the payee's signature is allocated to the issuer of the check, rather than to the taker from the forger, as if the check had originally been issued payable to the bearer and not to the payee's order.

Undoubtedly, UCC section 3-404(b) traces its roots to the fictitious payee provision of the BEA. While there is difference in language, in the final analysis, the impact of each provision is not substantially different. Consider the following analysis. First, in the BEA the provision applies to the case where the payee is "a fictitious or non-existing person." Conversely, under the UCC, the designated payee is either unintended or fictitious. Obviously, as a counterpart for "fictitious," "unintended" differs from "non-existing," but, as will shortly be shown, the meaning given in the United States to "unintended" necessitates a meaning for "fictitious" which differs from that under the BEA. Between the UCC and the BEA, not only does the scope of the provision not appear to be identical, but the meaning of a key term also appears to differ.

Second, the BEA is silent as to whose intention determines whether a check is payable to a fictitious or non-existing person. Conversely, whether a person identified as payee is not intended to have any interest in the instrument, so as to bring it into subsection (b)(i), is determined under section 3-110(a) or (b) to which UCC section 3-404(b)(i) specifically refers. Under section 3-110(a), it is the signer's intention which is usually determinative.' A narrow exception is provided for under section 3-110(b), providing that "[i]f the signature . . . is made by automated means, such as a check-writing machine, the payee of the instrument is determined by the

166. See discussion supra Part IV.A.1. The original language was much more apparent in section 9(3) of the Uniform Negotiable Instruments Law (NIL), the predecessor of UCC Article 3.
167. See supra note 94.
168. See U.C.C. § 3-404(b) (1999).
169. See supra note 94.
171. Where more than one signs on an issuer's behalf, "the instrument is payable to any person intended by one or more of the signers." U.C.C. § 3-110(a) (1999).
intent of the person who supplied the name or identification of the payee." Either way, the crucial moment for determining the intention of the relevant person, is that of the signature under subsection (a) and that of the supply of the name under subsection (b). A transformation of an honest intent into a dishonest one, occurring after the signature or the supply of the name to the signing machine, will not bring the case into UCC section 3-404(b), but as will be seen below, UCC section 3-405 may cover the case anyway. A classic example for the application of UCC section 3-404(b)(i) is the case where either the signer or the name supplier to an automated signing machine causes a check to be made out to an existing individual or entity, that the issuer may or may not own, without intending the check to be delivered to that payee.

Third, in BEA jurisdictions, case law has defined "fictitious" in terms of being inserted as payee by way of pretense, without any intention that payment will be made to him. This, however, strongly matches the "unintended" category of section 3-404(b)(ii). It follows that the meaning of "fictitious" under UCC section 3-404(b)(ii) cannot be the same meaning as under the BEA. Indeed, examples given in the official comment to section 3-404 demonstrate that "fictitious" under the UCC means "imaginary;" "fictitious" under the UCC is basically the parallel of the BEA "non-existing," as determined objectively, irrespective of anyone's intention. Accordingly, what is "unintended or fictitious" in the United States is "fictitious or non-existing" under the BEA. For example, a check payable to "Micky Mouse" will be payable to a non-existing payee under the BEA and to a fictitious payee under the UCC. Either way, it will fall within the provision.

Fourth, as indicated, by specifically providing whose intent

172. U.C.C. § 3-110(b) (1999).
174. This is on the basis of Lord Herschell's classic definition in Bank of England v. Vagliano Bros., 1891 App. Cas. 107, 153 (appeal taken from Eng.); see also supra Part IV.A.1.
determines the application of section 3-404(b)(i), the UCC provision is clearer than that of the BEA. Yet, other than in relation to a name supplier to an automated signing machine under section 3-110(b), the UCC test for determining whose intention determines whether the payee is unintended is along similar lines to the classic pre-Boma\textsuperscript{177} test for determining whether the payee is "fictitious" under the BEA. For example, as under the BEA, but in departure from the UCC's pre-1990 position,\textsuperscript{178} so far as a "real" payee is concerned, payroll padding, that is, the supply of a name to a real person who will consequently sign a check payable to that name, thereby unknowingly executing the name supplier's fraudulent design, falls outside the provision. Yet, as will be seen below, the case still falls into the ambit of UCC section 3-405 to which the BEA has no counterpart.\textsuperscript{179}

Fifth, both UCC section 3-404(b) and the BEA fictitious provision do not cover a check payable to an intended real payee.\textsuperscript{180} Such a check is payable neither to an unintended nor fictitious payee under the UCC, nor to a fictitious or non-existing payee under the BEA. Accordingly, and as indicated, theft followed by the forgery of the indorsement of the check originally made out to an intended real payee falls outside of the provisions of both the UCC and the BEA. Therefore, so far as these provisions are concerned, loss does not fall on the drawer. Additionally, these provisions do not apply when the real intended payee is either an accomplice of or a phony corporation set by the defrauder, whose intention determines to whom the instrument is payable. However, in such a case, the fraudulent payee's indorsement is effective and payment over it is a valid discharge, so that the loss will fall on the drawer anyway.\textsuperscript{181} On this point, there is no difference between the

\textsuperscript{177} See Boma Mfg. Ltd. v. Canadian Imperial Bank of Commerce (1996), 140 D.L.R.4th 463 (SCC); supra text accompanying note 21.
\textsuperscript{178} See U.C.C. § 3-405(1)(c) (1989).
\textsuperscript{179} See U.C.C. § 3-405 (1999).
\textsuperscript{180} See U.C.C. § 3-404(b) (1999); supra note 94.
\textsuperscript{181} This may very well be the answer to the query raised by WHITE & SUMMERS, supra note 34, at 583, as to the inapplicability of the provision to such
UCC and the BEA.

e. Employee's Fraudulent Indorsement: UCC § 3-405

UCC section 3-405 allocates to an employer losses caused when employees entrusted with checks fraudulently indorse them. It applies to checks the employer issues, as well as checks payable to him. It has no parallel in the BEA.

The scope of section 3-405, particularly in relation to identifying the employees and their responsibilities caught within the ambit of the provision, as well as in relation to other Code provisions, can be further elaborated as follows:

(1) "Employee" is broadly defined in subsection (a)(1) to include "an independent contractor and employee of an independent contractor retained by the employer." Presumably corporate officers are covered as well.

(2) For section 3-405 to apply to a fraudulent indorsement on a check an employer made out to a third party, the forger/defrauding employee must have had authority to sign or indorse, prepare or process instruments for issue, supply information determining the names or addresses of payees, or control the disposition of such instruments. For example, an employee authorized to supply information determining the payee's address could intentionally replace data and divert a check payable to a real creditor of the employer to the employee's own address. Upon the check's arrival, the employee could obtain or collect payment over the payee's fraudulent indorsement made by that employee.

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183. See id.
185. See U.C.C. § 3-405, cmt. 3, case 5 (1999); see also U.C.C. § 3-405, cmt. 3, case 6 (1999) (addressing embezzlement by an employee charged with authority or control over the disposition of outgoing checks).
(3) For section 3-405 to apply to a fraudulent indorsement on a check payable to and received by the employer, the forger/defrauding employee must have had authority to sign or process incoming instruments for any purpose, including bookkeeping or deposit to an account. In addition, section 3-405 covers theft of an incoming check and a bookkeeper's fraudulent indorsement of it, if the bookkeeper has the authority to post incoming payments to debtors' accounts with the employer. Conversely, indorsement by an employee who has the authority to indorse is valid, irrespective and outside of UCC section 3-405, even when inserted with the view of stealing the incoming check and diverting its proceeds. Loss will fall on the employer unless the depository bank had notice of the employee's breach of a fiduciary duty as determined under section 3-307.

(4) In any event, with regard to both outgoing and incoming checks, the authority to sign, process instruments or information, and control disposition does not exhaust all cases of "responsibility" entrusted to an employee whose fraudulent indorsement section 3-405 validates. Subsection (a)(3)(vi) explicitly states that in addition to all tasks described above, "responsibility" with respect to instruments includes the authority "to act otherwise with respect to instruments in a responsible capacity." This open-ended category may not be all that helpful, except for signaling the broad scope of the provision; the breadth of this residual category overshadows any narrow interpretation of the particular duties. Subsection (a)(3) nevertheless provides some assistance, providing that "[r]esponsibility' does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access." Notwithstanding access to a storing facility, a janitor will thus not be an employee entrusted with responsibility with respect to

instruments so that the janitor's fraudulent indorsement falls outside of section 3-405. In any event, the janitor's employer, whose negligence might have substantially contributed to the loss, may nevertheless be held responsible under section 3-406.190

f. The Relationship Between § 3-404(b) and -405

Effectively providing for the allocation of forged indorsement losses to an organization whose insider precipitated the fraud resulting in the losses, UCC sections 3-404(b) and -405 partly overlap and partly compliment each other. Thus, when an employee entrusted with responsibility causes the employer to generate a check payable to a fictitious, namely imaginary, person, and then indorses the check in the name of the payee and collects its proceeds, both provisions validate the indorsement so as to allocate the loss on the employer. Similarly, both provisions apply where such an employee is the person whose intent determines to whom the check is payable, and causes the employer to generate a check payable to a real person on whom the employee does not intend to confer any interest in the check. The overlap, however, is not total. For example, only section 3-404(b) will apply in each of the abovementioned cases if an independent third party, rather than a defrauding employee, makes the fraudulent indorsement, as for example, where the third party frustrates the perpetrator's design by stealing the check, either from the employer or the employee, and collecting its proceeds for his own benefit. Conversely, only section 3-405, and not section 3-404(b), applies (i) to a fraudulent indorsement on an incoming check payable to and received by the employer, and made by an employee entrusted with responsibility, (ii) to the case where an employee entrusted with responsibility, who supplies the name of a real person to an honest co-employee who signs a check payable to that person, makes the forged indorsement,191 as well as (iii) when an employee whose

190. For the inapplicability of UCC section 3-405 to the janitor's case, and the possible application of section 3-406, see U.C.C. § 3-405 cmt. 3, case 4 (1999).
intent determines to whom a check is payable, having caused the employer to generate a check payable to a real person, fully intending him to have an interest in the check, changes his mind and collects the proceeds of the check over his fraudulent indorsement.\textsuperscript{192}

C. The Anglo-American System: Concluding Remarks on Negligence

In the Anglo-American system, when an indorsement on a check has been forged, the true owner may sue prior parties on the instrument and subsequent parties in conversion (as well as money had and received under the BEA). The drawer is entitled to have his account credited (or not debited in the first place) with the amount of the check. Loss falls on the one who dealt with the forger. Where an exception to this scheme applies, the taker from the forger obtains title, and payment to the taker is good discharge. Loss falls on the one from whom the check was stolen or misappropriated.

The principal features distinguishing the UCC from the BEA is the extent of the exceptions and the operation, within their framework, of the comparative negligence rules. UCC exceptions are based on fault, whether presumed or proved, ability to prevent loss, and responsibility within one's sphere of influence. The exceptions thus contribute to loss prevention or reduction and constitute an improvement in relation to the BEA. At the same time, the UCC comparative negligence rules do not appear appropriate to me. First, they may prolong litigation. Second, comparative negligence rules are likely to require close analysis of degree of causation, which is precisely the task the substitution of a "substantially contributed" test for any proximity requirement seeks to avoid. Third, in many fact situations, the task of apportioning fault may be impossible.

In addition, a general duty to exercise ordinary care may be too open-ended. As such, it is likely to unnecessarily prolong litigation and bolster the position of the stronger party, which, not

\textsuperscript{192} See U.C.C. § 3-405 cmt. 3, case 6 (1999).
infrequently, is a bank. This is an important consideration, particularly in connection with cases involving consumers and small businesses. Thus, while the UCC exceptions rest on sound policies, their proper implementation requires further refinement.

I accordingly propose three modifications to the American scheme. First, "ordinary care" or reasonable commercial standards ought to be prescribed in codes of conduct agreed between banks and customer organizations, in a process that government may facilitate. Such codes of conduct may be national, regional, or even limited to specific sectors.

Second, I propose to eliminate the application of comparative negligence rules. In this respect, I am inspired by the pre-1990 principle of absolute preclusion, but the scheme I have in mind is not necessarily identical to that of the old UCC. My proposal is that the failure by the person who dealt with the forger to comply with reasonable commercial standards will nullify an otherwise applicable exception and restore the ineffectiveness of the indorsement, provided such compliance could have detected the forgery and prevented the loss. Under such circumstances, the failure to comply will serve as a basis for preclusion of anyone relying on the exception. Usually, the one who dealt with the forger is either a bank or a check cashing facility, whose compliance with reasonable commercial standards will not be hard to determine, particularly in the context of a code of conduct along the lines set out above. The negligence of any party, other than the one who has dealt with the forger, will be considered too remote to be a relevant factor.

193. Rules prescribed in such codes will fulfil the same function of UCC sections 3-404 and -405.

194. For example, there may be different standards for large businesses, small businesses, and non-profit organizations. At the same time, some common elements, for example, in scrutinizing employees, may exist across the board. For a proposed publicly supervised negotiated statutory standard form contract, see Reuben Hasson, The Unconscionability Business—A Comment on Tilden-Rent-a-Car Co. v. Clendenning, 3 CAN. BUS. L.J. 193, 196-98 (1979).

Third, I propose to eliminate all exceptions in connection with consumer checks, or at least for most of their categories. Alternatively, some rules which are to be retained are to be modified in the consumer context.\textsuperscript{196} Regardless, under my proposal, anyone who fails to disclose a forged indorsement known to him will be unable to shift the loss onto another.

V. EVOLUTION AND REFORM: COMMON LAW OR LAW MERCHANT?

Until recently, the conventional wisdom has been that one underlying distinction between law merchant and common law is concerned with the protection of property rights. While common law emphasizes static protection of existing property rights, law merchant prefers interests created by means of free circulation of instruments, and hence the dynamic protection accorded to their bona fide acquirer. Accordingly, it is tempting to point out that so far as the basic scheme for the allocation of forged indorsement losses is concerned, while the Continental system, which protects the bona fide acquirer, reflects principles derived from law merchant, the Anglo-American system, which protects the dispossessed owner, implements common law principles.

More recently, however, in his landmark book,\textsuperscript{197} Professor Rogers presents a convincing case for a revisionist view, that challenges the conventional wisdom in two ways. First, he dispels the myth of the law merchant as a distinct and cohesive body of law which supplanted the common law but was alien to it in its basic principles and concepts. Rather, in Professor Rogers' view, first, the true process of incorporating the law merchant was the adaptation

categorical on this point.

\textsuperscript{196} For example, even if the impostor rule under section 3-404(a) is retained with respect to consumers, I propose to exclude from its operation a consumer who took the precaution of writing the check to the alleged principal of the impostor (as, in effect, was the general rule under the pre-1990 UCC).

of the common law to cover, within its own doctrine, either new commercial instruments or new uses of old ones. Second, historically, within this process, the role of negotiability, or the free circulation of commercial instruments, was by no means central.

It is obvious that from this point of view, it is inappropriate to deal with the treatment of forged indorsement losses in the Anglo-American system as a case where common law property rules prevailed over law merchant free circulation rules. Rather, the correct point of view is to characterize the case as an instance where the better policies necessitated the law to prefer the protection of property, unless the dispossessed owner has been at some fault or is in a position to avoid loss. Nevertheless, as long as the subject matter remains a commercial situation that has to be dealt with under rules implementing the preferable policy, it is commercial law, or law merchant, which resolves the issue. In the final analysis, it is this redefinition of commercial law which can be deduced from Rogers' thesis\textsuperscript{198} and applied to the evolution of the law governing the allocation of forged check indorsement losses.

\textsuperscript{198} See id.