

**REPORT AND RECOMMENDATIONS
RELATING TO ARTICLES 3 AND 4
OF THE UNIFORM COMMERCIAL CODE**

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INTRODUCTION

The National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) have approved Revised Article 3 and Amended Article 4 of the Uniform Commercial Code. Article 3 governs negotiable instruments. Article 4 governs bank collections. Revised Article 3 and Amended Article 4 carry forward the central concepts of present law. They largely resolve issues produced by divided authorities and clarify ambiguities in statutory language.

Revised Article 3 and Amended Article 4 update Articles 3 and 4 which are based on a paper payment system. The existing articles "do not adequately address the issues of responsibility and liability as they relate to modern technologies" now employed to process negotiable instruments.¹ Revised Article 3 and Amended Article 4 accommodate modern technologies and practices, reflect the needs of an expanding national and international economy and recognize the requirement for rapid funds availability.

The Prefatory Note to Revised Article 3 lists the benefits that the revised articles confer on users, the public and the banks.³ The benefits for users include: (1) direct suits, (2) expanded definition of "good faith" to include "reasonable Commercial standards of fair dealing", (3) improved loss rules for cashier's checks and (4) reduced risk of forming unintentional accord and satisfaction agreements.⁴ The benefits to the public include: (1) increased certainty in rules to allow better planning, (2) removal of impediments to automation, (3) lower costs by allowing banks to automate procedures and (4) reduced litigation flowing from certainty of rules.⁵ The benefits to banks include: (1) new definition of "ordinary care" to exclude manual inspection of checks, (2)

¹ U.C.C. Revised Article 3, Prefatory Note 2 (1990 Official Text)(hereafter U.C.C. Rev. Art. 3). The existing articles are cited as U.C.C. 3 and U.C.C. 4. (1987 Official Text).

² Id. at 1.

³ Id. at 5-6.

⁴ The term "direct suits" refers to actions between parties who do not deal directly with one another. The existing articles often prohibit actions between these remote parties. For example, under the present rules, a depository bank cannot sue a drawer based on its negligence for contributing to a forgery. Girard Bank v. Mount Holly State Bank, 474 F. Supp. 1225 (D.N.J. 1979) (creating a common law cause of action between depository bank and drawer of check). The revised rules allow depository banks to sue drawers of checks even though the latter often never deal with the former. U.C.C. Amended Article 4 208(c) (hereafter U.C.C. Amend. Art. 4). In addition, payees can avoid "accord and satisfaction" by requiring the debtor to send payment to a specific office. U.C.C. Rev. Art. 3-311(c)(1). This rule discussed infra at notes 162-168 prevents a debtor from establishing an "accord and satisfaction" by writing "payment in full" on a check and sending the check to the creditor's general payment office.

⁵ U.C.C. Rev. Art. 3, Prefatory Note at 5.

expansion of per se negligence rules for employers, (3) truncation of bank statement and (4) certainty of obligations⁶.

The Commission has studied the proposed amendments in Articles 3 and 4 and supports them. However, the Commission recommends two changes in the Official Text. First, the Official Text would change the rules for allocation of the risk of loss in cases involving checks containing a forged drawers signature in a way that appears both unnecessary and inappropriate. Also, the Official text fails to provide a rule to assign responsibility for the unauthorized use of check writing machines and other automated devices that produce signed checks. The changes recommended are the smallest that will serve to solve the problems with the Official Text, and they do not change the basic structure or concepts of the Commercial Code. The need for these changes outweighs the need for strict uniformity.

Risk of loss - forged drawers signature

The present loss allocation rules follow a "winner take all" approach. They impose liability on the person in the best position to avoid the loss.⁷ In contrast, the revised rules adopt a comparative negligence standard to allocate loss among negligent parties.⁸ Comparative negligence assigns liability according to level of fault and rejects the "winner take all" approach. The comparative negligence approach also is designed to reduce litigation on the theory that parties will settle disputes if they know it is unlikely one party will take the loss if the suit is litigated. The adoption of the comparative negligence standard is the central difference between the present and revised loss allocation rules.

However, the equity of the comparative negligence approach is somewhat skewed by the definition of "ordinary care" applicable to banks. The new definition of "ordinary care", which is the second central difference between the present and revised rules, does not require a drawee bank using an automated payment procedure to examine the drawer's signature on checks. At present, payment of a check bearing a forged drawer signature imposes liability on the bank because the bank is presumed to know the customer's signature. The new "ordinary care" definition thus alters the traditional liability of bank and customer on losses due to forged drawer signatures.

⁶ Id. at 7-8.

⁷ Rapson, supra note 6 at 435 where Mr. Rapson states "The guiding principle and rationale for the loss allocation rules of former Uniform Commercial Code ... Articles 3 and 4 was said to be that loss should be imposed upon the party best able or in the best position to avoid the loss."

⁸ E.g., U.C.C. Rev. Art. 3-404(d), U.C.C. Rev. Art. 3-405(b), U.C.C. Rev. Art. 3-406(b), and U.C.C. Amend. Art. 4-406(e).

Under current law, initially, the code places the loss resulting from a forged drawer's signature on the bank which paid the item. A forged signature is "wholly inoperative as that of the person whose name is signed."⁹ Therefore, a check bearing a forged signature is not "properly payable" and the bank may not charge the customer's account.¹⁰ The rationale for this rule is that a bank is presumed to know the signature of its customer.¹¹

However, the code allows the bank to shift the risk of loss to the customer if the negligence of the customer substantially contributed to the making of the forged signature.¹²

Notwithstanding the customer's negligence, the code allows the customer to pass back the risk of loss to the bank if the customer shows that the bank was negligent in paying the check.¹³ The customer's assertion of contributory negligence, if successful, bars the bank's defense. Since the bank is presumed to know the customer's signature, failure to identify a forgery may establish the bank's negligence. If the customer makes out the defense of contributory negligence, the bank takes the loss even though the customer was negligent.

However, some recent cases acknowledge that, due to automation, banks no longer manually inspect the signatures on checks. The Supreme Court of Tennessee in Vending Chattanooga v. Am. Nat. Bk. & Tr. held that "a bank exercises ordinary care when it pays a check in good faith and in accordance with the reasonable commercial standards of the banking industry."¹⁴ In Rhode Island Hosp. Trust Nat. Bank v. Zapata, the First Circuit Court of Appeals found that a bank which examined all signatures on checks greater than \$1,000, examined signatures on checks between \$100 and \$1,000 only if there was reason to suspect a problem and did not examine any signature on

⁹ U.C.C. 3-404(1). The signature makes the check an obligation of the thief.

¹⁰ U.C.C. 4-401(1).

¹¹ 3 Burr. 1354 (1762) reported in 97 Eng. Rep. 871.

¹² U.C.C. 3-406 states "Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business."

¹³ "Of course negligence does not travel without its companion, contributory negligence and if both the customer and his bank are negligent, the two will usually offset one another and reopen the customer's claim on the forgery." White and Summers, Uniform Commercial Code 607 (2d ed. 1980). U.C.C. 3-406 states "payor who pays in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business."

¹⁴ 730 S.W. 2d at 628. See also Wilder Binding Co. v. Oak Park Trust and Savings Bank, 552 N.E. 2d 783 (Ill. 1990).

checks less than \$100, exercised ordinary care in paying an item.¹⁵ Therefore, the payment by a bank over a forged drawer signature may not constitute negligence. New Jersey courts have not considered this exact issue. Reported cases to date have not imposed liability on the customer for a forged drawer signature unless there was an employer-employee or other close relationship between the drawer and forger.¹⁶ However, given the widespread use of automation, it is possible the New Jersey courts would follow the rationale of Zapata and Vending Chattanooga

The revisions carry forward the basic concepts of the code governing a forged drawer's signature, but the revisions contain significant differences. First, the revised definition of "ordinary care" in Article 3 does not require the bank to examine the signature of a drawer if the bank takes the instrument for payment by automated means.¹⁷ Rev. Art. 3-103(7) provides "In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4." Second, the revision abolishes the defense of contributory negligence and adopts the concept of comparative negligence to allow parties to share the loss in proportion to their fault.¹⁸

The revisions have a substantial effect on the risk of loss in common forged drawer's signature cases. An item bearing a forged signature is an item not "properly payable" and therefore the bank cannot charge the customer's account. This is consistent with the present rule.¹⁹ Likewise, the revision allows the bank to shift the loss to the customer if the bank proves the customer's negligence substantially contributed to the making of the forged signature.²⁰ This too is consistent with the present rule.

However, the old and new rules diverge at this point. The revision does not allow the customer to show that the bank's failure to inspect the check manually to

¹⁵ 848 F. 2d at 294.

¹⁶ E.g., Brogan Cadillac v. Central Jersey Bk. & Tr., 183 N.J. Super. 333 (Law Div. 1981)(bank not liable to holder in due course for checks stolen and then forged in bank's name);

¹⁷ U.C.C. Rev. Art. 3-103(7).

¹⁸ U.C.C. Rev. Art. 3-406(b) provides that "if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss." The person asserting the preclusion is the bank; the person precluded is the customer. The bank and the customer, if both are negligent, share the loss.

¹⁹ U.C.C. 3-401 and U.C.C. Rev. Art. 3-401 are virtually identical.

²⁰ U.C.C. Rev. Art. 3-406.

detect a forgery constitutes negligence since the revised definition of "ordinary care" bars this claim.²¹ Thus, a bank may pay a check bearing a forged signature and charge it to the customer's account providing the negligence of the customer contributed substantially to the forgery. The revised rules assume that the customer is in the best position to prevent the loss. Consequently, unless the customer can show the bank otherwise acted negligently in paying the item, for example paying the check over a stop order, the customer takes the loss. Even assuming the bank was negligent, the revised rule splits the loss between the bank and the customer under a comparative negligence scheme.

The Commission has determined that some aspects of the change in risk of loss on forged drawer's signatures are not justified. The problem is important; in many common situations, some small act of negligence of the bank customer can be said to contribute to the forgery. Placing the cost of the forgery on the customer in all of these cases constitutes a major change in current practice, and current practice presents no problems. The decision not to examine signatures on checks is the bank's decision. While that decision may be commercially reasonable, the cost of the decision should be borne by the party that made it, the bank. The Commission conducted a survey of New Jersey banks and found that the losses due to forged drawer's signature are small. Banks now accept the risk of these losses as a cost of automated processing of checks. There is no reason to change existing practice. As a result, the Commission recommends a change in the official text that would prevent the bank from charging a customer with the cost of a forgery if an examination of the drawer's signature would have revealed the forgery. That change is found in Amended section 3-406.

Automated signing of checks

Under both the current and revised Article 4, a bank is directed to pay only those checks that are "properly payable", and an item is properly payable only if it is authorized by the customer. As is discussed above, a forgery is not authorized and so is not properly payable. The justification for this rule, that the banker is held to know his customer's signature, assumes a handwritten signature. The rule makes no sense in the context of a signature put on the check by automated means. In such a case, the signature is identical to the one established by the customer as his own. The bank can never know from examining the signature whether it is authorized or not. The agreement between a bank and its customer may settle the issue of liability for unauthorized automated signing of checks, but in the absence of such an agreement, the rule provided by the code is not the one that either the bank or the customer would expect. The better rule is that if a customer decides to have his checks signed mechanically, and provides a specimen signature based on that system, the customer bears the risk that someone uses his system to produce unauthorized checks. The risk is the customer's creation, and automated signing of checks serves the customer's purposes.

²¹ U.C.C. Rev. Art. 3-103(7).

There is no reason for the bank to be responsible if it pays a check with a proper, though unauthorized signature. The change in Amended 4-401 corrects this defect.

RECOMMENDED AMENDMENTS

Amended section 3-406. Negligence Contributing to Forged Signature or Alteration of Instrument.

(a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection. A bank which pays a check on a forged signature without an examination of the signature which would have revealed the forgery or alteration may not assert this preclusion against a person who complies with 4-406

(b) Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

(c) Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.

COMMENT

The amendment to the official text of 3-406, the preclusion defense, would prevent a bank from raising the defense if an examination of the check would have revealed the forgery or alteration. Though the bank does not have a duty to examine checks under the revisions, the proposed amendment would not allow banks to use the preclusion defense to shift losses to customers if the bank has chosen not to examine checks and a sight review of the check would have revealed the forgery or alteration. A banks would still be permitted to pay checks by automated means, but if a bank paid a forged or altered check, the bank could not avoid liability for the payment if the bank, had it examined the check, would have discovered the forgery or alteration.

Amended section 4-401. When Bank May Charge Customer's Account.

(a) A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer, or bears the customer's signature made by automated means provided by the customer and is in accordance with any agreement between the customer and bank.

(b) A customer is not liable for the amount of an overdraft if the customer neither signed the item nor benefited from the proceeds of the item.

(c) A bank may charge against the account of a customer a check that is otherwise properly payable from the account, even though payment was made before the date of the check, unless the customer has given notice to the bank of the postdating describing the check with reasonable certainty. The notice is effective for the period stated in Section 4-403(b) for stop-payment orders, and must be received at such time and in such manner as to afford the bank a reasonable opportunity to act on it before the bank takes any action with respect to the check described in Section 4-303. If a bank charges against the account of a customer a check before the date stated in the notice of postdating, the bank is liable for damages for the loss resulting from its act. The loss may include damages for dishonor of subsequent items under Section 4-402.

(d) A bank that in good faith makes payment to a holder may charge the indicated account of its customer according to:

- (1) the original terms of the altered item; or
- (2) the terms of the completed item, even though the bank knows the item has been completed unless the bank has notice that the completion was improper.

COMMENT

The proposed amendment to subsection (a) allows a bank to pay a check bearing a facsimile signature since there is no way for the bank to know if the signature is authorized. The customer who uses such an automated signature thus bears the risk of loss.

As a practical matter, the bank probably will have an agreement with the customer allowing the bank to debit the account of the customer for payment of any check produced by a check writing machine. Even in the absence of a specific agreement to this effect, proposed Section 4-401 allows the bank to debit the customer's account on the theory that the customer unleashed a check containing a signature whose authenticity cannot be ascertained by the bank.