

THE RESOLUTION OF PADDED PAYROLL CASES BY THE UNIFORM COMMERCIAL CODE: A PANDORA'S BOX

A perplexing problem under Article Three of the Uniform Commercial Code is the determination of the rights and liabilities of parties involved in a "padded payroll" or "fictitious payee" situation.¹ The following hypothetical case exemplifies the "padded payroll" problem.

Elmer Employee has worked for the Drawer Company as a payroll clerk for several years. It is within the scope of Employee's authority to supply the treasurer's office with a list of the names of persons who are to receive paychecks. Employee adds the name Peter Payee,² a person whom he intends to take no interest in the checks, to his list. When the checks are issued, Employee retains the one payable to Peter Payee. He then takes this check to a local sporting goods store where he purchases a bowling ball, indorsing the check in Payee's name and using for identification a driver's license in Payee's name which he has procured for this purpose. Employee leaves the store with the bowling ball and cash equivalent to the difference between the amount of the check and the purchase price.³

The proprietor of the sporting goods store takes the check to his bank where he adds his indorsement and deposits the check in his account. The

¹ A recent California case, *Pacific Indem. Co. v. Security First Nat'l Bank*, 56 Cal. Rptr. 142 (Ct. App. 1967), illustrates the complexity of "padded payroll" situations and the difficulty courts have in dealing with them. In this case an employee of a company caused six checks to be issued payable to the defendant bank, where the employee had a personal account. The checks were drawn to satisfy fictitious debts of customers of the company and the purpose of the checks was noted on them. Nevertheless, the defendant bank's tellers allowed the employee to credit these funds to his personal account. An action sounding in negligence and conversion was brought against the defendant bank by the employer's indemnity company and the plaintiff was allowed recovery. The case had arisen before the Code became the governing law in California but the court discussed many of the Code sections which are related to "padded payroll" problems. Because the *Pacific Indemnity* case involves a unique fact situation, "padded payroll" cases will be discussed in this comment in relation to a general hypothetical situation.

² The "payee" of a check is the individual who is intended by the drawer to be the recipient of the money. *Schweitzer v. Bank of America Nat'l Trust & Sav. Ass'n*, 42 Cal. App. 2d 536, 542, 109 P.2d 441, 445 (1941). In the hypothetical situation Peter Payee is a "fictitious payee." An instrument is drawn to order of a fictitious payee if it is not intended that the person named on its face have any interest in it. *Security-First Nat'l Bank v. Bank of America Nat'l Trust & Sav. Ass'n*, 22 Cal. 2d 154, 157, 137 P.2d 452, 453-54 (1943). See U.C.C. § 3-405, Comment 4. Unless otherwise indicated, all Uniform Commercial Code references are to the 1962 Official Text.

³ The means by which an employee in a "padded payroll" situation could dispose of the check is limited only by his resourcefulness. For example, he could: (1) establish an account in the name of the named payee, but not known to the payee, and deposit the checks in this account, *Security-First Nat'l Bank v. Bank of America Nat'l Trust & Sav. Ass'n*, 22 Cal. 2d 154, 137 P.2d 452 (1943); (2) simply indorse the checks in the name of the named payee and cash the checks at a bank (or elsewhere), *South Carolina Nat'l Bank v. Lake City State Bank*, 246 S.C. 287, 143 S.E.2d 584 (1965); (3) have the checks drawn payable to a bank at which he has a personal account and have the proceeds of the check credited to his account, *Pacific Indem. Co. v. Security First Nat'l Bank*, 56 Cal. Rptr. 142 (Ct. App. 1967).

depository bank,⁴ assuming that it is not the drawee bank⁵ of the company, will send the check out to be cleared.⁶ By this process the check will reach the drawee bank.

Assuming that the company is solvent, one of two alternatives will occur. It is conceivable that Employee's deception has been uncovered by the company and that it has directed the drawee bank to stop payment on the check. If this happens the drawee bank will not honor the check and it will be returned through the clearing process and eventually be given back to the shopkeeper.⁷ In order to avoid bearing the loss, the shopkeeper would try to find the employee and attempt to recover from him⁸ or would try to enforce payment against the company. However, if payment has not been stopped on the check, the drawee bank will honor the check and charge it against the company's account. Once the company discovers the loss, it will attempt to recover the money charged against its account by the drawee bank and to shift the loss to another party.⁹ The company will first recover whatever it can from the employee,¹⁰ but in the event of less than complete recovery, the company will seek restitution from the other parties to the transaction.

⁴ U.C.C. § 4-105(a) states: "'Depository bank' means the first bank to which an item is transferred for collection even though it is also the payor bank. . . ."

⁵ The Code does not use the term "drawee bank" but makes reference to the "payor bank." U.C.C. § 4-105(b) defines payor bank as "a bank by which an item is payable as drawn or accepted. . . ." The terminology used in commercial paper transactions is historically established. An early case defined a check as "a written request by one person who is called the drawer, directed to another person called the drawee, requesting him to pay a third person, called the payee, a certain sum of money therein specified. . . ." *Westminster Bank v. Wheaton*, 4 R.I. 30, 33 (1856).

⁶ If the depository bank is the drawee bank, then the check does not go through the clearing process, the process by which the check is transferred to the payor bank. Clearing may involve a simple exchange at a local clearing house if both depository and payor bank are from the same city. If the banks are in distant cities, clearing will be done through the Federal Reserve Bank and may involve several correspondent banks. The rules for clearing of checks and other bank procedures are found in Article 4 of the U.C.C. For an extensive discussion of the clearing process, see Huggins & Phemister, *The Illinois Uniform Commercial Code: Article 4—Bank Deposits and Collections*, 50 Ill. B.J. 838 (1962).

⁷ A customer has a right to order a stoppage of payment on a check. U.C.C. § 4-403. Since the credits given throughout the clearing process are provisional, the stop payment will mean that the customer's account will not be charged, the provisional credits will be cancelled, and the shopkeeper will be left with the check and no credit to his account. See U.C.C. § 4-213. If the shopkeeper had cashed the check, the cashing party has a right to demand repayment from him. See U.C.C. § 3-414, which provides that upon dishonor every indorser engages that he will pay the instrument according to its tenor at the time of his indorsement to any holder or subsequent indorser.

⁸ The action by the shopkeeper against the employee would be based on U.C.C. § 3-404(1) which states: "Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any person who in good faith pays the instrument or takes it for value."

⁹ Actually, many companies purchase indemnity policies so that the company's place in the suit may be subrogated to its indemnity. This will not effect the outcome of the case. See, e.g., *Pacific Indem. Co. v. Security First Nat'l Bank*, 56 Cal. Rptr. 142 (Ct. App. 1967).

¹⁰ U.C.C. § 3-405(2) provides: "Nothing in this section shall affect the criminal or civil liability of the person so indorsing."

It is the function of the Uniform Commercial Code to allocate the loss to one of these parties—the drawer company, the drawee bank, the intermediary bank or banks, or the shopkeeper. It is the purpose of this comment to examine the policy which determines the Code's treatment of "padded payroll" cases and to analyze the application of the Code provisions which are intended to effectuate this policy.

A consideration of "padded payroll" transactions under pre-Code law will contribute to an understanding of the treatment of these cases by the Code. The Uniform Negotiable Instruments Act, which was adopted by all 53 American legislative jurisdictions as of 1943,¹¹ approached the problem by treating the instrument as bearer paper. Section 9(3) of the U.N.I.A. stated that the instrument is payable to bearer "when it is payable to the order of a fictitious or non-existing person, and such fact was known to the person making it so payable." By making the instrument bearer paper, the U.N.I.A. made indorsement in the name of the payee unnecessary for negotiation, so that the taker from the employee would become a holder regardless of the forged character of the indorsement.¹² It was held that since the indorsement was unnecessary for negotiation, its forged character could not be the basis of a successful action by the employer to recover the money charged against its account by the drawee bank.¹³ On the basis of this result and because a holder of bearer paper could enforce payment against the drawer of an instrument, the effect of applying section 9(3) of the U.N.I.A. to a "padded payroll" situation was to impose the loss on the drawer-employer.¹⁴

However, a number of interpretative problems arose under the wording of the U.N.I.A. If the hypothetical "padded payroll" case were decided under the U.N.I.A. it is possible that the company would be able to prevail against any of the parties because the instrument might not be considered bearer paper; in which case the loss would be allocated as in an ordinary forged indorsement case.¹⁵ The instrument might not be considered bearer paper

¹¹ 5 ULA p. v (1943).

¹² U.N.I.A. § 30 states: "An instrument is negotiated when it is transferred from one person to another in such manner as to constitute the transferee the holder thereof. If payable to bearer it is negotiated by delivery, if payable to order it is negotiated by the indorsement of the holder completed by delivery." The term "holder" is not defined by the U.N.I.A. Nevertheless, Article IV of the U.N.I.A. §§ 51-59 describes the rights of the holder and then contrasts them in certain instances to the rights of a holder in due course.

¹³ "If the checks were 'bearer' instruments within the meaning of the statute, and therefore transferable by delivery, then it becomes immaterial whether the indorsements were forged or genuine, and plaintiff cannot recover. In such case the endorsemments of the names of the designated payees, by whomever made, may be treated as superfluous and disregarded." *Prugh, Combest & Land, Inc. v. Linwood State Bank*, 241 S.W.2d 83, 87 (Mo. Ct. App. 1951), noted in 3 *Hastings L.J.* 58 (1951).

¹⁴ See, e.g., *Norton v. City Bank & Trust Co.*, 294 F. 839, 845 (4th Cir. 1923); *Houghton Mifflin Co. v. Continental Ill. Nat'l Bank & Trust Co.*, 293 Ill. App. 423, 12 N.E.2d 714 (1938); *Chartered Bank v. American Trust Co.*, 263 N.Y.S.2d 53, 47 Misc. 2d 694 (Sup. Ct. 1965).

¹⁵ In an ordinary "forged indorsement" case under the U.N.I.A., the forged indorsement was not effective to pass any title to the instrument so that regardless of the good faith of the transferee, he would be liable to either the drawer or the real payee. See, e.g., *Los Angeles Inv. Co. v. Homes Sav. Bank*, 180 Cal. 601, 182 P. 293 (1919).

because the treasurer and not Employee was the person who made it "so payable" and the treasurer had no fraudulent intent.¹⁶ Thus the wording of section 9(3) allowed the employer the chance of recovery in many "padded payroll" instances and gave rise to much litigation.¹⁷ To alleviate the interpretative problems and to effectuate the policy of allocating the loss to the employer, the American Bankers' Association proposed an amendment to section 9(3) of the U.N.I.A. This amendment, adopted with slight variation by nineteen states,¹⁸ generally read as follows:

The instrument is payable to bearer—(3). When it is payable to the order of a fictitious or nonexisting *or living person not intended to have any interest in it* and such fact was known to the person making it so payable *or known to his employee or other agent who supplies the name of such payee*.¹⁹ (Emphasis added to show deviation from the U.N.I.A.)

If the hypothetical "padded payroll" case arose under the amended U.N.I.A., the instrument would become bearer paper and the employer would bear the loss. Thus the effect of the amendment to the U.N.I.A. was to increase the likelihood of a "padded payroll" transaction falling within the purview of the statute, and of the loss thereby being allocated to the drawer. But even under the U.N.I.A. as amended, courts, in order to reach a desired result, could construe the statute so that the instrument was not bearer paper.²⁰

¹⁶ Many cases were decided on the issue of who was the person "making it so payable" or the related situation in which the "payroll padding" employee was cosigner with an innocent party. E.g., *Hartford Accident & Indem. Co. v. Middletown Nat'l Bank*, 126 Conn. 179, 10 A.2d 604 (1939). *Home Indem. Co. v. State Bank*, 233 Iowa 103, 8 N.W.2d 757 (1943). A California case foreshadowed the amendment to § 9(3) of the U.N.I.A. by holding that where the actual signer of the checks could have no intention as to the payee's identity, the controlling intent was that of the person who within the scope of his authority affixed the payee's name. *Security-First Nat'l Bank v. Bank of America Nat'l Trust & Sav. Ass'n*, 22 Cal. 2d 154, 137 P.2d 452 (1943).

¹⁷ The meaning of "fictitious" has often been litigated. E.g., *Pennsylvania Co. v. Federal Reserve Bank*, 30 F. Supp. 982 (E.D. Pa. 1939); *Portland Postal Employees' Credit Union v. United States Nat'l Bank*, 171 Ore. 40, 62-63, 135 P.2d 467, 475-76 (1943). The issue of "knowledge" has also been a source of litigation. For example, one court held that the instrument in question could not become bearer paper unless the maker knew the payee to be fictitious and actually intended to make the paper payable to a fictitious person. *Swift & Co. v. Bankers Trust Co.*, 280 N.Y. 135, 139, 19 N.E.2d 992, 994 (1939).

¹⁸ The nineteen states are: Alabama, California, Florida, Georgia, Idaho, Illinois, Iowa, Louisiana, Massachusetts, Minnesota, Missouri, Montana, New Mexico, New York, North Carolina, Oregon, Utah, Virginia and West Virginia. The Utah amendment varied from the proposed amendment in that the words "in course of his employment" were used to modify "employer or other agent." The Missouri amendment included the words "or entitled" following the words "not intended." See 5 ULA § 9, 3 *Hastings L.J.* at 58 n.4 (1951).

¹⁹ Cal. Civil Code § 3090(3) (West 1954).

²⁰ The court in *Pacific Indem. Co. v. Security First Nat'l Bank*, 56 Cal. Rptr. 142 (Ct. App. 1967), held that checks which the employee caused to be payable to the defendant bank as a part of a scheme to have the funds credited to his account were not to be considered bearer paper. The court reached its decision by construing the "no interest in it" portion of the statute to mean that the payee was not to gain possession of the instrument. Since the payee bank in this case did gain possession of the checks, they were

The Uniform Commercial Code, although specifically repealing the U.N.I.A.,²¹ basically adopts the pre-Code policy in "padded payroll" situations. Comment 4 to section 3-405 of the Code states that "the loss should fall upon the employer as a risk of his business enterprise rather than upon the subsequent holder or drawee." Although the underlying policy remains the same, the method by which the policy is effectuated is different.

The Code rejects the "bearer paper" approach²² and replaces it with an "effective indorsement" approach. The applicable provision, section 3-405(1) (c), states that: "(1) An indorsement in the name of a named payee is *effective* if . . . (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest." (Emphasis added.) Although intended by the draftsmen to cover "padded payroll" situations, the section neither defines "effective" nor delineates how and to what degree an "effective" indorsement imposes the loss on the employer. To answer these questions requires an examination of the policy of the Code in regard to "padded payroll" cases and an analysis of the several sections which affect the rights and liabilities of the parties to a "padded payroll" transaction.

Basic to the Code's policy is the idea that allocation of the loss to the employer is practical and equitable.²³ The Code comments explain this allocation:

The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or if he is not, is at least in a better position to cover the loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.²⁴

not considered to be bearer paper. *Id.* at 151-53. In this case the payee bank (defendant) was obviously negligent and the employee's scheme was dependent upon the bank's employees negligently allowing the employee to credit checks, made payable to the bank for another purpose, to his personal account.

²¹ U.C.C. § 10-102.

²² See U.C.C. § 3-405, Comment 1.

²³ It has been proposed that the allocation of loss in a "padded payroll" case should be based on four considerations: promotion of transferability; placing the loss on the best risk bearer; placing the loss on the negligent party; and uniformity of result in application of the preceding standards. Comment, Allocation of Losses from Check Forgeries under the Law of Negotiable Instruments and the Uniform Commercial Code, 62 Yale L.J. 417, 433-34 (1953). In light of these four considerations, it has been further proposed that when no party has been negligent, the loss should be allocated to the drawee-bank rather than the drawer-employer because the drawee is in the better position to distribute the loss by allowing for it as part of its operating expense, thereby passing the cost on to its customers. *Id.* at 474. The Code rejected the allocation of loss to the drawee for the reasons enumerated in Comment 4 to § 3-405. As Professor Sutherland stated in justifying the allocation of the loss to the employer: "Ultimately the question is whether the cost of insuring shall rest on customers of the bank or customers of the employer-depositor, and in the long run and over-all, these will probably be the same people." Sutherland, Article 3—Logic, Experience and Negotiable Paper, 1952 Wis. L. Rev. 230, 244.

²⁴ U.C.C. § 3-405, Comment 4.

This comment seems to imply that the imposition of the loss on the employer is virtually absolute when the facts of the case are governed by section 3-405(1)(c).

An absolute imposition of loss on the employer was not the intention of the earliest draftsmen of the Code. The following section, which is the forerunner of present Code section 3-405(1)(c), appeared as section 3-404(1)(c) of the 1949 proposed draft and as section 3-405(1)(c) of the 1950 proposed draft:

(1) With respect to a holder in due course or a person paying the instrument in good faith an indorsement is effective when made in the name of the specified payee by any of the following persons, or their agents or confederates:

. . .

(c) an agent or employee of the drawer who has supplied him with the name of the payee intending the latter to have no such interest.

Comment 4 to this section in the 1950 draft stated, "the principle followed is that the loss should fall upon the employer as a risk of his business enterprise rather than upon the *innocent holder in due course or drawee*." (Emphasis added.) In the 1952 draft, the first official draft, section 3-405(1)(c) appeared in its present form except that words "maker or" did not appear before "drawer" in subsection (c). Comment 4 also appeared in its present form: "[T]he loss should fall upon the employer as a risk of his business enterprise rather than upon the *subsequent holder or drawee*." (Emphasis added.)

In adopting this change from "innocent holder in due course or drawee" to "subsequent holder or drawee," the draftsmen of the Code manifested an intent to extend the degree to which an employer would absorb the loss. In order to prevail against the employer under the proposed drafts, a party had to be an innocent holder in due course or an innocent drawee bank. The distinction between a holder in due course and a holder is clearly defined throughout Article 3 of the Code. In essence, holders in due course are only those holders who have given good faith payment without notice of any irregularity.²⁵ A holder under the Code is merely a party who is in possession of an instrument drawn, issued or indorsed to him, to his order, to bearer or in blank.²⁶ Therefore, the change in section 3-405(1)(c),²⁷ extending

²⁵ U.C.C. § 3-302(1).

²⁶ U.C.C. § 1-201(20).

²⁷ The wording of the original section 3-405(1)(c) was defective because it limited the parties by whom an effective indorsement could be made. Therefore, in making the language of the section more general, the draftsmen corrected a fault in the earlier draft because according to the earlier draft if someone had stolen the check from the employee and transferred it to a good faith taker, this taker would not have been protected from the employer. As the good faith taker was being protected because the employer's loss was caused by the action of the employee, it was illogical to remove this protection simply because it was not the employee or his agent or confederate who actually indorsed the check to him. This correction dealt only with the wording of the last part of subsection (1) and is not related to the policy change which was also manifested when the section was rewritten.

protection to holders, broadens the scope of immunity from the employer, ostensibly to the point of imposing an absolute loss on him. Because it is conceivable that a party in a "padded payroll" case could prevent the loss by acting with a minimum of prudence,²⁸ the advisability of imposing an absolute loss on the employer is debatable. Before considering this question, however, it is necessary to trace a "padded payroll" transaction through the Code to see how and if in fact the loss is absolutely allocated to the employer when, in relation to the hypothetical "padded payroll" case, the company stops payment on the check, or the company initiates an action to recover the money charged against its account by the drawee bank.

If the company stops payment on the check, then all the provisional credits established throughout the clearing system would be erased when the drawee bank refuses to honor the check.²⁹ Thus no money would be credited to the shopkeeper's account by his depository bank and the shopkeeper, assuming that the employee could not be found, will bring an action to enforce payment against the company. If the Code's enunciated policy is to be fulfilled, the shopkeeper³⁰ should be able successfully to enforce payment against the company.

Under Code section 3-301, a party must have at least the status of holder in order to enforce payment on an instrument.³¹ The Code defines a holder as a "person who is in possession of a document of title or an instrument or an investment security drawn, issued or *indorsed* to him or to his order or to bearer or in blank."³² (Emphasis added.) The process by which an instrument is normally transferred so that a taker becomes a holder is called "negotiation." Section 3-202(1) states that: "Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary indorsement. . . ." Section 3-202(2), in addition, states that: "An indorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof." In relation to the "padded payroll" hypothetical, the indorsement necessary for "negotiation" is that of Payee. Section 3-405 has circumvented this requirement by making Employee's indorsement in Payee's name "effective." Therefore, an "effective" indorsement by Employee is one which is capable of fulfilling the negotiation requirements,³³ and of allowing a taker from Employee to be-

²⁸ It was the plaintiff's contention in *Pacific Indem. Co. v. Security First Nat'l Bank*, 56 Cal. Rptr. 142 (Ct. App. 1967) that if the defendant bank had abided by the standard of care which it had established for itself the loss would have been avoided.

²⁹ See notes 6 & 7 *supra*.

³⁰ The shopkeeper here is representative of any party in a "padded payroll" situation who has given value for the check and either has had his provisional credit removed or has been compelled to return the money he received to his transferee when the drawer stopped payment on the check.

³¹ The action by the shopkeeper against the employer would be based upon U.C.C. § 3-413(2), which provides that the drawer engages upon dishonor he will pay the amount of the draft to the holder or any subsequent indorser.

³² U.C.C. § 1-201(20).

³³ It has been suggested that the employee's indorsement should be considered "effective" so as to pass title. Britton, *Defenses, Claims of Ownership and Equities—A Comparison of the Provisions of the Negotiable Instruments Law with Corresponding*

come a holder. Because a holder is able to enforce payment on an instrument,³⁴ and because comment 4 to section 3-405 states that the purpose of that section is to protect "the subsequent holder or drawee," the problem of the stop payment situation seems to be easily solved.

However, because a holder of an instrument takes it subject to certain defenses,³⁵ it may be argued that only a holder in due course is able to enforce payment against the drawer. A holder in due course, according to section 3-302(1) is a holder "who takes the instrument for (a) value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." A holder in due course takes the instrument free from all defenses of any party with whom he has not dealt except for infancy, other incapacity, duress, illegality, misrepresentation which induced the party to sign the instrument, and discharge in insolvency.³⁶ In the hypothetical "padded payroll" case the shopkeeper would be a holder in due course. He would be able to enforce payment against the drawer³⁷ because none of the defenses available against a holder in due course apply to the hypothetical situation.³⁸

However, the hypothetical "padded payroll" case could be modified so that the shopkeeper does not achieve the status of holder in due course. Suppose that the shopkeeper knows Peter Payee, a real person, and that they had done business before by check so that the proprietor is familiar with Payee's signature. The indorsement by Employee in the name of Payee bears no resemblance to Payee's true signature. According to the Code, the shopkeeper would be placed on "notice"³⁹ and thus would not be able to take the instrument as a holder in due course,⁴⁰ but would take the instrument as a

Provisions of Article 3 of the Proposed Commercial Code, 7 *Hastings L.J.* 1, 30 (1955). The concept of passing title to the instrument is a further explanation of what occurs when a "negotiation" takes place. "Negotiation takes effect only when the indorsement is made and until that time there is no presumption that the transferee is the owner." U.C.C. § 3-201(3).

³⁴ U.C.C. §§ 3-301, -413.

³⁵ See U.C.C. § 3-306.

³⁶ U.C.C. § 3-305.

³⁷ See U.C.C. § 3-413.

³⁸ The subsequent parties in the hypothetical case have acted in good faith without notice of claims or defenses and have given value for the instrument by granting credit for it. They are, therefore, holders in due course, U.C.C. § 3-302, or, in the case of the drawee, able to subrogate to the rights of a holder in due course, U.C.C. § 4-407(a).

³⁹ U.C.C. § 1-201(25) defines "notice."

A person has "notice" of a fact when

(a) he has actual knowledge of it; or
(b) he has received a notice or notification of it; or
(c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists.

"Notice" is also defined by § 3-304(1)(a):

The purchaser has notice of a claim or defense if

(a) the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay

⁴⁰ See U.C.C. § 3-302(1)(c).

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mere holder. Section 3-306 states that a party, who is not a holder in due course, takes the instrument subject to certain defenses, including:

- (d) the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to such holder would be inconsistent with the terms of a restrictive indorsement. The claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party.

A holder, attempting to enforce payment against the company, might be challenged by the defense that a holder takes subject to section 3-306(d). In considering this defense, the issue which ultimately determines if the holder will prevail is whether "he or a person through whom he holds acquired the instrument by theft." The term "theft" is not defined in the Code. Applying various common law definitions of "theft" to the hypothetical case does not establish whether the check in this case was acquired by "theft."⁴¹ If the instrument were so acquired, then the company, by asserting section 3-306(d), has a valid defense against the holder. If the instrument were not "acquired by theft," then the holder is able to enforce payment against the company.

In summary, if a stop payment situation arises in a "padded payroll" case, a holder in due course under the Code will undoubtedly be able to enforce payment against the drawer. In contrast, it is questionable whether a holder, who is not a holder in due course, is able to enforce payment against the drawer. In light of comment 4 to section 3-405, which states that the loss should fall upon the drawer rather than "upon the subsequent holder or drawee" (Emphasis added.), a holder should be able to prevail. The language of the several Code sections discussed above fails, however, to show conclusively that a holder will always prevail against the drawer in a stop payment situation in a "padded payroll" case.

If, in the "padded payroll" case, there were no stop payment ordered and the check had been cleared and charged against the drawer's account by the drawee bank, then it would be the company that would initiate the action in order to shift the loss. The only action which the company could bring under Article 3 of the Code would be an action in conversion. Section 3-419-(1)(c) states that: "An instrument is converted when it is paid on a forged indorsement." At this point section 3-405(1)(c) and the concept of "effective" indorsement again become crucial. If section 3-405 is interpreted to

⁴¹ The courts do not agree as to what the term "theft" encompasses. It has been stated that: "Ordinarily theft is the felonious taking of the property of another without his consent with intent to deprive him thereof [and] . . . includes larceny, embezzlement, obtaining money by false pretences and kindred offenses. . . ." *People v. Goodman*, 159 Cal. App. 2d 54, 61, 323 P.2d 536, 541 (1958). On the other hand, it has been stated that "It is generally held that theft and embezzlement are distinct and separate crimes. . . . The distinction between them seems to be that whereas theft is the fraudulent taking of property with intent to appropriate it, embezzlement is the fraudulent appropriation of another's property by a person to whom it has been intrusted." *Great Nat'l Lloyds v. Hall*, 265 S.W.2d 875, 879 (Tex. Civ. App. 1954).

mean that the indorsement should be treated as if actually made by the named payee, then this avenue of recovery is closed to the drawer, since his action in conversion is based on the *forged* indorsement. One of the few cases that has been considered under any subsection of section 3-405, and the only case which considered this particular problem, proposed that the indorsement retains its forged character.⁴²

However, even if the indorsement remains a forgery for the purpose of section 3-419(1)(c), there is still the question of whether the drawer of an instrument could proceed in an action in conversion. The authorities are "hopelessly divided" on this question.⁴³ The action in conversion, if allowed, could be brought directly against a transferee of the employee. This one action would eliminate the two steps otherwise required: (1) the company's proceeding against the drawee;⁴⁴ and (2) if the company prevails, the drawee's proceeding against its transferor.⁴⁵ Thus the argument for allowing the action in conversion is based on the principle of judicial economy.⁴⁶ The argument against allowing the action rests on the property concept that a drawer does not have the requisite interest in an instrument to sustain an action in conversion, and, in the context of the Code, on the more important consideration of the lack of availability of defenses.⁴⁷

If the drawer were allowed to proceed with an action in conversion based on section 3-419(1)(c) it is obvious that, if the policy of the Code is to be effectuated, there must be found within the Code a viable defense for the transferees of the employee. Apparently the only defense which could be raised under Article 3 is that of discharge of liability by payment. Section 3-603(1) states that the "liability of any party is discharged to the extent of his payment." This discharge of liability is limited in that it does not extend to a "party who in bad faith pays or satisfies a holder who acquired the instrument by theft or who (unless having the rights of a holder in due course) holds through one who so acquired it. . . ."⁴⁸ The wording of sub-

⁴² See *First Pa. Banking & Trust Co. v. Montgomery County Bank & Trust Co.*, 29 Pa. D. & C.2d 596, 600 (Montgomery County Ct. 1962).

⁴³ See *Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co.*, 345 Mass. 1, 7-8, 184 N.E.2d 358, 362 (1962).

⁴⁴ The basis of an action by the company against the drawee is that the check was not "properly payable." See U.C.C. § 4-401(1).

⁴⁵ The drawee bank may proceed against its transferor on the basis of the warranties established by the Code. See U.C.C. § 4-207(1). The transferor of the drawee may proceed against its transferor under U.C.C. § 4-207(2). More general warranties which are also relevant to the reallocation of the loss in this situation are established by U.C.C. § 3-417(1) and § 3-417(2). See also U.C.C. § 3-417, Comments 3, 8. The loss may also be reallocated according to the contract of the indorser. See U.C.C. § 3-414. In terms of the "padded payroll" hypothetical these warranties and contracts mean that if the employer prevails against the drawee, the loss will be shifted up the chain of indorsements until the loss in theory reaches the employee. See U.C.C. §§ 3-404, -414. As Employee is unable to pay or not to be found, the loss would fall upon his first transferee, the shopkeeper.

⁴⁶ *Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co.*, 345 Mass. 1, 8, 184 N.E.2d 358, 362-63 (1962).

⁴⁷ *Id.* at 10, 184 N.E.2d at 363.

⁴⁸ U.C.C. § 3-603(1)(a).

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section 1(a) is ambiguous.⁴⁹ The major problem which arises, however, is that although the wording of section 3-603 seems to apply as an answer to an action in conversion, it is doubtful that the draftsmen intended this section to apply to "padded payroll" cases. The section is concerned with discharge of liability by payment to *holders*, and as the employee in the "padded payroll" hypothetical is not a holder, this section is not properly applicable.⁵⁰ Moreover, the defense of discharge of liability by payment is one which is usually reserved to a drawee bank or a party who is discharging a contractual obligation.⁵¹ If the defense of section 3-603 is not available to the transferees of the employee in a "padded payroll" situation, the policy of the Code can only be effectuated by denying the employer the right to proceed against the transferees of the employee in conversion. Denying the employer this right of action does not leave him with an absolute loss but does compel him to proceed only against the drawee bank.

The employer's action against the drawee bank would be based on the assertion that the drawee, by paying upon an instrument which carried a forged indorsement, charged the employer's account with an item that was not "properly payable."⁵² The only answer that the drawee bank can formulate is that the indorsement is "effective" under section 3-405, that the check has been paid in good faith and with ordinary care,⁵³ and that therefore the item is "properly payable" and the drawee is entitled to charge the drawer-customer's account.⁵⁴ The outcome of the action between the company and the drawee will conclusively determine who bears the loss. If the company fails in its action against the drawee, it bears the loss. However, if the company prevails, then the loss will be allocated not to the drawee but to the first transferee of the employee because of the chain of warranties clearly

⁴⁹ Seemingly there are two categories of parties who are not discharged. The first is the bad faith party who pays or satisfies one who has acquired the instrument by "theft." In terms of the "padded payroll" hypothetical (assuming *arguendo* that the instrument were "acquired by theft") this party would be the shopkeeper who had knowledge or notice that Employee had acquired the instrument by "theft." The second category is the non-holder in due course who holds the instrument through "one who so acquired it." If "one who so acquired it" refers to the thief himself (Employee), then this category amplifies the first by stating that the shopkeeper must be a holder in due course in order to discharge his liability by payment. Therefore, if § 3-603 were to be applied and if the instrument were considered to be "acquired by theft," then it could be argued that payment would discharge the liability of a holder in due course only. On the other hand, "who holds through one who so acquired it" may be interpreted to refer to the recipient of the payment. Thus, in the hypothetical case, if the shopkeeper were not a holder in due course, and the depository bank paid him in bad faith, the bank could not be discharged.

⁵⁰ Employee in this case is not a holder because the check in the "padded payroll" hypothetical was not "drawn, issued or indorsed to him" and was not a bearer instrument. See U.C.C. § 1-201(20). The reference in § 3-603 to a "holder who acquired the instrument by theft" can only logically refer to a person who has stolen a bearer instrument. For the Code's definitions of bearer instruments see U.C.C. §§ 3-111, -204(2).

⁵¹ See U.C.C. § 3-603, Comment 3; W. Willier & F. Hart, *Forms and Procedures* under the U.C.C. ¶¶ 42.09[2], .10[2] (1966).

⁵² U.C.C. § 4-401(1).

⁵³ See U.C.C. § 4-103(1).

⁵⁴ See U.C.C. § 4-401; *id.*, Comments 1, 2.

established by the Code.⁵⁵ In order that the policy of the Code, the protection of the "subsequent holder or drawee," be effectuated, the action against the drawee bank by the drawer-employer must fail.

The avowed policy of the Code is that in a "padded payroll" situation the employer should bear the loss. The comment to the Code implies that this loss should be absolute. Tracing a "padded payroll" case through the Code has revealed that it is doubtful that the Code sections which apply to "padded payroll" cases effectuate this absolute imposition of loss. The basic question remains what does an "effective" indorsement mean in terms of section 3-405(1)(c) and the treatment of "padded payroll" cases by the Code? Other questions raised are: Is the indorsement a forgery; is the instrument "acquired by theft;" and what are the available and applicable actions and defenses? In the stop payment situation, if the instrument were considered "acquired by theft," then the employer would defend successfully against a holder, while he definitely would not successfully defend against a holder in due course. If the company were to initiate the action, whether the indorsement is a forgery for the purpose of section 3-419(1)(c) and whether the drawer may proceed in an action in conversion are the first questions to be considered. If the action in conversion were allowed, the employee's transferees would be left with no viable defense under the Code. If the action by the employer were limited to the drawee bank, the basis of the drawee's defense would have to be section 3-405(1)(c), the concept of "effective" indorsement.

It is submitted, however, that this policy of imposing an absolute loss on the employer is in itself undesirable because it disregards the distinctions between holder and holder in due course which are so clearly and explicitly established by Article 3 of the Code. Any party in a "padded payroll" case worthy of protection from the employer would be a holder in due course. Anyone who pays the instrument knowing or with notice⁵⁶ that it carries a forged indorsement deserves to bear the loss when compared with the relative innocence of the defrauded employer. A problem arises when considering a negligent party. The Code in several sections of Articles 3 and 4 alludes to standards of care and the burden which will be placed on a negligent party.⁵⁷ None of the "negligence" sections applies directly to a transferee of the employee in "padded payroll" cases. But if the distinction between holder and holder in due course is preserved in "padded payroll" cases, as it should be, then a negligent party should be liable to the employer if his negligence is great enough to place him on notice and thus to prevent him from becoming a holder in due course.

A second important concern regarding the application of section 3-405(1)(c) to "padded payroll" cases is that ultimately one cannot be sure of what section 3-405(1)(c) does. Its inability to provide "that certainty

⁵⁵ See note 45 *supra*.

⁵⁶ See note 39 *supra*.

⁵⁷ The Code prescribes a standard of ordinary care for banks in their general business activities, U.C.C. §§ 4-103(1), (3), and in the collection process, U.C.C. § 4-202(1). A party's negligence, which contributes to the alteration of an instrument or to an unauthorized signature, may bar him from recovery, U.C.C. § 3-406.

which is the predominant need of the law of commerce"⁵⁸ is its greatest failure. The section has thus far been mentioned in the decisions of three cases. In *Pacific Indem. Co. v. Security First Nat'l Bank*⁵⁹ the issue was not properly governed by section 3-405(1)(c) because the named payee actually indorsed the check. In *Thompson Maple Prods. v. Citizens Nat'l Bank*,⁶⁰ the trial court found a fact situation which probably should have been decided under section 3-405(1)(c), but failed to so decide the case. The Pennsylvania Superior Court made proper reference to section 3-405(1)(c) in a footnote but, as it was affirming the decision, did not change the findings of the trial court. In *May Dep't Stores Co. v. Pittsburgh Nat'l Bank*,⁶¹ the Court of Appeals for the Third Circuit upheld in a per curiam decision a summary judgment against an employer who had brought an action against its drawee bank which had cashed a check on the indorsement of an employee in a "padded payroll" type of situation. The decision was based on section 3-405(1)(c) but no explanation of how the court solved the problem was given. Thus of the three courts mentioning section 3-405(1)(c), one discussed it in detail without noting that it was inapplicable to the fact situation; one found that the fact situation may have warranted application of section 3-405(1)(c) but allowed the judgment of the trial court, which was based on other sections, to stand; and one applied the section without any manifest awareness of the complexity of the problem.

It is suggested that certain changes be incorporated in section 3-405 of the Code. The distinction between holders and holders in due course should be explicitly preserved and the implication of absolute loss to the employer in a "padded payroll" situation should be eliminated. This change could be accomplished by rewriting subsection (1) to read: "With respect to a holder in due course or a person paying the instrument in good faith an indorsement by any person in the name of a named payee is effective if . . ." The comment to the subsection should be rewritten to explain how the "effective" indorsement would allocate the loss to the employer in the proper circumstances. The draftsmen should also enumerate what actions and defenses are available to the employer and to the transferees of the employee. In so doing, the draftsmen should state whether the instrument is to be considered "acquired by theft" and whether the indorsement should be considered to retain its forged character. These changes, if effectuated, would promote a more equitable allocation of loss and would clearly provide for the application of section 3-405(1)(c) to particular fact situations.

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⁵⁸ Sutherland, *supra* note 23, at 245.

⁵⁹ 56 Cal. Rptr. 142 (Ct. App. 1967).

⁶⁰ 234 A.2d 32 (Pa. Super. Ct. 1967). The trial court characterized the individual who caused the "padded payroll" situation as an agent of the plaintiff but failed to apply § 3-405(1)(c). The Superior Court, although recognizing this inconsistency, *id.* at 36 n.5, did not disturb the findings of the lower court because it was affirming the judgment against the plaintiff.

⁶¹ 374 F.2d 109 (3d Cir. 1967).