

UCC DEPOSIT LAW NOTES

A Monthly Review
of the Operations of
Banks, Thrifts
and Credit Unions

Defense to a Payor Bank's Liability for Late Returns

As a rule, a depository bank cannot avoid liability to a payor bank when it cashes or accepts a check for deposit over the payee's forged or missing endorsement by claiming that the payor bank failed to return the item by its midnight deadline.

As a rule, a payor bank must exercise extreme caution when a customer's check is presented for payment. The bank must either pay the check or return it by its midnight deadline (Revised UCC § 4-301). The midnight deadline is midnight of the banking day following the banking day the check is presented for payment (Revised UCC § 4-104(10)). So, if a check is presented for payment on Monday, the payor bank must either pay it or return it by midnight Tuesday.

Late Returns

The consequences resulting from the late return of an item are severe. Normally the payor bank will be required to pay the entire amount of the check to the holder whether or not it is properly payable. For instance, even if a check is drawn on insufficient funds, a payor bank will still have to pay it if it is not returned by the midnight deadline.

Without this rule of accountability, an element of uncertainty would exist in the check collection process concerning when a payor bank has finally paid a check. With this rule of accountability, banks and other holders of checks know that after the deadline has expired checks will be paid contributing to the stability of the check collection process and upholding the value of a check as a meaningful substitute for money.

Defenses to Late Return Claims

Nevertheless, not all late returns lead to loss. One of the most common situations creating a defense to a late return claim is

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when a check has been paid over the payee's forged or missing endorsement. Under these circumstances, the UCC places the ultimate liability for the loss on the depository bank. This is because the depository bank warrants to the payor bank at the time it transfers a check for payment that it has good title to the item. In essence, the depository bank warrants to the payor bank that the check does not bear any forged or unauthorized endorsements.

Typically, forged or missing endorsement claims arise long after the forged check was presented to the payor bank for payment. Under these circumstances, the depository bank may attempt to avoid liability on a breach of warranty claim by asserting that the forged check was returned for refund after the payor bank's midnight deadline expired, thus making the payor bank accountable for the item.

However, under the UCC, a payor bank is not subject to the depository bank's late return claim when the check in issue contains a missing or forged endorsement. Specifically, the UCC states that the liability of a payor bank to pay an item that has been returned after the midnight deadline has expired is subject to defenses based upon breach of warranty of good title or proof that the person seeking enforcement of the late return liability presented or transferred the item for the purpose of defrauding the bank (Revised UCC § 4-302(b)).

Put another way, a payor bank's liability for a late return is extinguished if the check in question bears a forged or missing endorsement. As illustrated in the following recently decided case, the liability for the forged check in this situation falls upon the depository bank.

First National Bank & Trust Co. of the Treasure Coast v. Belmont National Bank

THE FACTS. Clifford Lowe borrowed money from Belmont National Bank to purchase a vehicle from Heritage R.V. Center, Inc. Part of the loan was to be used to pay off the liens on the new vehicle and an old vehicle Lowe used as a trade-in. On April 7, Belmont National Bank issued a check for \$68,000 payable to the joint order of "Heritage and Mr. Lowe." and mailed the check to Heritage.

Heritage endorsed the check in its name and then deposited the item into its checking account at First National Bank. Despite the fact that the check was missing Mr. Lowe's endorsement, First National processed the check for payment and permitted Heritage to draw on the deposited funds. On April 17, Belmont National Bank received the check.

On May 17, Heritage delivered the vehicle to Mr. Lowe and took possession of the trade-in. However, Heritage failed to pay off the lienholders of both the new and trade-in vehicles. On May 29, Heritage filed for bankruptcy.

When Belmont National failed to receive the title to the new vehicle pledged as security for the loan, it initiated an investigation and discovered that Heritage had gone bankrupt and that Mr. Lowe had never endorsed the loan check. On June 6, Belmont National returned the check with Mr. Lowe's missing endorsement to First National. First National again presented the check for payment and Belmont National again returned it. First National then attempted to recover the funds from Heritage's account, but the account balance had been withdrawn.

In the meantime, Belmont National disbursed the loan proceeds to pay off the lienholders of the new and trade-in vehicles. First National then sued Belmont National to recover its \$68,000 loss on the check. The trial court entered judg-

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ment in favor of Belmont National and First National appealed the ruling.

THE ARGUMENTS. First National argued that Belmont National is absolutely accountable for the check since it failed to return it by its midnight deadline, which expired at midnight on April 18, the day after the check was presented for payment. Belmont National countered that it is not liable to pay a check returned after its midnight deadline if the check is returned because it bears the payee's missing or forged endorsement.

THE COURT DECISION. The Court first noted that, as a general rule, a payor bank is accountable for the amount of a presented check, whether properly payable or not, if the bank retains the check beyond midnight of the banking day of receipt without settling for it or does not pay or return the item or send notice of its dishonor until after its midnight deadline. It also stated that the midnight deadline is midnight of the banking day following the banking day on which the bank receives the check.

The Court then observed that an exception to a payor bank's liability for the late return of a check arises when the item bears a payee's forged or missing endorsement. It pointed out that under these circumstances, the depository bank has breached its warranty of good title and such breach provides a defense to any late return claim.

Accordingly, the Court ruled that the trial court properly held that First National's cause of action for Belmont National Bank's violation of the midnight deadline was barred by Belmont National's defense based on First National's breach of its warranty of good title. *First National Bank & Trust Co. of the Treasure Coast v. Belmont National Bank*, 43 UCC Rep Serv 2d 666 (OH 2001).

Protection Points

As a rule, a depository bank cannot avoid liability to a payor bank when it cashes or accepts a check for deposit over the payee's forged or missing endorsement by claiming that the payor bank failed to return the item by its midnight deadline. Under the UCC, a payor bank has three years to assert a breach of warranty claim against the depository bank after the payor bank has reason to know of the breach (Revised UCC § 4-208(f)). ♦

Depository Bank Liable to Drawee Bank for a Check Altered in the Amount of \$249,750

As a rule, a depository bank is liable to the drawee bank for an altered check that it has cashed or accepted for deposit.

As previously noted, when a depository bank accepts a check for deposit into its customer's account that is drawn on another bank, it makes certain warranties to the drawee bank about the check when it is transferred for payment. Specifically, under the UCC, the depository bank warrants to the drawee bank at the time a check is transferred for collection that:

- the depository bank has good title to the instrument, which means that it does not bear the payee's forged or missing endorsement;
- the instrument has not been altered; and
- the depository bank has no knowledge that the signature of the drawer of the check is unauthorized (Revised UCC § 4-208(a)).

If it turns out that any one of these warranties is not true, then the drawee bank may recover damages for breach of warranty from the depository bank up to the amount of the check. In addition, the drawee bank is entitled to compensation for expenses and loss of interest resulting from the breach (Revised UCC § 4-208(b)).

A depository bank may resist or defend against a breach of warranty claim under several circumstances. One of those circumstances arises if the drawer of the check has failed to exercise ordinary care in preparing the check and such failure has substantially contributed to an unauthorized endorsement or alteration.

For instance, suppose a company writes a check for \$10. The figure "10" and the word "ten" are written in the appropriate places on the check, however, a large space is left after both the figure and the word. The payee of the check, using a typewriter with a type face similar to that used on the

check, types the word “thousand” after the word “ten” and a comma and three zeros after the figure “10.” The drawee bank then pays the check and debits the drawer’s account for \$10,000.

In this situation, a judge or jury could find that the drawer of the check was careless in writing the check by leaving the spaces and that such carelessness substantially contributed to the alteration. In that case, the drawer would be precluded from asserting the alteration against the drawee bank and, thus, the drawee bank would not have to assert a warranty claim against the depository bank.

The following recently decided case illustrates the circumstances under which a depository bank is liable to a drawee bank based upon the breach of the depository bank’s warranty that an item it transferred to the drawee bank for payment was not altered.

HSBC Bank USA v. F&M Bank

THE FACTS. Donald Lynch purchased a check from Allied Irish Bank. The check was made payable to Advance Marketing and Investment, Inc. for \$250.00. The manner in which the check was drawn by AIB left less than one-half inch of open space in the numerical portion of the item and one inch of open space in the written portion of the item. The check was drawn on AIB’s account with HSBC Bank.

Before the check was deposited into AMI’s account at F&M Bank, the amount was altered from \$250.00 to \$250,000.00 by adding three zeros and changing the period to a comma in the numerical portion of the check and adding the letters “Thoud” in the written portion.

F&M Bank presented the check to HSBC Bank for payment. HSBC honored the check for \$250,000. HSBC was subsequently advised by AIB of the unauthorized alteration of the check. HSBC recredited AIB’s account for the altered amount and then sued F&M Bank to recover its loss. The trial court entered judgment in favor of HSBC and F&M Bank appealed the ruling.

THE ARGUMENTS. HSBC argued that F&M Bank breached its presentment warranty that the item was not altered and, thus, is obligated to refund to HSBC \$249,750, the amount of the alteration, plus

interest. F&M countered that, although the item was altered, it is not liable for breach of warranty since AIB failed to exercise ordinary care in preparing the check and such failure substantially contributed to the alteration of the check.

THE COURT DECISION. The Court first noted that there is no question that F&M breached its presentment warranty that the check in question was not altered. It stated that the only issue before it is whether F&M’s affirmative defense that AIB failed to exercise ordinary care in preparing the check by leaving the open spaces as it did in the numerical and written portions of the check is supported by the evidence and, thus, exonerates F&M from liability.

The Court then pointed out that the only evidence submitted by F&M in support of its burden of proving that AIB failed to exercise ordinary care in making out the check was the check itself. It observed that the trial court physically examined the check, including the less than one-half inch of open space in the numerical portion of the check and the one-inch of open space in the written portion of the check. Based upon this examination, the trial court found that AIB had filled in the open spaces of the check sufficiently such that any alteration that was made was obvious. Accordingly, the trial court found that AIB had exercised ordinary care in writing the check.

The Court next stated that its review of the check leads it to agree with the trial court’s finding that AIB exercised ordinary care in drawing the check was. . . . It noted that it finds sound logic in the trial court’s rationale that, if the written portion of the check contained enough writing so that the check’s alteration could only be accomplished with the “scrawled up,” abbreviated form of the word “thousand,” ordinary care was exercised in making out the check. Accordingly, the Court upheld the judgment of the trial court in favor of HSBC, the drawee bank. *HSBC Bank USA v. F&M Bank*, Case No. 00-2052 (VA 2001).

Protection Points

Under the UCC not only does a depository bank warrant to the drawee bank that it has good title to a check it transfers for payment, but it also warrants to the drawee bank that the check has not

been altered. If the depository bank breaches either one of these warranties, then, absent a defense, it is liable to the drawee bank for the item together with compensation for expenses and loss of interest resulting from the breach. ♦

Charge Back Permitted Despite Delay in Notifying Customer

A bank's right to charge back a credit given for a dishonored item is not extinguished by either the bank's action in permitting its customer to withdraw the credit or its failure to timely notify its customer of the dishonor.

Under the Uniform Commercial Code, a depository bank has the right to charge back to its customer's account the credit given for a deposited item that has been returned unpaid (Revised UCC § 4-214). Thus, if a customer deposits a check for \$900 that is dishonored by the drawee bank, the depository bank may deduct or charge back the \$900 credit given for the check from its customer's account.

Notice to the Depositor

A depository bank is not exposed to liability when it charges back a dishonored item to its customer's account as long as it returns the item or notifies its customer of the dishonor by its midnight deadline. Under the UCC the midnight deadline is defined as midnight on its next banking day following the banking day on which it receives the relevant item (Revised UCC § 4-104(10)).

This means that, if a bank receives the dishonored check on Wednesday, it must return the item to its customer or notify the customer of the facts surrounding the dishonor by midnight Thursday. Under the UCC, an item is returned when it is sent to the customer. Moreover, an item or notification is sent when it is deposited in the mail or delivered for transmission by any other usual means of communication (Revised UCC § 1-201(38)).

Delay in Notice

Even if the depository bank fails to act by its midnight deadline, it may still charge back the dishonored item to its customer's account. However, under these circumstances, the depository bank will be liable to its customer for any loss resulting from the delay (Revised UCC § 4-214(a)). The amount of damages that can be recovered from a depository bank under these circumstances is the amount of the item reduced by an amount that could not have been recovered even if the bank had properly notified its customer of the dishonor. In other words, the depositor must prove that he or she could have recovered all or part of the dishonored item if timely notice had been given, but that the delay in notice now prevents this recovery.

Withdrawal of the Credit

In addition, the fact that a customer is permitted to withdraw a credit received for a deposited item that is subsequently dishonored by the payor bank, does not extinguish a depository bank's right to charge back the amount of the returned item to its customer's account. This is because the UCC explicitly states that the right to charge back is not affected by the previous use of a credit given for an item (Revised UCC § 4-214(d)).

The following recently decided case illustrates a depository bank's right to charge back a returned item against its depositor's account even though it allowed its customer to withdraw the credit given for the item and then failed to timely notify its customer of the return.

Chitty v. Bank One

THE FACTS. In November 1998, Terry Chitty sold a racing car engine. In payment for the engine he received an item purporting to be a cashier's check drawn on Harris Trust and Savings Bank for \$22,000. On November 7, 1998, Chitty deposited the check into his savings account with Bank One. On November 9, 1998, Bank One forwarded the cashier's check to Harris Bank for payment. Chitty then withdrew the funds from his savings account before Bank One received notice of dishonor of the cashier's check from Harris Bank on November 12, 1998.

After learning of the dishonor, Bank One charged back the \$22,000 credit given for the deposited item against an \$8,000 balance in Chitty's savings account leaving an overdraft of \$14,000. Bank One failed to notify Chitty of the charge back within its midnight deadline.

Chitty then sued Bank One to reverse the charge back. In response, Bank One filed a counterclaim against Chitty for the \$14,000 it had been unable to recover from his account. The trial court entered judgment in favor of the Bank and Chitty appealed the ruling.

THE ARGUMENTS. Chitty first argued that since Bank One permitted him to withdraw the amount credited to his account by issuing a Bank One cashier's check, it is precluded from charging back the dishonored item to his account. Furthermore, Chitty asserted that, since he did not receive timely notice from Bank One that Harris Bank had dishonored payment of its cashier's check, Bank One could not charge back the amount of the credit or obtain a refund from him.

Bank One disagreed with Chitty's arguments first stating that the UCC permits charge back even if the depository bank had permitted its customer to withdraw the credit given for the dishonored item in cash, by personal check or by bank check. Next, Bank One pointed out that, although it failed to timely notify Chitty of the dishonor, it still is permitted under the provisions of the UCC to charge back the amount of the dishonored item against Chitty's account.

THE COURT DECISION. The Court concurred with the Bank's position. First, it noted that the UCC states that the right of charge back is not affected by previous use of a credit given for a dishonored item. Next, the Court observed that, if a bank fails to abide by its midnight deadline in notifying its customer that a deposited item has been returned unpaid, the UCC adopts the view that a depository bank loses its rights regarding charge back only to the extent that it exposes itself to liability for any loss resulting from the delay.

The Court then pointed out that Chitty failed to produce any evidence demonstrating that he suffered a loss due to the delay in notice by Bank One. Accordingly, it upheld the judgment of the

trial court in favor of Bank One concluding that the Bank was not precluded from prevailing on its counterclaim because it allowed Chitty to withdraw against the credit given for the dishonored item or due to its failure to give him timely notice of the dishonor. *Chitty v. Bank One*, C.A. No. 19829 (OH 2000).

Protection Points

Remember, a bank's right to charge back a credit given for a dishonored item is not extinguished by either the bank's action in permitting its customer to withdraw the credit or its failure to timely notify its customer of the dishonor. ♦

Payor Bank Tenders Defense of a Forged Endorsement Claim to Depository Bank

As a rule, a payor bank has the right to tender the defense of a conversion claim to the depository bank. If the depository bank refuses the tender it will be bound by any determination of fact made in the proceeding brought against the payor bank.

When a check is delivered to an agent of the payee who forges the payee's endorsement on the check, the payee may recover his or her loss against the payor and depository banks based upon a claim for conversion. Under the UCC, a bank commits conversion if it pays or accepts a check for deposit over the payee's forged endorsement (Revised UCC § 3-420). Conversion liability is founded upon the wrongful exercise of control over another person's property. A bank exercises wrongful control over a payee's check if it permits another party to receive payment on the item.

Depository Bank's Liability to Payor Bank

If the payee of a check sues the payor bank to recover a check paid over the payee's forged endorsement, the payor bank may hold the depository

bank responsible for any loss it may incur. This is because the depository bank warrants to the payor bank that the check does not contain any forged endorsements (Revised UCC § 4-208(a)). A warranty is not an agreement to pay an instrument; instead, it is a representation by the depository bank to the payor bank that certain things are true about the check. One of those representations is that at the time the item was received for deposit and collection it did not contain any forged endorsements. If the check does bear a forged endorsement then the depository bank has breached (violated) its endorsement guarantee and is liable to the payor bank for the forged item.

Payor Bank's Tender of Defense to the Depository Bank

Once sued by the payee of a check for conversion, the payor bank has the right under the UCC to give the depository bank notice of the lawsuit and request that the depository bank defend the payor bank against the payee's claim (Revised UCC § 3-119). The payor bank's right to tender the defense of the lawsuit derives from the depository bank's warranty to the payor bank that it had good title to the check in question. If it turns out that the payor bank is liable to the payee because the check was converted, then the depository bank is answerable over to the payor bank for the item.

If the depository bank refuses to assume the defense of the payor bank in a conversion action, then it will be bound by any determination of fact in the lawsuit brought by the payee. In other words, the depository bank may be precluded from submitting any evidence in a subsequent action against it by the payor bank that could establish a defense to the payee's forged endorsement claim.

For instance, as illustrated in the following recently decided case, the depository bank accepted the payor bank's tender of defense of a lawsuit based upon a forged endorsement claim and successfully asserted a defense against liability. If the depository bank had refused the tender, it may have been precluded from raising its defense in a subsequent suit brought against it by the payor bank.

Siler v. Northern Trust Company

THE FACTS. Elizabeth Siler was named as the trustee of the Donald J. Siverling Trust. Peter Orlings, attorney for the Estate of Donald Siverling, sold some stock owned by the Trust without the Trustee's permission. Pursuant to the sale, Orlings received a check for \$292,097.74 drawn on an account at Northern Trust Company and payable to Elizabeth Siler, TTEE Donald Siverling Trust. Orlings then forged the payee's endorsement and deposited the check into his law office account at First State Bank.

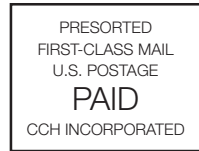
Siler sued Northern Trust for conversion. Northern Trust then sent a letter to First State tendering defense of the lawsuit to the depository bank. In support of the tender, Northern Trust noted that First Bank, by accepting the check for deposit, is answerable to Northern Trust under the UCC warranty provisions for any liabilities Northern Trust may have in this matter. Northern Trust also warned First State that, if it decides not to participate in the lawsuit, it will be bound by any determination of fact binding on Northern Trust. First State accepted the tender and filed a motion to dismiss Siler's suit.

THE ARGUMENTS. Siler argued that, since Northern Trust paid the check over her forged endorsement, it is liable to her for conversion of the item. First State first pointed out that Siler previously settled her claim against First State. It noted that, in exchange for \$12,500, Siler agreed to release and protect First Bank from any liability resulting from any claim made by any other persons or entities for the damages incurred by Siler as a result of Orlings' misconduct. Accordingly, First State argued that the case should be dismissed because the lawsuit is circuitous and, therefore, futile. It pointed out that, even if Siler wins against Northern Trust, under the UCC, First State would be liable for the award. In turn, according to the settlement agreement, Siler would be liable to First State for its payment to Northern Trust. Consequently, the result of a win by Siler is an award against herself.

THE COURT DECISION. The Court first noted that First State Bank, the depository bank, is liable to Northern Trust for the check bearing Siler's forged endorsement. It stated that the ultimate liability for

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forged endorsement claims is placed upon the depository bank that dealt with the wrongdoer and is best able to prevent conversion by carefully checking endorsements. The Court ruled, however, that Siler's case is futile. It observed that even if Siler wins her case against Northern Trust and Northern Trust prevails against First State, her pre-existing settlement agreement with First State means she could recover an award only from herself. Accordingly, the Court granted judgment in favor of First State Bank. *Siler v. Northern Trust Company*, 80 F Supp 2d 906 (IL 2000).

Protection Points

As a rule, a payor bank has the right to tender the defense of a conversion claim to the depository bank. If the depository bank refuses the tender it will be bound by any determination of fact made in the proceeding brought against the payor bank. Accordingly, it may be prudent for a depository bank to accept a payor bank's tender of defense to maintain control of the lawsuit and to present any potential defenses against the conversion claim that otherwise may be lost if not raised in the case brought solely against the payor bank. ♦

FDIC Warns Banks of Missing, Fraudulent Cashier's Checks

Two Special Alerts recently were released by the Federal Deposit Insurance Corp. warning banks under its supervision to be aware of missing and fictitious cashier's checks. The agency said that 200 cashier's checks from the Hudson City Savings Bank, Paramus, N.J., are missing and presumed stolen from a shipment from the check printer. The miss-

ing cashier's checks range in number from 296501 to 296700. Any information about these items should be sent to: Ralph A. Cabrera, Vice President and Security Officer, Hudson City Savings Bank, Paramus, N.J., Phone: (201) 967-1900, ext. 1390.

The FDIC also advised banks that fictitious cashier's checks drawn on "Ferndale Trust & Loan" are in circulation. The fictitious checks bear the address: 22750 Woodward Avenue, Ferndale, Mich., 48226. According to the Michigan Division of Financial Institutions, Ferndale Trust & Loan does not exist. The FDIC warns that at least one of the checks has been presented in Florida, and inquiries about these checks have been received from other areas of the United States. More information is available from the FDIC's Special Activities Section. ♦

FDIC Warns Banks of Unauthorized Banking Entities

A "Monthly Warning Advisory" by the Office of the Superintendent of Financial Institutions of Canada has been released by the Federal Deposit Insurance Corp. to banks under its supervision. The advisory contains names of entities brought to the OSFI's attention through an injury or complaint. Each "Monthly Warning," including the current issue, can be found on the OSFI's website at www.osfi-bsif.gc.ca/eng/newscentre/warning/index.asp.

The listed entities may be violating provisions of the Bank Act (Canada) or other Canadian federal financial institution regulations and also may be operating without authorization in the United States. Any information on these entities should be forwarded to the FDIC's Special Activities Section. ♦