Question 5 – July 2012 - Selected Answer 1

1. Local Bank may defend on the grounds that Albert acted negligently, that the forger was a trusted employee of his, that Albert did not timely report the forgery, and that the bank did not violate its duty of ordinary care. At issue are the available defenses to a bank when a customer demands repayment based on forgery.

First, Local Bank may argue that Albert was negligent in failing to properly supervise his own business checkbook. Although Albert trusted Jane, Jane turned out to be untrustworthy. Therefore, Albert ultimately entrusted his business checkbook to an untrustworthy person. Therefore, the bank may argue that Albert is estopped from denying that the signature is his, because he negligently entrusted his checkbook to an employee. But, this employee rule typically only involves forged indorsements, not drawers. But, the negligence of the checkbook owner would be a general defense that bank could assert against both a claim of forger drawer and forged indorser. Albert's negligence is the bank's strongest defense.

Second, the bank could claim that Albert did not timely report the forgery. The bank statement rule generally provides that a customer has a duty to inspect, in a timely manner, bank statements for forgeries and alterations. If a customer does not discover a forgery within one year, they will not be entitled to reimbursement. But, in some circumstances, the customer must act more quickly: if it involves a serial forger, or the bank could have prevented further loss. In these situations, the customer can only get reimbursed for the first month's forgeries. Here, there is no evidence that Jane is a serial forger or that the bank suffered further loss, so the bank will likely not prevail on this defense.

Third, Albert will likely argue that the bank breached its duty of ordinary care by not checking the forged signature against Albert's signature card. According to the facts, this would have alerted the bank to the forgery and prevented any money from being withdrawn in the first place. But, the bank can defend on the ground that it does not owe a fiduciary duty in this situation, but simply a duty of ordinary care, which is a much lower standard. The bank does not appear to have breached this duty, because the teller followed bank protocol, which was in line with industry standards. Thus, not comparing the check's signature to Albert's signature care was probably reasonable given that the check was for less than $1,000. Therefore, the bank will likely prevail if Albert asserts a breach of the bank's duty of care.

2. Albert is liable to Supplier for the $1,500 promissory note because Supplier is a holder in due course (HDC). At issue is whether Supplier is a holder in due course who may demand payment free of Albert's personal defenses. A holder in due course is a holder of a negotiable instrument who received the instrument in good faith, for value, without notice of any claims or defects regarding the instrument or underlying transaction. Furthermore, holder in due course status is determined at the time negotiation occurs.

The effect of being a holder in due course (as opposed to simply a holder), is that an HDC is not subject to personal defenses such as breach of contract or failure of consideration. An HDC is subject to "real" defenses, none of which are applicable here.

Here, Albert made the note to Danny, who simply signed the back of the note--an indorsement in blank--which converted it to bearer paper. When Danny gave the bearer paper (equivalent to cash) to Supplier, Supplier became a holder. Supplier also paid value by taking it in satisfaction of a debt. Unlike contract law, commercial paper in the UCC includes past consideration as "value." Furthermore, Supplier had no knowledge of any problems with the note or underlying transaction when it paid value and took possession of the note. Therefore, Supplier became an HDC would could successfully demand payment from the maker, not subject to a breach of contract or failure of consideration defense. Thus, Supplier wins.

3. Albert is not liable to Ned for the $500 promissory note. At issue is whether Ned is a holder in due course who may demand payment free of Albert's personal defenses.

As explained above, only an HDC is immune to "personal" defenses, whereas a mere holder is subject to those defenses. As explained above, an HDC is a holder who acquires a negotiable instrument in good faith, for value, without notice of any problems with the instrument or underlying transaction. Here, although Ned became a holder by taking possession of an instrument with a blank indorsement, Ned did not give value. A gift of a negotiable instrument will prevent the new holder from being an HDC, regardless of notice. Therefore, Ned is subject to Albert's breach and lack of consideration defenses, and will not recover any money from Albert.

Ned may assert that he acquired the protections of an HDC through the shelter doctrine, which states that a person who did not pay value can have the protections of an HDC if they received the instrument from an HDC. But, this is not an available doctrine for Ned because he received the note from Danny, who certainly was not an HDC because he was an original party to the transaction.

Question 5 - Selected Answer 2

1. Local Bank improperly paid an unauthorized check drawn on Albert's account because Albert's signature was forged. In the absence of defenses, the bank must credit Albert's account. However, the bank may bring at least two defenses to Albert's demand. First, the bank may claim that Albert acted unreasonably in reporting the forgery to the bank on Dec. 5 when Albert received the bank statement on November 4. The bank may be successful on this claim only if it can also show that the delay caused the bank to suffer a loss it would not otherwise have suffered; that is, had Albert reported the forgery sooner, the bank would have been able to recover from Jane while she was still solvent. Bank's negligence defense fails, though, because Jane was already insolvent at the time she forged the check, and because Albert reported the forgery within a month and day of receiving a statement providing sufficient information about the check. Albert's timeliness in reporting the forgery would most likely be considered reasonable under the circumstances. Finally, the one year bar does not apply here, as Albert waited only 31 days to report the forgery.

Another claim the bank may bring is a claim to preclude Albert from asserting the forgery when his own negligence in allowing Jane to take the checkbook substantially caused the loss. The facts indicate that Jane had been entrusted to write checks on behalf of the business as its business manager, but that Jane had moved (and presumably left Albert's employ). Albert, thus, had a duty to use reasonable care in ensuring that Jane did not still have the checkbook in her possession when she left town and the business. The bank may have a claim for negligence, but Albert will counter under a comparative negligence theory that bank is party responsible for the loss because the forgery was obvious. Had the bank compared the signature to Albert's signature card, they would have noticed the forgery. The bank will argue that it followed industry standards in failing to compare the signature because the check was for less than $1000. Only if the industry standard is found to be reasonable will the bank's negligence claim succeed.

2. Albert is liable as maker of the promissory note to pay Supplier the $1500 on July 1, 2012. At issue is whether Supplier is a holder in due course (HIDC) and is thus not subject to Albert's personal defense against Danny of breach of contract. A HIDC is, first, a holder, which is a person in possession of a bearer instrument or of an order instrument indorsed to that person. Supplier is a holder because he is in possession of the note, and it has been properly indorsed by the original payee Danny. Danny indorsed in blank because he merely signed the back of the note without indicating that he was indorsing it to Supplier. Thus, Danny's indorsement made the note a bearer instrument. Supplier's mere possession of the

note is sufficient to confer holder status on Supplier. Supplier is a HIDC because he took the instrument for value (in satisfaction of a $2500 debt Danny owed to Supplier), in good faith, and without notice that the note was overdue, dishonored, or that there were any claims in recoupment, or defenses. The note, moreover, did not bear any obvious indication of forgery or alteration. Thus, supplier is a holder in due course, and as such, he holds the note free of any personal defenses Albert may have against Danny, including the breach of contract claim. Albert must pay Supplier $1500 and pursue a claim for reimbursement from Danny separately.

3. Albert is not liable to Ned on the $500 note. At issue is whether Ned is a holder in due course. First, Ned is a holder for the same reason that Supplier is a holder: Ned is in possession of a bearer instrument, properly indorsed by Danny, in blank, in the negotiation to Ned. But Ned is not a HIDC because he did not pay value for the instrument. [HIDC analysis from (2) applies] Ned is a donee, and is therefore subject to all of the defenses that Albert may raise against Danny on the underlying contract to network Albert's office computers.

Question 5 - Selected Answer 3

1. Local Bank ("Bank") might assert the defense of negligence and the bank statement rule defense. The issue is what are defenses a payor bank can assert against the drawer when checks are forged. Checks are forged when the drawer's signature is forged. The forgery however is a valid signature as that of the forger. Drawer can generally get money back that was paid from his account if he can show that the check was not properly payable. A check is properly payable when it is paid according to the drawer's instruction in accordance in an agreement the drawer and the payor bank had. Here, the check was not properly payable because Albert did not instruct the bank to pay Jane because his signature was forged. The bank will have to re-credit his account unless it has defenses.

Bank will assert the defense of negligence against Albert. Negligence of the drawer can arise when he entrusts his employee with the checkbooks. This is good policy because it places the burden on the drawer to check the character of the people he hires. Also the employer is the one who deals with the employee so he has control over who can deal with the checks. Albert here is negligent because he entrusted Jane with his checkbooks. He was the one was in a position to deal with the forger and thus the loss should fall on him according to public policy. He could have inspected the books on a daily basis or he could have kept the checkbooks in his desk and only given her checks to pay for specific business expenses. Because he entrusted her with the checkbook, he was negligent. He was also negligent for not discovering that she took the checkbook for a couple weeks (she moved in September and forged in October).

Bank can also assert the Bank statement rule. Banks are not required to send bank statements to their customers but if they do then the customers have a duty to inspect the statements in a reasonable time. There are three rules that are part of the bank statement rule: actual loss, same wrongdoer, one year rule. The only one Bank can assert is the actual loss rule. Here if there is a forged check that is not reasonably discovered in a reasonable amount of time, the bank can claim had the customer discovered it promptly, the bank could have gone after the forger and retrieved the actual losses. This is very hard to prove. Same wrongdoer rule does not apply because we only have 1 forged check. One year rule does not apply because Albert notified his bank within a year of the statement being sent.

Although Bank can assert negligence, it will be subject to comparative negligence principles because it was negligent as well. The bank should have checked the signature of their customer, Albert, against his signature card. Although Bank has a policy not to do this with checks less than $1000, that's there own prerogative and will be liable for their negligence, regardless.

2. Albert will have to pay Supplier the $1,500 promissory note despite the fact that Danny did not perform the contract. The issue is will Albert have to pay for the note even though Danny did not perform the contract. Albert liability in this case is that of a maker. One does not have liability until they sign and will be liable in the capacity that they signed in. A maker is one who promises to pay a note and will be liable to pay the note according to its terms when made. This is primary liability and runs to all people entitled to enforce. Maker will be liable to pay absent defenses. Albert has maker's liability because he made a note promising to pay $1,500. He must pay unless he can show defenses.

Albert has defense of breach of contract (he might also argue fraud in the factum but that requires that the fraud go to the making of the note which is not the case here because he knew he was making a note, just did not know that Danny was incapable of performing). Breach of contract is an ordinary contract defense. To a holder of a note, Albert can raise his ordinary contract defense. But, to a holder in due course ("HDC"), Albert will remain liable on the note even with his defense. HDC will take a note free of personal defenses (ordinary contract defenses, claims in recoupment, article 3 defenses) but will still be subject to real defenses. Thus, it must be determined whether Supplier, who is now the holder of the note, is an HDC.

To be an HDC must: 1) be a holder, 2) of a negotiable instrument, 3) that has no facial irregularities, 4) taken for value, 5) in good faith, 6) with no notice that the note is overdue, has been altered, or subject to any claims or defenses.

- Holder: if the note is an order form (which is payable to the order of an identifiable person) there must be a transfer of the possession of the note plus the indorsement of the person identified in the note. Here, Supplier is a holder because possession of the note was transferred to him and indorsed by Danny (who was the identified person in the note)
- Negotiable instrument: an unconditional promise or order to pay a fixed amount of money, with or without interest, payable to order or bearer, on demand or a definite time, with not other instructions or undertaking. Here, there are no conditions to the note being paid, its paid to order (payable to order of Danny), its a fixed amount of money (because its a certain identifiable sum - $1500), payable at a definite time because its payable on a fixed date (July 1, 2012), and has no other instructions on it.
- No facial irregularities to put the holder on notice that it has been altered - none stated in the facts
- Taken for value: value can be taking it for an antecedent debt. Here, Danny owed supplier $2500, and Supplier took the note in exchange for the debt. It is not important, on its own, that the value was lower that what was owed
- In good faith means honesty in fact (subjective) plus adherence to reasonable commercial standards. Appears to have been made in good faith here. Albert might argue that because it was taken for a lower amount of value, that shows bad faith, but that fact alone is not enough to show bad faith
- No notice: the facts state that Supplier had no notice of the dispute between Albert and Danny, and thus has no notice that the note was subject to a defense or claim

Thus, because Supplier is an HDC, he takes the note free from personal defenses (the breach of contract claim by Albert) and Albert must pay the $1500 note to Supplier.

3. Albert will not have any liability to Ned for the $500 promissory note. The issue is whether Ned is an HDC so that he takes the note free from Albert's personal defense of breach of contract. The same analysis should take place as in #2--Albert has maker's liability on the note, he has a personal defense on the note and thus the issue turns on whether Ned is an HDC. Ned meets all the qualifications to be an HDC except that he did not take the note for value. Rather he acquired it as a gift. Because he acquired it as a gift he cannot be an HDC. Ned might argue that he is sheltered under Danny's rights. The shelter rule applies when a note is transferred. The transferee of the note gets all the rights that his transferor had. The shelter rule

will not give Ned HDC protection here, though. This is because Danny was not an HDC. Danny had notice of Albert's defense and therefore cannot be an HDC. While Ned is still a regular holder of the note, he is not an HDC, he does not take the note free of personal defenses and, therefore, Albert will not have to pay Ned because of Albert's personal defense.

End of selected answers for Question 5