

Question 3 – July 2013 – Selected Answer 1

(1) With respect to the \$1,000 check, Tom has no defense because he created bearer paper and negligently left the check in his pocket--Tom had the right to deposit the check (although a cause of action for theft arises). At issue is whether the check was properly payable. Under Texas law a drawee (bank, usually) is liable for a check that is not properly payable. A check, however, is properly payable if the maker signed with the intent to authorize the check. If made payable to a specific person, the check is deemed order paper and may only be indorsed or deposited by that person. However, order paper may be converted by the holder of the instrument by indorsing the check in blank by signing only his name. Once in bearer form, anyone with possession of the check has the authority to present the check for payment. As such, where a person finds a check in bearer form and deposits it, the check is properly payable regardless of the fact that it was stolen. Here, because Tom signed his name without restrictions, he converted the check from order paper to bearer paper. Further, by leaving it in his pocket, Tom acted negligently and Steve took the note. While that may create a cause of action for Tom against Steve based on theft, the check was properly payable upon presentation by Steve. As such, Tom has no defense to payment and cannot force Beth to write him another check. His negligence was the cause of the theft. Tom has no defenses and neither Beth nor First Bank is responsible for his loss.

With respect to the \$500 check, Beth and First Bank may have causes of action against Tom for negligence, but Beth will not have a cause of action against First Bank because of the impostor rule. At issue is whether Tom's negligence in leaving the \$1,000 check in his pocket caused Beth to issue another check to Steve. Also at issue is whether Beth can assert a claim against First Bank for payment on a check that was not properly payable due to the forged indorsement by Steve. Under Texas law, a check is not properly payable if it contains forged indorsements. That is, a person cannot be a holder of a check if the check does not contain all of the necessary indorsement. Therefore, if a check is stolen from the payee and the payee's name is forged by the thief, the thief is not a holder because he lacks the necessary indorsements for good title. Therefore, the drawer may hold the bank liable for payment of a check that was not properly payable. But, the payee would not be able to bring a claim for conversion unless the payee was entitled to the payment and actually received the check. Conversion is not possible if the check was never received because no interest ever arose.

In response, a bank or a drawer may raise a defense to payment of a check on the theory of negligence on the part of the payee. That is, the bank may argue that the check would not have been fraudulently indorsed had the payee not acted negligently. Here, if Tom had not left the \$1,000 in bearer form in his pocket, Steve would not have known about the check and would not have approached Beth for the additional check. While this is a tough argument to make, it is a possible defense for the Bank. Further, the bank also has a defense against the drawer under the impostor rule. That is, because Beth wrote a check to Steve believing him to be Steve's employee without obtaining any proof of that relationship, Beth was responsible for the payment on the check. That is, Beth was in the best position to uncover the fact that Steve was an impostor. By acting negligently and writing a check to someone without knowing who they were, the Bank should not be held liable for the payment of a check that was not properly payable. This defense is similar to an estoppel defense in that it argues that equity should prevent the Bank from incurring liability. Given these defenses, Bank should not be liable due to both Tom's negligence and Beth's issuance of a check to an impostor, Steve. Also, because Tom did not have an actual claim for the \$500, but instead Steve was lying, Tom has no right to the \$500 and should not be able to assert a claim against Beth for that check.

First Bank might assert that it is not obligated to pay the \$2,500 check payable to Michael because the check was stale and because payment would cause Beth's account to be overdrawn. If First Bank paid the check, however, it would not be liable to Beth if it acted in good faith. At issue is whether the check was stale and whether First Bank could pay the check in good faith regardless of Beth's oral stop payment order.

Under Texas law, a check is deemed stale after 6 months. While a check that is stale may be paid by the bank, it does not have to. Further, a bank may pay a check that would otherwise overdraw the drawer's account, but it may also decline the check without incurring liability. While these two scenarios are not issues of payment of a check that is not properly payable, the bank must exercise good faith if it decides to pay the check. That is, the bank must be following some guidelines set out by the bank and not act in an arbitrary way or with actual bad faith. Further, because oral stop payment orders are ineffective in Texas, the bank is under no obligation to stop payment on a check by oral request. The request must be in writing and describe the check with such particularity that the check can be reasonably identified by the bank. If these conditions are not met, the bank is not liable for payment of a check that was orally stopped. However, the bank may rely on an oral stop payment order if it wishes without incurring liability for dishonoring a check that would otherwise be properly payable absent the oral request. Therefore, a bank does not incur liability for payment of a check that was orally requested not to be paid, is stale, or would overdraw the drawer's account, unless the bank did not act in good faith.

Here, there are no facts that would indicate whether First Bank was acting in good or bad faith, as such; the issue is left open to decide. However, given the state of the law in Texas, First Bank would not be liable for payment or dishonor of the \$2,500 check to Michael unless an argument was made that the bank acted in bad faith. The check to Michael was over 6 months old, and as such was stale, the check would have overdrawn Beth's account, and Beth's stop payment order was not in writing. As such, First Bank was not absolutely barred from paying the check. However, given all of these facts, additional facts could show that First Bank acted in bad faith because all three of these things together would preclude the bank from arguing that it paid the check in good faith. On the other hand, if the bank showed that it had a policy, which was customary in the banking industry, to only inspect checks that were issued for an amount greater than \$2,500 (or some value above), First Bank could show that it was acting in good faith because it was unaware of the stale nature or the overdraw potential. Therefore, given the facts, First Bank is not likely to be liable regardless whether it paid the check or dishonored it.

Question 3 – July 2013 – Selected Answer 2

1. Tom would have a claim against Steve for conversion of the \$100 check and Beth would have a claim against Steve for the \$500 check, but neither Tom nor Beth would have a claim against the banks. The issue is whether an indorsed, but stolen check and a check given to an unintended payee are properly payable. A drawee bank cannot pay on a check not properly payable. However, when National Bank presented the \$1000 check to First Bank, the check was properly payable. Beth had authorized the check on her account and made it payable to Tom. Tom indorsed the check with a blank indorsement. When he did so, the check became bearer paper, meaning that whoever was in possession of the check was the holder of it and entitled to enforce it. When Steve transferred the check to National Bank, which then presented it to First Bank, no transfer or presentment warranties had been breached and the check was properly payable. Therefore, the banks would not be liable to Tom. Tom would have a claim against Steve for taking his property, the check, out of his pocket and converting it.

The banks would not be liable to Beth for the \$500 check either. When Beth made the check payable to Tom and handed it to Steve, Steve's intentions were to keep the check and deposit it for himself, so

when he signed, he was actually making the proper indorsement.. Beth could argue that she actually intended the check to go to Tom, and that when Steve indorsed the check "Tom"; it constituted a forgery and made the check not properly payable. However, under the imposter rule, a drawer of a check is responsible to make sure that the person they are making the check payable to or delivering the check to is actually who they say they are. Because Beth was negligent in doing this, First Bank will not be liable to her. She could have a claim against Steve for misrepresentation and false pretenses. Tom would not have any conversion claim, because even though Beth thought the check was going to Tom, he never had possession of it.

2. First Bank could say that it was not required to deposit the check made payable to Michael because it was stale. The issue is how long can a check go undeposited before a drawee bank is not required to honor it. If a check is not deposited within six months, it is considered stale. At that point, a drawee bank may refuse to honor it. It can still choose to honor it, but it does not have to. Here, the check made payable to Michael was over six months old. Therefore, First Bank did not have to honor it.

First Bank would not have to be liable to Beth. The issue is whether or not an oral stop payment is valid and whether a drawee bank can pay on a check presented to it when there are insufficient funds in the account. Oral stop payment orders are not valid. In order to be enforceable, a stop payment order has to be in writing. Therefore, since Beth only requested that First Bank not pay on the check orally, First Bank

could still pay on the check and not be liable to her. Also, a drawee bank may pay on a check, even if there are insufficient funds in the account on which the check is drawn. If it does, the drawer would be liable to the bank for the deficit, plus any fees it might charge for the overdraft. Here, even though Beth had insufficient funds in her account, since the bank was under no obligation to not pay on the check, it would not be liable to Beth.

Question 3 – July 2013 – Selected Answer 3

1) \$1,000 Check: Steve has the right to cash the \$1,000 check and there is no defense to the payment of the check. Beth wrote the check payable to the order of Tom, properly completed the check, and signed it. When Tom received the check, he made a blank indorsement on the back of the check. This had the effect of turning the check from order paper to bearer paper. Because the check was now bearer paper, anyone who was in possession of the check was entitled to seek payment on the check. When Steve took possession of the check, he could seek payment because it was bearer paper. Beth cannot contest the payment of the check, as it was not forged or altered and was deposited within six months of it being issued, thus it was properly payable. Neither bank can challenge the payment on the check because presentment warranties have not been breached. As the holder of bearer paper, Steve was entitled to enforce the check, and as stated there is no sign of forgery or alteration to the check. Additionally, the indorsement was not forged, as Tom signed it. Because the check was bearer paper due to the blank indorsement by Tom, anyone in possession of it, including Steve, was entitled to enforce the check and there are no defenses to his receiving payment. Tom may have a cause of action against Steve for conversion of the check as he took it from Tom's shirt, but that would be outside any consideration of whether Steve was actually entitled to seek payment on the check. Because the check was validly issued, was not forged or altered, and had a blank indorsement on the back, Steve, as the holder of bearer paper, is entitled to payment of the \$1,000. However, because of the differences in the indorsements by Tom and Steve, National Bank and First Bank might have presentment warranty claims based on the check appearing to be forged for the reasons set out below.

\$500 check: Tom has no rights in the \$500 check. While it was made payable to him, the check was not stolen from him, and he never had any claim to the money as he had been paid in full for the services rendered. Beth cannot defend against the payment of the check because of Steve's forgery of Tom's indorsement. It was written by her, not forged or altered, and thus was properly payable. While it was written to Tom and cashed by Steve and was for services not rendered, this does not impact the ability of Beth to try and claw back the \$500 after the check was cashed. She will be held to be contributorily negligent for writing the check to someone she believed to be an employee of Tom's without ensuring first that the amount was actually due and that Steve actually worked for Tom. Because of this negligence, she will not be able to contest the payment of the check. However, she may be able to bring a tort claim against Steve for his fraudulent conduct. Beth may have a claim against National Bank for not exercising reasonable care in paying the \$500 check for the reasons set out below. First Bank would not have a claim to claw back the \$500 from National Bank. It paid the money and did not contest the payment by midnight the next business day after the check was presented for payment. First Bank never made an attempt to stop the payment on the check, thus this provision would not apply. First Bank could bring a claim that National Bank breached the presentment warranty. Presentment warranties arise when a holder of an instrument presents it to another for payment. By presenting an instrument, the presenter makes a number of implied warranties, such as the instrument is entitled to payment and they have no knowledge of forgery or alteration. By presenting the check to First Bank, National Bank made such implied warranties that the check was entitled to payment and that it did not know that it was forged or altered. Here, Steve's forgery of Tom's indorsement on the \$500 check both made it so that the check was not entitled to enforcement, as it had not been indorsed by the payee. Because the check was not entitled to payment, First Bank could recover from National Bank for breach of the presentment warranty. Likewise, National Bank could recover from Steve as he also made these warranties to National Bank when he sought payment and violated them by presenting a check that was not entitled to enforcement (although it was properly payable) due to the forged indorsement. It is arguable that National Bank did not exercise reasonable care in paying both checks. It already had one check properly indorsed by Tom. If Steve's forged indorsement on the second check would have clearly been a forgery, or at least apparent enough to raise suspicions, National Bank may have failed to exercise reasonable care in accepting the checks if it failed to compare the two indorsement signatures. There is no indication that Tom is a customer of National Bank, so there is no evidence that National Bank would be familiar with Tom, his business, or his signature, and thus would know Steve was not entitled to payment. However, because it could compare the two signatures in front of it to see if they matched, if they did not, then the banks could assume that at least one of the checks was forged and thus halt payment on both until the matter could be sorted out. If there was such a discrepancy, and it would have been clear, and the banks failed to exercise reasonable care in paying the checks, then National Bank may have breached the presentment warranty it gave to First Bank and they may have both breached a duty of reasonable care towards Beth. Steve has no rights to the \$500 check, although he already has the money and may be long gone. As stated, his forgery of Tom's indorsement did not make the check entitled to enforcement, and thus he breached his presentment warranty when he sought payment of the check from National Bank.

2) \$2,500 check: First Bank can assert that it is not obligated to pay the check because of Beth's oral stop payment notice, the fact that the check was over six months old, and the fact that the check would overdraw Beth's account. The issue for stop payment orders is the proper form they must be in for them to be effective against a bank. The rule is that a stop payment order must be in writing and accurately describe the check, such as by date, check number, amount, and payee. Here, Beth only made an oral stop payment order, thus the stop payment order is not binding on First Bank. However, First Bank can choose to honor the oral stop payment order of its customers and not pay the check, it just has no

liability for ignoring the stop payment order if it does pay the check. Thus, because Beth requested First Bank to stop payment on the \$2,500 check, it can choose to honor the oral stop payment order as a basis for it not being obligated to pay the check. First Bank can also refuse to pay the check because it is more than six months old. The issue here is how long after a check is written can it be cashed or deposited. The rule is that banks are not obligated to pay checks more than six months old. Here, the check to Michael is more than six months old as it was written on December 15, 2012, and it is now August of 2013. Because of the age of the check, First Bank is not obligated to pay the check.

Lastly, First Bank asserts that it is not obligated to pay the check because it would overdraw Beth's account. The issue here is what are the obligations of banks to pay checks that would overdraw their client's accounts. The rule is that banks may pay checks which would overdraw accounts, but are not obligated to do so. Because the \$2,500 check would overdraw Beth's account, First Bank can refuse to pay the check and "bounce it." Therefore, First Bank is not obligated to pay the check as it would overdraw Beth's account. First Bank would have no liability to Beth if it chose to pay the \$2,500 check. First, the check was not forged or altered, so on its face it would be properly payable. Second, while Beth made an oral stop payment order, such requests must be in writing to be binding on the bank and expose it to liability for paying a check in violation of such a stop payment order. Because Beth's stop payment order was oral and not in writing, First Bank could pay the check without exposing itself to liability to Beth for payment of the check. Third, while the check was more than six months old, First Bank could pay the check if it wished to honor it. Banks have the option of refusing payment on old checks, but are not obligated to deny payment on such a check. Thus, while the check is more than six months old, First Bank can pay the check as it is valid and properly payable without exposing itself to liability to Beth. Finally, as stated previously, Bank's have the authority to pay checks that would overdraw the client's account, and therefore Beth could not sue First Bank for paying the \$2,500 check even though it would result in her account being overdrawn and likely in her incurring overdraft fees.