

Chapman Client Alert

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Current Issues Relevant to Our Clients

Notable Updates in the Law of the Uniform Commercial Code

The Uniform Commercial Code (“UCC”) affects financial institutions in countless ways. From duties of care for customers to the banks’ inspection of checks, familiarity with the UCC is critical when examining potential and actual legal disputes. With each state having enacted its own version of the UCC, developments in the law are constant and sometimes vary between states as courts disagree on how to interpret the UCC. Below are a few recent developments in UCC law that provide insight into how courts examine these rules and financial institutions’ responsibilities under the UCC.

UCC Section 4-406 — Bank Immunity

UCC Section 4-406 imposes duties on banks and customers to act with diligence in detecting fraudulent instruments, such as altered checks. Importantly, Section 4-406(f) provides that if a customer “sits on his rights” for more than a year without notifying a bank of fraud, a bank is protected by an absolute bar on any claim unless the customer can show bad faith on the part of the bank. This important protection was reaffirmed in a case where a bank successfully defended against a lawsuit stemming from its payment on fraudulent instruments because the customer failed to timely plead and prove that the bank acted in bad faith.¹ The court noted that “mere suspicious circumstances are not enough to require the bank to inquire”, the customer presented no evidence that the bank actually knew the fraudster was not authorized to withdraw funds, and the bank did not benefit from the fraudulent transactions nor deliberately refrain from investigating suspicious transactions. The court concluded that the evidence showed “at most negligence, and not bad faith.”

Customers also have a general duty to timely review their account statements and notify their bank of any irregularities. Such duties and applicable limitation periods to report unauthorized items are also typically set forth in the depository agreements between banks and their customers. The consequences of a customer’s failure to comply with the terms of their depository agreement and exercise appropriate diligence was well illustrated in another recent matter involving a federally chartered bank² where the court ruled that Section 4-406(f) barred a customer from asserting certain claims against her bank resulting from allegedly unauthorized account withdrawals by her estranged husband because the transactions were reflected on account statements and accessible online, and were thus “made available” to her within the meaning of Article 4 well before the expiration of the 30-day review period set forth in the account agreement terms.

UCC Section 3-406 — Customer Duty of Care

Pursuant to UCC Section 4-401, a bank may only process and deduct from a customer’s account checks that are “properly payable.” A check containing a forged drawer’s signature is not, of course, “properly payable” and cannot be charged to the customer’s account. However, under UCC Section 3-406 a bank paying a forged check drawn on a customer’s account may be able to escape liability for returning the funds if it can demonstrate that the customer failed to exercise ordinary care and thereby contributed to the forgery or alteration of the instrument.

In *Forcht Bank, N.A. v. Gribbins*,³ the court rejected the bank’s §3-406 defense, finding that the bank was liable to its customer for paying eight checks forged by the customer’s former boyfriend. The bank claimed that the customer was at least partially responsible for the loss under UCC Section 3-406 because she was careless in her relationship with the fraudster boyfriend and negligently failed to safeguard her checks, all of which “substantially contributed” to the making of the unauthorized signature. The court found the bank’s contentions unpersuasive because the customer had used “ordinary care” in immediately reporting the forged checks, was unaware of the forgeries, took no part in them, did not benefit from them, and was unaware that her checks had been stolen. *Gribbins* thus suggests that courts may set a high bar for banks to prove a customer’s actions or omissions contributed to the making of a fraudulent instrument and that a customer does not have to take any special precautions *vis-à-vis* those with whom he/she has a close personal relationship.

Duties under Article 4A and Electronic Transfers

With electronic fund transfers now standard operating procedure for both banks and consumers alike, courts are more frequently called upon to interpret the relative obligations

of parties under the UCC and state law when it comes to litigation arising from the digital transfer of funds. For instance, in *Atl. Energy Group Ltd. v. Ne. Direct Corp.*,⁴ a bank which had processed a wire transfer was sued by the sender of the wire for negligence and breach of fiduciary duty after the wire transfer recipient allegedly breached an agreement with the sender. The contract between the parties provided that the wire recipient would obtain a performance bond and the plaintiff/sender argued that the bank had a duty to make sure the recipient complied with that agreement term before processing wire transfer. In turn, the bank argued that because the claim arose out of the bank's processing of a funds transfer, any dispute was controlled by Article 4A of the UCC, which governs the issuance and acceptance of payment orders and the execution of a sender's payment order by a receiving bank. Article 4A-212 expressly provides that a receiving bank "is not the agent of the sender or beneficiary of the payment order it accepts, or of any other party to the funds transfer" and thus owes no duty to any party to the funds transfer outside of those provided in Article 4A-212 unless otherwise provided "by express agreement" of the parties. In granting the bank's motion to dismiss, the court found that because the only contract between the bank and the plaintiff/sender was the wire transfer request and bank did not therein expressly agree to any additional or altered duties, the plaintiff's claims were preempted by Article 4A. *Atl. Energy Group* is confirmation that common law claims cannot operate to expand the duties and liabilities of banks for electronic transfers beyond those contained in Article 4A.

The rights and liabilities of parties to a fraudulent email scheme also presents another area for application of the UCC. In *McClain v. 1st Sec. Bank of Wash.*,⁵ a bank customer sent a fraudulent email to two companies directing them to redirect

certain payments to the customer's account. When the fraud was discovered, the bank returned the misdirected funds to the victims of the scheme. The customer then (astonishingly) sued the bank for breach of fiduciary duty and conversion, alleging that the bank wrongfully removed the funds from the customer's account without his permission. In analyzing the customer's claim, the court cited to UCC section 4A-501, which states that the rights and obligations of a party to a funds transfer may be varied by agreement of the affected party. Because the customer's agreement with the bank provided for the return of deposited funds that were erroneously transferred, the court rejected the customer's argument that the money in his account should have remained his, regardless of its origin. The lesson of *McClain* is that, depending on the applicable UCC section, a bank will be protected in the context of erroneous electronic transfers by accounting for such possibilities in the depository agreement with its customer.

For More Information

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- 1 2015 IL App (1st) 142916-U.
 - 2 2015 WL 2358240 (N.D. Ill. May 12, 2015).
 - 3 2015 WL 4039612 (Ky. Ct. App. July 2, 2015).
 - 4 53 F.Supp. 3d 810 (D.S.C. 2014).
 - 5 192 Wash. App. 1063 (Div. 1 2016).

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