

# Catholic University Law Review

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Volume 18 | Issue 2

Article 1

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1968

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### Recommended Citation

Robert M. Spaulding & Arthur M. Sherwood, *The Wayward Corporate Check: Notice of Diversion under the UCC*, 18 Cath. U. L. Rev. 127 (1969).

Available at: <https://scholarship.law.edu/lawreview/vol18/iss2/1>

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# The Wayward Corporate Check: Notice of Diversion under the UCC

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Millions of checks that circulate each day are drawn on corporate bank accounts or payable to corporations. Many of these corporate checks become wayward. The checks or their proceeds are diverted to noncorporate purposes by dishonest corporate officers who have been authorized to indorse the checks. The checks may be cashed or deposited in personal accounts or used to pay personal obligations. In any event, anyone who takes such a wayward check from the diverter faces a lawsuit by the corporation or possibly by its creditors for conversion.<sup>1</sup> To avoid liability in such a lawsuit the taker must have the rights of a holder in due course<sup>2</sup>—one who takes in good faith, for value and without notice of the corporation's claim to the check.<sup>3</sup>

This article will consider the present law of good faith and notice in cases of diversion of such wayward checks as set forth in the Uniform Commercial Code (UCC).<sup>4</sup> To understand the UCC in this area, it is also necessary to

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1. See, e.g., *Maley v. East Side Bank*, 234 F. Supp. 395 (N.D. Ill. 1964), *aff'd*, 361 F.2d 393 (7th Cir. 1966); *Wagner Trading Co. v. Battery Park Nat'l Bank*, 228 N.Y. 37, 126 N.E. 347 (1920); Comment, *Adverse Claims under the Uniform Commercial Code: A Survey and Proposals*, 65 YALE L.J. 807 (1956).

2. UNIFORM COMMERCIAL CODE § 3-305: "To the extent that a holder is a holder in due course he takes the instrument free from (1) all claims to it on the part of any person . . . ." Unless otherwise indicated, all citations to the UCC are to the Uniform Laws Annotated edition (1968).

3. UNIFORM COMMERCIAL CODE § 3-302(1): "A holder in due course is a holder who takes the instrument (a) for 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."

4. Good faith and notice in the law of negotiable instruments generally have been the subject of voluminous discussion in legal commentary. See, e.g., 28 MD. L. REV. 176 (1968); 51 VA. L. REV. 1342 (1965); Fagan, *Notice and Good Faith in Article 3 of the U.C.C.*, 17 U. PITT. L. REV. 176 (1956); Britton, *Holder in Due Course—A Comparison of the Provisions of the Negotiable Instruments Law with Those of Article 3 of the Proposed Commercial Code*, 49 NW. U.L. REV. 417 (1954); Palmer, *Negotiable*

consider its origins in the Negotiable Instruments Law (NIL) and the Uniform Fiduciaries Act (UFA), as well as certain nonuniform provisions amending and supplementing the UCC.

### 1. *The Relevant UCC Provisions*

#### a. *Good faith*

UCC Section 3-302(1) makes good faith a requirement for holder in due course status, but Article 3 of the UCC has no definition of good faith. Therefore, the good faith of a holder in due course is "honesty in fact in the conduct or transaction concerned" under the general definition in UCC Section 1-201(19).<sup>5</sup> In the 1952 draft of the UCC, Section 3-302 defined the good faith requirement for a holder in due course to include "observance of reasonable commercial standards of any business in which the purchaser may be engaged." The reference to reasonable commercial standards was stricken in later drafts of Section 3-302. The deletion was intended to eliminate any objective standard for good faith and continue in Sections 3-302 and 1-201(19) the subjective standard of good faith established under prior law.<sup>6</sup>

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*Instruments Under The Uniform Commercial Code*, 48 MICH. L. REV. 255 (1950); Rightmire, *The Doctrine of Bad Faith in the Law of Negotiable Instruments*, 18 MICH. L. REV. 355 (1920). An especially comprehensive study is found in N.Y. LEG. DOC. No. 65(D) (1955), NEW YORK LAW REVISION COMM'N, STUDY OF UNIFORM COMMERCIAL CODE, ARTICLE 3—COMMERCIAL PAPER, 116-45, 157-98. For a general discussion of the history of the UCC, see Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798 (1958); Supplement, 2 AM. BUS. L.J. 155 (1964).

For discussion of the wayward check under prior law, see Merrill, *Bankers' Liability for Deposits of a Fiduciary to His Personal Account*, 40 HARV. L. REV. 1077 (1927); Comment, *The Responsibility of a Bank for Misappropriation by a Fiduciary*, 35 YALE L.J. 854 (1926); Comment, *Duties of Banks as Depositories of Trust Funds*, 32 YALE L.J. 377 (1923); Scott, *Participation in a Breach of Trust*, 34 HARV. L. REV. 454 (1921); Thulin, *Misappropriation of Funds by Fiduciaries: The Bank's Liability*, 6 CALIF. L. REV. 169 (1918); McCollom, *Liability of Banks Receiving Checks to a Trustee's Order for Deposit in his Individual Account*, 11 COLUM. L. REV. 428 (1911). See also J. BRADY, BANK CHECKS §§ 8.7, 8.8 (3d ed. 1962).

5. The New York Annotation to UCC Section 1-201(19) states that the use of the term good faith is the same as in other statutes previously in force in New York, such as the Uniform Stock Transfer Act and the Uniform Sales Act, which state "A thing is done 'in good faith' . . . when it is in fact done honestly, whether it be done negligently or not." The official comment to UCC Section 1-201(19) also cites the same Uniform Acts defining good faith as honesty regardless of negligence. The Uniform Fiduciaries Act also adopts the same definition of good faith in Section 1(2).

6. "The omission is intended to make clear that the doctrine of an objective standard of good faith, exemplified by the case of *Gill v. Cubitt*, 3 B. & C. 466 (K.B. 1824), is not intended to be incorporated in Article 3." U.C.C. Supp. No. 1, at 18-19 (1955). See N.Y. LEG. DOC. No. 65(D), at 141 (1955). For an excellent summary of the development of the test of good faith in the law of negotiable instruments, see Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48 (1966).

Thus, the taker of a corporate check from a diverter may satisfy the good faith requirement for a holder in due course simply by acting honestly, even if he is also acting stupidly in not recognizing that a diversion is taking place. Indeed, the test of good faith has often been described as the rule of the pure heart and the empty head.<sup>7</sup>

*b. Notice*

The UCC purports to deal with the question of notice of claims to a check in Section 3-304.<sup>8</sup> Subsection (4) (e) makes clear that notice of a corporation's claim does not result merely from knowledge of the fact that the person negotiating the check is a fiduciary. The official comment states: "Under paragraph

7. See, e.g., Braucher, *UCC Article 3—Commercial Paper—New York Variations*, 17 RUTGERS L. REV. 57, 68 (1962).

8. UNIFORM COMMERCIAL CODE § 3-304 provides:

- (1) 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; or
  - (b) the purchaser has notice that the obligation of any party is voidable in whole or in part, or that all parties have been discharged.
- (2) The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.
- (3) The purchaser has notice that an instrument is overdue if he has reason to know
  - (a) that any part of the principal amount is overdue or that there is an uncured default in payment of another instrument of the same series; or
  - (b) that acceleration of the instrument has been made; or
  - (c) that he is taking a demand instrument after demand has been made or more than a reasonable length of time after its issue. A reasonable time for a check drawn and payable within the states and territories of the United States and the District of Columbia is presumed to be thirty days.
- (4) Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim
  - (a) that the instrument is antedated or postdated;
  - (b) that it was issued or negotiated in return for an executory promise or accompanied by a separate agreement, unless the purchaser has notice that a defense or claim has arisen from the terms thereof;
  - (c) that any party has signed for accommodation;
  - (d) that an incomplete instrument has been completed, unless the purchaser has notice of any improper completion;
  - (e) that any person negotiating the instrument is or was a fiduciary;
  - (f) that there has been default in payment of interest on the instrument or in payment of any other instrument, except one of the same series.
- (5) The filing or recording of a document does not of itself constitute notice within the provisions of this Article to a person who would otherwise be a holder in due course.
- (6) To be effective notice must be received at such time and in such manner as to give a reasonable opportunity to act on it.

(e) of subsection (4) mere notice of the existence of the fiduciary relation is not enough in itself to prevent the holder from taking in due course, and he is free to take the instrument on the assumption that the fiduciary is acting properly." The notice, if any, must come from additional facts within the knowledge of the person taking the check. Regarding such additional facts, Section 3-304(2) provides: "The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty."

There is no question that a corporate officer is a fiduciary within the meaning of Section 3-304. The UCC nowhere defines the term fiduciary, but the official comment to Section 3-304 indicates that subsection (2) follows the Uniform Fiduciaries Act, which expressly includes an agent and an officer of a corporation in its definition of fiduciary.<sup>9</sup> Moreover, the courts have consistently recognized the fiduciary relation of an officer to his corporation.<sup>10</sup>

Under Section 3-304(2), a purchaser from a fiduciary has notice of a claim only if he has actual knowledge of the fiduciary's personal benefit or breach of duty.<sup>11</sup> As stated in the UCC general definitions at Section 1-201 (25), "A person 'knows' or has 'knowledge' of a fact when he has actual knowledge of it." The 1952 draft of Section 3-304(2) provided that a purchaser had notice of a claim to a check if he had "reasonable grounds to believe" that a fiduciary negotiated the check in breach of duty. The substitution of "knowledge" for "reasonable grounds to believe" in later drafts of Section 3-304(2) indicates an intention to limit notice to actual knowledge in cases of diversion by a fiduciary.

The form of the transaction may give the person taking a check from a corporate fiduciary actual knowledge of personal benefit or breach of duty. For example, if a corporate officer uses a check payable to his corporation to pay a personal debt, the person taking the check knows that the negotiation is for the officer's own benefit and is therefore deemed to know under Section 3-304(2) that the negotiation is in breach of duty to the corporation if such use is in fact unauthorized. The purchaser of the check has actual knowledge

9. UNIFORM FIDUCIARIES ACT § 1(1):

"Fiduciary" includes a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust or estate.

10. See 3 W. FLETCHER, PRIVATE CORPORATIONS § 838 (Perm. ed. rev. repl. 1965) and cases cited therein.

11. Cf. UNIFORM COMMERCIAL CODE § 3-206(4), which provides that a restrictive indorsement will not prevent a later holder for value from being a holder in due course, "unless he has knowledge that a fiduciary or other person has negotiated the instrument in any transaction for his own benefit or otherwise in breach of duty."

that corporate funds are being used for a noncorporate purpose and is therefore precluded by Section 3-304(2) from becoming a holder in due course if such use is unauthorized.

However, the form of the transaction does not always in itself give notice of personal benefit or breach of duty. For example, an officer may cash a check payable to his corporation. The cashing of a check is not necessarily a transaction for the officer's own benefit or otherwise in breach of duty, since the cash may be used for a corporate purpose. At least the person cashing the check cannot be said to have actual knowledge at the time of the transaction that the money is *not* going to be used for a corporate purpose. The official comment to Section 3-304 states, "[t]he purchaser may pay cash into the hands of the fiduciary without notice of any breach of the obligation."<sup>12</sup>

Similarly, if an officer deposits in his personal account a check payable to his corporation, the depository bank cannot be said to have actual knowledge that the funds will thereafter be withdrawn for a noncorporate purpose, however unusual the deposit may be. The same reasoning applies to checks drawn by an officer payable to his own order and either cashed or deposited in the officer's personal account. Thus, under Section 3-304(2), a person does not have notice of a claim to a corporate check simply because he cashes it for a corporate officer or accepts the check for deposit in the officer's personal account.

Support for such a construction of Section 3-304(2) is found in analogous provisions of UCC Article 8 on investment securities. The concept of bona fide purchaser in Article 8 is modeled on the concept of holder in due course in the law of negotiable instruments,<sup>13</sup> and therefore the Code treatment of notice to a purchaser of securities clarifies the meaning of notice to a purchaser of a corporate check or other negotiable instrument under Article 3. According to Section 8-304(2):

The fact that the purchaser (including a broker for the seller or buyer) has notice that the security is held for a third person or is registered in the name of or indorsed by a fiduciary does not create a duty of inquiry into the rightfulness of the transfer or constitute notice of adverse claims. If, however, the purchaser (excluding an

12. The official comment to the 1952 draft of UCC Section 3-304 made the identical statement. Thus, in the view of the UCC draftsmen, the cashing of a corporate check does not appear to give the purchaser even "reasonable grounds to believe" that a corporate officer is negotiating the instrument for his own personal benefit or in breach of duty, under Section 3-304(2).

13. Investment securities, the subject matter of Article 8, were previously covered by The Uniform Negotiable Instruments Law. According to UCC Section 8-302, a bona fide purchaser of securities is "a purchaser for value in good faith and without notice of any adverse claim . . . ."

intermediary bank) has knowledge that the proceeds are being used or that the transaction is for the individual benefit of the fiduciary or otherwise in breach of duty, the purchaser is charged with notice of adverse claims.

In contrast, the 1952 draft of Section 8-304(2) provided that if the proceeds of a purchase of securities were placed by the purchaser in the individual account of the fiduciary or were made payable in cash or to the fiduciary individually or if the purchaser had "reason to know" that such proceeds were being used or that the transaction was for the personal benefit of the fiduciary, the purchaser was charged with notice of claims of ownership. The later drafts substituted the requirement of "knowledge" for "reason to know," and omitted the statement that a purchaser had notice of claims if he placed the proceeds of a sale of securities in the fiduciary's personal account or paid the fiduciary in cash. The Code draftsmen apparently intended by these changes to protect the purchaser of securities from the imputation of notice of claims to the proceeds of sale paid in cash to a fiduciary or deposited in his own account.<sup>14</sup>

In short, when a corporate officer attempts to cash or deposit in his personal account a check either made payable to his corporation or drawn by his corporation to the officer's own order, the purchaser of the check is not on notice under Section 3-304(2) of a corporate claim to the check or its proceeds, because the purchaser cannot be said to have actual knowledge that the transaction is for the officer's own benefit or that a breach of duty is taking place.

A perplexing problem of statutory construction was raised in the following comment of the New York Law Revision Commission: "It is also not clear from Section [3-304(2)] whether the rule it states is a rule of law, requiring a directed verdict on the issue of holding in due course, or is an attempt to describe the situation in which a verdict for defendant on that issue will not be set aside, or a charge allowing the case to go to the jury will be upheld."<sup>15</sup> If Section 3-304(2) can be construed to leave open the possibility that a purchaser can be on notice of claims as a matter of fact even

14. *See* UNIFORM COMMERCIAL CODE § 8-304, Comment 3:

The fact that the security may be transferred to the individual account of the fiduciary or that the proceeds of the transaction are paid into that account in cash would not be sufficient to charge the purchaser with notice of potential breach of fiduciary obligation but as in *State Bank v. Bache*, 162 Misc. 128, 293 N.Y.S. 667 ([Sup. Ct.] 1937) knowledge that the proceeds are being applied to the personal indebtedness of the fiduciary will charge the purchaser with such notice.

15. N.Y. LEG. DOC. NO. 65 (D), at 167-68 (1955).

without actual knowledge of personal benefit or breach of duty by a fiduciary,<sup>16</sup> then the general definition of notice in Section 1-201(25) is also applicable. This section provides:

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.

It is highly doubtful that the draftsmen of the UCC intended the broad objective "reason to know" test to determine notice of claims in cases of negotiation by a corporate officer or other fiduciary. Otherwise there would have been no reason for the inclusion in the UCC of Section 3-304(2), seemingly limiting notice to cases of actual knowledge of personal benefit or breach of duty. The general definitions in Section 1-201 apply "unless the context otherwise requires," and Section 3-304(2) apparently provides its own more limited definition of notice in the context of claims to instruments negotiated by fiduciaries.

To complicate matters further, when the UCC was adopted in New York and Virginia, a nonuniform subsection 7 was added to Section 3-304, concerning notice to a purchaser of a negotiable instrument. The paragraph provides: "In any event, to constitute notice of a claim or defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the instrument amounts to bad faith." Subsection 7 was enacted in New York to substitute a "bad faith" test of notice for the broader "reason to know" test under Section 1-201(25), and thereby give additional protection to purchasers of negotiable instruments acting honestly but stupidly.<sup>17</sup>

16. The official comment to the analogous provision, Section 8-304, gives some support for such a construction of Section 3-304(2). The comment states, in pertinent part:

This section deals only with notice and presents three specific situations in which a purchaser is charged with notice of adverse claims as a matter of law. The listing is not exhaustive and does not exclude other situations in which the trier of the facts may determine that similar notice has been given. For example, . . . suspicious characteristics of the transaction may give a purchaser (particularly a commercially sophisticated purchaser such as a broker) "reason to know." (citations omitted.)

\* \* \*

In subsection (2) some situations involving purchase from one described or identifiable as a fiduciary are explicitly provided for, again imposing an objective standard, while leaving the door open to other circumstances which may constitute notice of adverse claims.

See also N.Y. LEG. DOC., *supra* note 15, at 145; Braucher, *supra* note 7, at 69.

17. Pierce, *Commercial Paper in the Uniform Commercial Code and the N.I.L.*, 79 BANKING L.J. 1031, 1041-42 (1962); Braucher, *The Uniform Commercial Code—A Third Look?* 14 W. RES. L. REV. 7, 12 (1962). See also Penney, *New York Revisits the*



In those cases of diversion by fiduciaries where a purchaser has actual knowledge of personal benefit but does not have actual knowledge of a breach of duty, the purchaser may be protected under Section 3-304(7) from the imputation of notice under Section 3-304(2) or Section 1-201(25). Actual knowledge of personal benefit does not necessarily give rise to bad faith, even though such actual knowledge may give the purchaser "reason to know" that a diversion is taking place. For example, if a corporate officer draws a check on his corporation's account payable to himself individually and he then negotiates the check to a creditor in payment of a personal debt, the creditor is deemed under Section 3-304(2) to have notice of any claim to the check by the corporation, because the creditor has actual knowledge that the negotiation is for the fiduciary's personal benefit. The creditor, however, is not necessarily in bad faith in taking the check, as required for notice under Section 3-304(7), since he may reasonably presume that the officer was authorized to draw the check payable to himself, as some form of compensation or reimbursement.

In other cases of diversion by fiduciaries, those involving actual knowledge of a breach of duty, Section 3-304(7) provides no additional protection for purchasers since "actual knowledge" is an even more stringent test for notice under Section 3-304(2) than is "bad faith" under Section 3-304(7). Any purchaser having actual knowledge of a breach of duty will be in bad faith in taking the check.

The most plausible construction of Section 3-304(2) is that it imposes an "actual knowledge" test for notice of claims in cases of diversion by a corporate officer or other fiduciary, and that in cases not involving a fiduciary, the "reason to know" test of Section 1-201(25) is applicable in all UCC jurisdictions except New York and Virginia, which apply a narrower "bad faith" test under Section 3-304(7). Under such a construction, neither the "bad faith" nor "reason to know" tests are relevant to the question of notice in cases of diversion by a fiduciary, except in the above described situation where the purchaser has knowledge of personal benefit but no knowledge of a breach of duty.<sup>18</sup> Any other construction would seem to make Section 3-304(2) superfluous.

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*Code: Some Variations in the New York Enactment of the Uniform Commercial Code*, 62 COLUM. L. REV. 992 (1962); Penney, *Uniform Commercial Code—A Summary of Articles 3 and 4 and Their Impact in New York*, 48 CORNELL L.Q. 47 (1962); Miller & Crea, *The Uniform Commercial Code: Effect on the Law of Negotiable Instruments in New York*, 30 BROOKLYN L. REV. 204 (1964).

18. Section 8-304, which deals with the analogous question of notice to a purchaser of securities, was amended in New York to add subsection (3), which provides: "[e]xcept as provided in this section, to constitute notice of an adverse claim or a defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that

## 2. The Prior Law

### a. The Negotiable Instruments Law

The Negotiable Instruments Law, repealed by the UCC, contained no provision comparable to Section 3-304(2), dealing expressly with notice to a purchaser from a corporate officer or other fiduciary. The statute contained only a broader provision on notice in Section 56, which stated: "To constitute notice of an infirmity in the instrument or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or knowledge of such facts that his action in taking the instrument amounted to bad faith." Obviously, Section 56 was the source for UCC Section 3-304(7), enacted in New York and Virginia.

Numerous cases arising under the NIL held the test of bad faith for notice to be a subjective test, dependent on the purchaser's actual state of mind and not on what a reasonable man would have surmised from the facts known to him. In the early case of *Magee v. Badger*,<sup>19</sup> the court summarized the law in a statement often quoted in later cases:

One who purchases commercial paper for full value . . . [i]s not bound, at his peril, to be upon the alert for circumstances which might possibly excite the suspicions of wary vigilance. He does not owe to the party who puts negotiable paper afloat, the duty of active inquiry, to avert the imputation of bad faith. The rights of the holder are to be determined by the simple test of honesty and good faith, and not by a speculative issue as to his diligence or negligence.<sup>20</sup>

The NIL did not expressly define either good faith or bad faith, but logically bad faith meant the opposite of good faith or, in other words, dishonesty. As the court in *Gerseta Corp. v. Wessex-Campbell Silk Co.*<sup>21</sup> stated, to be in bad faith under NIL Section 56, a purchaser "must have knowledge of facts which render it dishonest to take the particular piece of negotiable paper under discussion. Knowledge, not surmise, suspicion, or fear, is necessary; not knowledge of the exact truth, but knowledge of some truth that would prevent action by those commercially honest men for whom law is made."

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his action in taking the security amounts to bad faith." The phrase "[e]xcept as provided in this section" suggests that the "bad faith" test of Section 8-304(3) is irrelevant in cases involving the purchase of securities from a fiduciary, in which cases the "actual knowledge" test of Section 8-304(2) applies. N.Y. UNIFORM COMMERCIAL CODE § 8-304(2) (McKinney 1964).

19. 34 N.Y. 247 (1866). The *Magee* case precedes the NIL, which was drafted in 1896 as a codification of existing law.

20. *Id.* at 249. See, e.g., *Manufacturers & Traders Trust Co. v. Sapowitch*, 296 N.Y. 226, 230, 72 N.E.2d 166, 168, *reargument denied*, 296 N.Y. 998, 73 N.E.2d 574 (1947).

21. 3 F.2d 236, 238 (2d Cir. 1924).

In many cases arising under the NIL, however, bad faith was held to be something less than dishonesty. Especially in cases involving negotiation by corporate officers and other fiduciaries, the courts had a tendency to ignore the subjective bad faith test of Section 56 and to imply a duty of inquiry as to the authority of the fiduciary to act. For example, in the leading case of *Wagner Trading Co. v. Battery Park National Bank*,<sup>22</sup> where a corporate officer deposited a check payable to the corporation in his own personal account, the depository bank was held to be on notice of a misappropriation of the proceeds, because "the nature of this transaction was such as to warn defendant that the checks were being diverted from usual business channels."<sup>23</sup> And in another leading case, *Rochester & Charlotte Turnpike Road Co. v. Paviour*,<sup>24</sup> where a corporate officer drew a check on his corporation's account in payment of a personal debt, the New York Court of Appeals affirmed a directed verdict in favor of the corporation against the payee, stating:

While he was not bound to be on the watch for facts which would put a very cautious man on his guard, he was bound to act in good faith. . . . Even if his actual good faith is not questioned, if the facts known to him should have led him to inquire, and by inquiry he would have discovered the real situation, in a commercial sense he acted in bad faith, and the law will withhold from him the protection that it would otherwise extend.<sup>25</sup>

Faced with such uncertainty in the meaning of bad faith, the draftsmen of UCC Section 3-304 deliberately rejected the bad faith test for notice as formulated in NIL Section 56. Additionally, the Permanent Editorial Board for the UCC rejected Section 3-304(7) as enacted in New York and Virginia for the reason that it "repeats the formulation and much of the language of NIL Section 56. That section produced a tremendous amount of litigation and was intentionally abandoned in the Code."<sup>26</sup> Thus the UCC significantly changes the prior law with respect to negotiations by corporate officers and

22. 228 N.Y. 37, 126 N.E. 347 (1920).

23. *Id.* at 43, 126 N.E. at 349.

24. 164 N.Y. 281, 58 N.E. 114 (1900).

25. *Id.* at 284, 58 N.E. at 114-15. Although the result in *Paviour* would be the same under UCC Section 3-304(2), the reasoning would be different. Under Section 3-304(2), the payee would be deemed to have notice of the corporation's claim to the funds because of his actual knowledge that the officer negotiated the instrument in payment of his own debt, and not because the payee would be deemed to have acted in bad faith.

26. REPORT NO. 1 OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE at 74. According to STATE OF NEW YORK COMMISSION ON UNIFORM STATE LAWS, REPORT ON 1963 PROPOSED AMENDMENTS TO UNIFORM COMMERCIAL CODE (1963): "In the view of the New York Clearing House Association, it was not the language of N.Y. N.I.L. § 95 which produced such a tremendous amount of litigation, but the large dollar amounts to be gained or lost depending upon whether under specific factual situations the holder did or did not qualify as a holder in due course."

other fiduciaries by limiting notice of claims to cases of actual knowledge of personal benefit or breach of duty and making bad faith terminology irrelevant.

*b. The Uniform Fiduciaries Act*

In 1922, the National Conference of Commissioners on Uniform State Laws and the American Bar Association approved the Uniform Fiduciaries Act, dealing expressly with questions relating to notice of breach of fiduciary obligations. The Act was designed in part to overrule cases such as *Wagner Trading Co.* imposing a duty of inquiry on purchasers from a fiduciary, and to reaffirm the subjective bad faith test of NIL Section 56.<sup>27</sup> Although the UCC generally supersedes the UFA with respect to commercial paper, the law of each UFA jurisdiction must be closely analyzed to determine the extent to which the UFA remains in effect after the enactment of the UCC.<sup>28</sup> In any

27. See UNIFORM FIDUCIARIES ACT § 6, Commissioner's Note:

Where it appears on the face of the instrument that it is drawn, made or indorsed by a fiduciary the courts have usually ignored the Negotiable Instruments Law, and have simply said that the payee or indorsee is bound to make inquiry as to the authority of the fiduciary, and is negligent if he fails to make such inquiry. And yet it is well settled that where there is nothing on the face of the instrument to indicate any equity, one may be a holder in due course whether negligent or not unless he acts in bad faith. In cases where the fiduciary relation appears on the face of the instrument it seems that the courts unconsciously substitute the objective test of negligence for the subjective test laid down by the Negotiable Instruments Law.

The effect of these sections is to bring cases involving fiduciaries into harmony with the principle intended to be laid down in the Uniform Negotiable Instruments Law, Sec. 56. They supplement but do not in any way contradict the Uniform Negotiable Instruments Law.

28. The UNIFORM FIDUCIARIES ACT was enacted in twenty-five jurisdictions. See 9B UNIFORM LAWS ANN. 21. UCC Article 10, which provides for repeal of prior law, is not uniform in such jurisdictions with respect to repeal of the UFA. Most of the jurisdictions, *e.g.*, Alabama, Arizona, Idaho, Illinois, Indiana, Maryland, New Mexico, North Carolina, Pennsylvania, Texas, and Utah, provide for repeal of portions of the UFA concerning commercial paper only by implication, in general language stating that acts and parts of acts inconsistent with the UCC are repealed. See UNIFORM COMMERCIAL CODE § 10-103. As stated in the text, UFA Sections 4, 5, and 6 are inconsistent with UCC Section 3-304(2) to the extent that they retain a "bad faith" test for notice of claims to corporate checks negotiated by an officer. Moreover, UFA Section 6 is inconsistent with UCC Section 3-304(2) to the extent that knowledge of personal benefit to a fiduciary, in the negotiation of a check drawn by the fiduciary payable to himself, puts the purchaser on notice of the principal's claim under Section 3-304(2) but not under UFA Section 6. Therefore, UFA Sections 4, 5, and 6 would seem to be repealed as inconsistent legislation, in UFA jurisdictions enacting UCC Section 10-103. In certain other UFA jurisdictions, *e.g.*, Wyoming, Ohio and Minnesota, UFA Sections 4, 5, and 6 have been explicitly repealed. In New Jersey only Sections 4 and 5 have been explicitly repealed, but Section 6 would also seem to have been implicitly repealed by a general repeal of inconsistent legislation. In Missouri, the UFA has not been repealed either expressly or impliedly by the UCC. In Rhode Island the UFA was enacted at the same time as the UCC.

The general confusion surrounding the relation of the UFA to the UCC is illustrated by a Legislative Service Commission Note to UCC Section 3-304(2) in Ohio (OHIO REV. CODE. ANN. tit. 13, § 1303.33 (Page 1962)), stating that since Section 3-304(2) is a codification of Sections 4, 5, and 6 of the Ohio UFA, the repeal of these sections and enactment of Section 3-304(2) does not represent any change in the law.

event, many of the policies of the UFA concerning commercial paper are continued by the Code.

UFA Sections 4, 5 and 6 deal with the question of notice to holders of negotiable instruments drawn or indorsed by fiduciaries. Specifically, Section 4 deals with cases where a fiduciary transfers a negotiable instrument payable or indorsed to the fiduciary in his fiduciary capacity (or a negotiable instrument payable or indorsed to the principal and indorsed by a fiduciary empowered to indorse the instrument on behalf of the principal). Section 5 deals with the case where the fiduciary is the drawer of a check in his fiduciary capacity, payable to a third person, and Section 6 deals with the case of a check drawn by a fiduciary in his fiduciary capacity, payable to himself personally or transferred to the fiduciary personally by a third party payee. Each section provides that in such cases, the transferee from the fiduciary

is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in transferring the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith.

Under Sections 4, 5 and 6 of the UFA, if a transferee from a fiduciary has knowledge of such facts that his action in taking an instrument amounts to bad faith, the taker is deemed to have notice of the principal's claim, whether or not he has actual knowledge that the transfer is for the fiduciary's personal benefit. The test for notice to the transferee under UFA Sections 4, 5 and 6 is therefore basically the same bad faith test stated in NIL Section 56 and UCC Section 3-304(7) enacted in New York and Virginia.

The mere fact of transfer by a fiduciary in the cases dealt with by UFA Sections 4, 5 and 6 does not in itself create any duty of inquiry by the transferee or the imputation of bad faith. Thus, for example, under Section 4 a fiduciary's action in cashing a check payable to his principal would not in itself require the purchaser to inquire into a possible breach of duty by the fiduciary. UFA Sections 4, 5 and 6 are similar in this respect to UCC Section 3-304(4)(e), which provides that knowledge that the person negotiating the instrument is a fiduciary, is not of itself notice of a defense or claim.

The UFA draws a distinction between checks covered by Sections 4 and 5 and checks covered by Section 6. Concerning checks payable to a corporation (Section 4) or drawn on a corporation's account (Section 5), the UFA provides that if the checks are transferred by the officer

in payment of or as security for a personal debt of the fiduciary to the actual knowledge of the creditor, or is transferred in any transaction

known by the transferee to be for the personal benefit of the fiduciary, the creditor or other transferee is liable to the principal if the fiduciary in fact commits a breach of his obligation as fiduciary in transferring the instrument.<sup>29</sup>

On the other hand, where an officer draws a check on the corporation's account payable to himself, UFA Section 6 provides that a transferee of the check is not deemed to have notice of diversion even though he has knowledge that the transfer is for the fiduciary's personal benefit. The basis for the distinction is a presumption that a corporate officer or other fiduciary drawing a check to himself is acting properly, in accordance with his high standard of fiduciary duty, and that the check represents some form of compensation or reimbursement to him. Such a presumption is not made under the UFA where a fiduciary indorses a check payable to his principal (Section 4) or draws a check on his principal's account payable to the fiduciary's own creditor, in satisfaction of a personal debt (Section 5).

UCC Section 3-304(2) is derived from UFA Sections 4 and 5. Each of these provisions puts the transferee on notice of the principal's claim to a check payable to the principal or to a third party, if the transferee has knowledge that the transaction is for the fiduciary's personal benefit. Official comment 5 to UCC Section 3-304 states that subsection (2) of Section 3-304 follows the policy of the UFA. However, the comment erroneously cites Section 6 of the UFA.<sup>30</sup> Section 3-304(2) does not follow UFA Section 6, which provided that the transferee was not on notice of a claim despite knowledge that the transfer was for the fiduciary's personal benefit. UCC Section 3-304(2) follows the policy of UFA Sections 4 and 5, which provided that the transferee was on notice of a claim to the instrument if he knew the transaction was for the fiduciary's personal benefit.

UCC Section 3-304(2) in fact borrows language from UFA Sections 4 and 5 which is omitted in UFA Section 6. Indeed, Section 3-304(2) has the effect of removing protection that a creditor of a fiduciary enjoyed under UFA Section 6 in cases where a fiduciary draws a check on his principal's account payable to himself and negotiates it to a creditor in payment of a personal debt.

29. UNIFORM FIDUCIARIES ACT § 4. Section 5 uses the words "drawn and delivered" for "transferred," and "payee" for "transferee."

30. UNIFORM COMMERCIAL CODE § 3-304, Comment 5: "Subsection (2) follows the policy of Section 6 of the Uniform Fiduciaries Act, and specifies the same elements as notice of improper conduct of a fiduciary." Although the New York Law Revision Commission correctly pointed out in 1955 that the official comment should have cited UFA §§ 4 and 5, (N.Y. LEG. DOC. NO. 65 (D), at 164 (1955)), the comment has not yet been amended. However, UNIFORM COMMERCIAL CODE § 8-304, Comment 3 correctly states: "Subsection (2) follows the policy of Section 4 of the Uniform Fiduciaries Act and of Section 3-304(2) with respect to commercial paper."

Under UCC Section 3-304(2), the creditor is deemed to have notice of the principal's claim, since the creditor knows the transaction is for the fiduciary's personal benefit. The presumption of UFA Section 6 that the fiduciary is acting properly in such a case is written out of UCC Section 3-304(2).

In short, when the draftsmen of the UCC formulated the "actual knowledge" test of Section 3-304(2) for notice of claims in cases of negotiation by a fiduciary, they apparently took language out of context from UFA Sections 4 and 5. The source language of UCC Section 3-304(2) was included originally in UFA Sections 4 and 5 as an illustration of the "bad faith" test of those sections, and to distinguish the rule of UFA Section 6 that a creditor of a fiduciary could take a check drawn by a fiduciary as such payable to himself, despite the creditor's actual knowledge that the transaction was for the fiduciary's own benefit. The removal of the source language of UCC Section 3-304(2) from the context of the "bad faith" test of the UFA was part of a conscious attempt to remove the bad faith criterion of notice from the law of negotiable instruments. The result was a more stringent "actual knowledge" test for notice of claims in cases of diversion by a fiduciary, and the removal of the protection previously afforded by UFA Section 6.

Another significant provision of the UFA is Section 9, which provides:

If a fiduciary makes a deposit in a bank to his personal credit of checks drawn by him upon an account in his own name as fiduciary, or of checks payable to him as fiduciary, or of checks drawn by him upon an account in the name of his principal if he is empowered to draw checks thereon, or of checks payable to his principal and indorsed by him, if he is empowered to indorse such checks, or if he otherwise makes a deposit of funds held by him as fiduciary, the bank receiving such deposit is not bound to inquire whether the fiduciary is committing thereby a breach of his obligation as fiduciary; and the bank is authorized to pay the amount of the deposit or any part thereof upon the personal check of the fiduciary without being liable to the principal, unless the bank receives the deposit or pays the check with actual knowledge that the fiduciary is committing a breach of his obligation as fiduciary in making such deposit or in drawing such check, or with knowledge of such facts that its action in receiving the deposit or paying the check amounts to bad faith.

Under UFA Section 9, a depository bank could safely accept for deposit by a fiduciary a check either payable to his principal or drawn by the fiduciary on the principal's account, unless the bank had actual knowledge of additional facts establishing a diversion by the fiduciary or at least establishing bad faith. The fact of deposit of such checks did not in itself put the bank upon inquiry as to a breach of obligation.

*c. Nonuniform Provisions in New York*

Section 9 of the UFA appears to have been a stimulus to the enactment in 1927 of a nonuniform amendment to Section 95 of the New York NIL, the New York counterpart of Section 56 of the Uniform Negotiable Instruments Act, concerning notice to purchasers of negotiable instruments.<sup>31</sup> The amendment provided:

but the drawing or making of a check or other negotiable instrument by an officer or agent of a corporation against the account of, or in the name of such corporation, to himself as payee, or the endorsement of a check or other negotiable instrument in the name of such corporation, to himself as endorsee, and in either case the cashing of such check or other negotiable instrument or the deposit thereof to his personal account, and whether such check or other negotiable instrument is drawn against an account standing in the name of such corporation, or in the name of such officer or agent of such corporation as such, shall not be sufficient to put a bank, banker or trust company on inquiry as to the authority of such officer or agent, or impute knowledge of any infirmity or defect in such check or other negotiable instrument, provided such bank, banker or trust company have on file an authorization from said corporation showing that the said officer or agent is authorized on behalf of the corporation to perform any of the above acts for unlimited or limited amounts, and that the amount of the said check or negotiable instrument does not exceed the maximum limits of the amount so contained in the authorization so filed for the said officer or agent when such a limitation is contained therein.

The implication of this amendment, consistent with previous holdings under the NIL, was that without a resolution on file establishing the officer's authority to act, a bank would be put on inquiry by the form of the transaction and if the officer were in fact acting improperly the bank would be deemed to have knowledge of the diversion of the corporate funds.

When the UCC was enacted in New York, the nonuniform amendment to Section 95 of the New York NIL was reenacted in slightly different language in Section 9 of the New York Banking Law. This section provides:

Notwithstanding section 3-304 of the uniform commercial code, the drawing of a check by an officer or agent of a corporation against the account of, or in the name of the corporation, whether the check is drawn against an account in the name of the corporation, or in the name of such officer or agent of the corporation as such, to

31. In 1930, the Rhode Island counterpart of Section 56 of the Uniform Negotiable Instruments Act was amended by the addition of provisions based on UFA Sections 4, 5 & 6. R.I. PUB. LAWS, ch. 1561, § 2 (1930), *amending* R.I. GEN. LAWS, ch. 227, § 62 (1923); R.I. GEN. LAWS, ch. 455, § 62 (1938).



himself as payee, or the endorsement of a check in the name of the corporation, to himself as endorsee, and in either case the cashing of such check or the deposit thereof to the credit of his personal account, shall not constitute notice to a private banker, banking organization or branch of a foreign banking corporation of any defense against or claim to the check on the part of any person, provided that the private banker, banking organization or branch has on file an authorization from the corporation showing that the officer or agent is authorized on behalf of the corporation to perform any of the above acts for unlimited or limited amounts, and that the amount of the check does not exceed the maximum limits of the amount so contained in the authorization so filed for the officer or agent when such a limitation is contained therein.

The nonuniform amendment to Section 95 of the New York NIL, reenacted in Section 9 of the New York Banking Law, was in effect a compromise between the policy of UFA Section 9, permitting the deposit of corporate checks in an officer's personal account even without a resolution on file, and prior New York decisions such as *Wagner Trading Co.* holding the bank liable for conversion. The New York nonuniform amendment permitted deposit of corporate funds in an officer's personal account without constituting notice to the bank of the corporation's claim if the bank had on file a resolution authorizing the transaction.

If Banking Law Section 9 is construed to mean that the cashing or depositing of a corporate check in an officer's personal account in itself gives notice of the corporation's claim in the absence of a resolution authorizing the transaction, Section 9 conflicts with UCC Section 3-304(2). Under Section 3-304(2), the cashing or depositing of a corporate check in an officer's personal account does not in itself give notice of a claim, since the bank does not have actual knowledge of personal benefit or breach of duty from the form of the transaction alone. It is possible that the funds may still be used for corporate purposes. Thus, the apparent requirement under Banking Law Section 9 of a resolution to protect a bank from the imputation of notice, when an officer cashes or deposits corporate checks in his own account, may well operate in the absence of a resolution to remove the protection from notice a bank has under Section 3-304(2).

According to a memorandum of the New York State Banking Department, however, Banking Law Section 9 was enacted "to preserve for the specified banking institutions the protection which would otherwise be removed by repeal of certain provisions of law in connection with enactment of the Uniform Commercial Code."<sup>32</sup> It would be anomalous to construe Banking Law

32. 1964 NEW YORK STATE LEGISLATIVE ANNUAL 166-67.

Section 9 as removing protection, when the intention of the statute was to preserve it. It is also possible to read Banking Law Section 9 as protecting a bank from notice of a corporate claim if, in addition to the form of the transaction, the bank has actual knowledge of facts establishing that the transaction is for the fiduciary's personal benefit, provided the bank has a resolution on file authorizing the transaction.<sup>33</sup> Such a construction reconciles Banking Law Section 9 with UCC Section 3-304(2).

A further possibility is that if UCC Section 3-304(2) is to be construed as leaving open the possibility that a purchaser can be on notice of claims as a matter of fact even without actual knowledge that the transfer is for the fiduciary's personal benefit or in breach of duty, Banking Law Section 9 protects a bank with a resolution from the possible imputation of such notice by the trier of fact. Of course, if a bank has actual knowledge of facts establishing not only personal benefit but also a breach of duty by a corporate officer in cashing or depositing a corporate check in his personal account, even a resolution authorizing the transaction should not protect the bank from notice of the corporation's claim.

UFA Section 9 was also the source of an additional nonuniform statute enacted in New York as Section 359-1 of the General Business Law, which provides:

If a fiduciary makes a deposit in a bank to his personal credit of checks drawn by him upon an account against which he is empowered to sign as a fiduciary, or of checks drawn by him upon an account in the name of his principal if he is empowered to draw checks thereon, the bank receiving such deposit may assume, if acting in good faith and without actual knowledge to the contrary, that the funds so deposited by the fiduciary are funds to which the fiduciary is personally entitled. Nothing contained in this section shall be deemed to modify or otherwise affect any provision of section ninety-five of the negotiable instruments law, nor to relieve such bank from any liability imposed upon it by law to the extent of any payment or amount which such bank may receive for its benefit from any withdrawal or application of such funds so deposited.<sup>34</sup>

Thus, under General Business Law Section 359-1, a depository bank may be a holder in due course of a check drawn on a corporation's account by an

33. In N.Y. LEG. DOC. NO. 65(k) at 97 (1955), the New York Law Revision Commission speculated that the predecessor statute, New York NIL Section 95, "probably gives the bank broader protection than it would otherwise enjoy under Sections [3-304(2), 3-304(4) (e)] of the Code."

34. Although the Negotiable Instruments Law was repealed by the UCC in New York, effective September 27, 1964, N.Y. GEN. BUS. L. § 359-1 (McKinney 1968) has not been amended to reflect the change.

officer or agent and deposited in his personal account if the bank has no actual knowledge of a diversion, is acting in good faith and does not profit by the diversion, if any. Section 359-1 in effect states the same rule in such a case as do UFA Section 9 and UCC Section 3-304(2). Under each of these statutes, the depository bank is deemed not to be on notice of a corporate claim to the proceeds unless the bank has actual knowledge of a breach of duty based on facts other than the mere form of the transaction.

Section 359-1 was enacted in 1948 to limit prior New York case law<sup>35</sup> making a bank liable for all subsequent diversions of fiduciary funds from a fiduciary's personal account once any such funds were applied against the fiduciary's personal indebtedness to the bank or withdrawn from the account by a third party such as a joint depositor or attorney in fact. A memorandum of the State Bankers Association supporting enactment of Section 359-1 stated:

The fiduciary was chosen, not by the bank, but by the principal. The principal may protect itself with a bond. There appears no sound reason why the bank should insure the fidelity of a fiduciary in whose selection it had no choice, against whose infidelity it has no practical means of protection, and with whom its only relationship is that of a routine depositor.<sup>36</sup>

The reasoning of this memorandum is equally applicable to the case of the check payable to a corporation cashed or deposited by an officer in his personal account, although Section 359-1 does not cover such cases.

General Business Law Section 359-1 and Banking Law Section 9 each apply to the case where a corporate officer deposits in his personal account a check he has drawn on his corporation's account. According to Section 359-1, the bank may safely accept such a check for deposit even without a resolution authorizing the deposit unless the bank has actual knowledge of a breach of duty. Banking Law Section 9 is in accord, if it is construed to mean that a resolution is necessary to protect a bank only if in addition to the fact of deposit itself, the bank has knowledge of facts establishing that the deposit is for the corporate officer's own benefit or in breach of duty to the corporation.

35. *Lee v. Corn Exch. Bank Trust Co.*, 295 N.Y. 945, 68 N.E.2d 43 (1946); *Bischoff v. Yorkville Bank*, 218 N.Y. 106, 112 N.E. 759, 156 N.Y.S. 563 (1916). See 1948 NEW YORK STATE LEGISLATIVE ANNUAL 248-50; Willard, *Liability of Banks for Misappropriations by Fiduciary Depositors*, 20 N.Y. STATE B. ASS'N BULL. 270 (1948). In *American Sur. Co. v. St. Lawrence County Nat'l Bank*, 201 N.Y.S.2d 965 (Sup. Ct. 1960), *aff'd*, 14 App. Div. 2d 618, 218 N.Y.S.2d 744 (1961), the only reported case under N.Y. GEN. BUS. L. § 359-1 (McKinney 1968), the section was held inapplicable to checks drawn by a town supervisor on a municipal account and deposited in his partnership account.

36. 1948 NEW YORK STATE LEGISLATIVE ANNUAL 49.

### 3. *The Maley case*

The foregoing discussion has analyzed UCC Section 3-304(2) concerning notice to purchasers of corporate checks, in light of related provisions of the UCC and prior law. It is seen that Section 3-304(2) is a conscious attempt to remove the bad faith criterion from the law of notice to purchasers of checks from a corporate officer or other fiduciary. However, in *Maley v. East Side Bank*,<sup>37</sup> the most significant case to date involving UCC Section 3-304(2),<sup>38</sup> neither the district court nor the Seventh Circuit Court of Appeals made any attempt to analyze Section 3-304(2) and both courts apparently overlooked the significance of the section.

In *Maley*, one Schulman purchased all the shares of an established corporation, became its president and then purchased large quantities of inventories on the corporation's credit, which inventories were promptly resold. Ten checks payable to the corporation which were received in payment for the inventories were cashed for Schulman by the defendant bank within one month, and Schulman either dissipated or secreted the proceeds. During this period, the bank received an average of two or three credit inquiries per day regarding the corporation. The bank had never before received such a volume of credit inquiries concerning any of its customers. Upon the corporation's bankruptcy, the trustee sought to recover from the bank \$42,902.98 paid to Schulman and \$3,224.00 credited to his personal account.

About two weeks before such transactions began, the corporation filed a resolution with the bank requiring the countersignature of the corporation's treasurer for withdrawal of corporate funds on deposit with the bank. The corporate resolution did not authorize the cashing of checks payable to the corporation or their deposit to an officer's personal account. The resolution had been filed with the bank at a time when one of the previous owners of the corporation still remained as treasurer pending Schulman's payment in full of the purchase price. Before the checks were cashed, the bank was informed that the previous owners were no longer acting as officers since the purchase price had been paid in full. Thus the resolution was known by the

37. 234 F. Supp. 395 (N.D. Ill. 1964), *aff'd*, 361 F.2d 393 (7th Cir. 1966).

38. In *Maber, Inc. v. Factor Cab Corp.*, 19 App. Div. 2d 500, 244 N.Y.S.2d 768 (1963), a New York court considered Section 3-304(2) in a case arising before the UCC became effective in New York. In *Maber*, promissory notes payable to an attorney in his fiduciary capacity were negotiated by the attorney to a corporation which purchased the notes by a check payable to the attorney individually and also by a payment of the attorney's personal indebtedness to a bank. The court held the corporation was not a holder in due course of the notes because they were negotiated to the corporation for the attorney's own benefit. The court noted in dicta that the attorney could have cashed the notes "because it may have been within the fiduciary purpose to convert them into cash, provided, of course, there were no other circumstances to put the holder on notice that the instrument was being diverted from a fiduciary purpose." *Id.* at 502-03, 244 N.Y.S.2d at 771.

bank to be obsolete since it required the countersignature of a man known by the bank to be no longer associated with the corporation.

The district court granted summary judgment for plaintiff on the grounds that the bank's action in cashing the checks constituted gross negligence under the circumstances and also violated the corporate resolution on file. The court did not purport to apply or even mention the UCC, which was in effect in Illinois at the time of the transactions in question. The Seventh Circuit Court of Appeals affirmed. The court rejected the bank's contention that Schulman and the corporation were identical for purposes of the transactions in question, and therefore refused to consider the bank's defenses of Schulman's actual or apparent authority to cash the checks. Unlike the district court, the court of appeals recognized the applicability of the "actual knowledge" test of UCC Section 3-304(2), but concluded that the test was satisfied by the bank's actual knowledge that Schulman's action in cashing the checks was not authorized by the resolution on file.

It is submitted that in the case of a one-man corporation, noncompliance with an obsolete resolution requiring the countersignature of an officer no longer associated with the business does not in itself give a bank actual knowledge of breach of duty to the corporation by its president and sole stockholder. The court of appeals in *Maley* was apparently eager to find a rationale for liability because of the credit inquiries and other circumstances which, in the court's view, established gross negligence on the part of the bank. Therefore the court seized upon noncompliance with the corporate resolution to justify the result. While gross negligence was in theory irrelevant under the "actual knowledge" test of UCC Section 3-304(2), the court was clearly persuaded of its importance as a basis for liability, stating:

However, evidence of all the circumstances . . . has well satisfied this Court that the decision below was based, not upon any mere technicality, but upon the obvious fact that the defendant East Side Bank committed a serious breach of its duty to its depositor, National Lumber, and to that corporation's innocent creditors. And it is upon that ground that we hereby affirm the judgment below.<sup>39</sup>

As already observed in legal commentary,<sup>40</sup> the *Maley* opinion is unfortunate in that it imposes liability on a bank for a breach of duty to a corporation and its creditors without any attempt to define the scope of such duty. In the case of a one-man corporation, it is futile for a bank to inquire into an officer's authority or motive in negotiating a corporate check, since the

39. *Maley v. East Side Bank*, 361 F.2d 393, 402 (7th Cir. 1966).

40. Note, 65 MICH. L. REV. 531 (1967); Penney, *Commercial Paper, Bank Deposits and Collections, and Letters of Credit*, 23 BUS. LAW. 836 (1968), at 842-44; W. WILLIER & F. HART, UNIFORM COMMERCIAL CODE REPORTER-DIGEST, Supplement § 3-306 ANN. A9, at 152-54 (1965).

sole stockholder will certainly ratify his own action as officer, and he is unlikely to admit a misappropriation of corporate funds.<sup>41</sup>

The imputation of such a duty to a corporation and its creditors not only places an impractical burden of inquiry on the bank; it also unfairly makes the bank, in effect, an insurer of the fidelity of a fiduciary who is nothing more to the bank than a routine depositor. The corporation may protect itself and its creditors with a fidelity bond. The bank may also obtain coverage for such misappropriations by a corporate officer under a banker's blanket bond.<sup>42</sup> However, it would seem that the liability for the fidelity of a fiduciary is more appropriately borne by his principal's bonding company than that of the bank.<sup>43</sup>

In *Maley*, the bank's action in cashing the check could reasonably have been held to amount to bad faith under the test of the NIL and UFA, in view of the large number of credit inquiries after a sudden change in ownership and management, and Schulman's suspicious behavior including his weak explanation of the need for cash and his refusal to adopt the alternative procedure suggested by the bank of depositing the checks in the corporate checking account and then drawing checks on the account payable to cash. However, the bank's knowledge of such circumstances in the *Maley* case did not give the bank actual knowledge that Schulman's action in cashing the checks was for his personal benefit or in breach of duty to his corporation, as required for notice under UCC Section 3-304(2), since the bank did not have actual knowledge at the time of cashing the checks that the proceeds would be used for noncorporate purposes. The *Maley* decision may therefore be understood as an application of prior law because of the court's apparent failure to appreciate the change in the law effected by Section 3-304(2).

#### 4. The Burden of Proof Problem

As already noted, when a fiduciary negotiates an instrument in breach of duty to his principal, the principal has a claim for the proceeds against the purchaser from the fiduciary. The purchaser can avoid liability for such a

41. In *Wheeler Motor Sales Co. v. Guerguin*, 16 S.W.2d 309 (Tex. Civ. App. 1929), the president and majority shareholder of a corporation deposited a check payable to the corporation in his personal account. The depository bank was held not liable to the corporation for conversion of the check. In the court's view the bank had no duty of inquiry since "the money was deposited by the president of the corporation, who had absolute control of the financial affairs of the corporation, and the bank had no grounds of suspicion that the president was misappropriating funds of the corporation." *Id.* at 310-11.

42. *Cf. Bank of Altenburg v. Fidelity & Cas. Co.*, 118 F. Supp. 529 (E.D. Mo. 1953), *aff'd*, 216 F.2d 294 (8th Cir. 1954), *cert. denied*, 348 U.S. 952 (1955); *St. Lawrence County Nat'l Bank v. American Motorists Ins. Co.*, 21 App. Div. 2d 702, 249 N.Y.S.2d 543 (1964).

43. *See text at note 36 supra*; Comment, *Adverse Claims Under the Uniform Commercial Code: A Survey and Proposals*, 65 YALE L.J. 807, 829 (1956).

claim if he is a holder in due course of the instrument. Inexplicably, the UCC is silent as to the burden of pleading and proof as to holder in due course status in such cases. UCC Section 3-307(3) provides: "After it is shown that a defense exists a person claiming the rights of a holder in due course has the burden of establishing that he or some person under whom he claims is in all respects a holder in due course."

Section 3-307(3) covers only the situation where the purchaser of a negotiable instrument is a plaintiff, seeking to recover on the instrument as a holder in due course despite the existence of a personal defense such as failure of consideration. Section 3-307(3) does not cover the case where the purchaser is a defendant, faced with a claim to the instrument which he can avoid only if he has the rights of a holder in due course.

The predecessor statute, NIL Section 59, provided: "Every holder is deemed prima facie to be a holder in due course, but when it is shown that the title of any person who has negotiated the instrument was defective, the burden is on the holder to prove that he or some person under whom he claims acquired the title as a holder in due course." NIL Section 59 was construed as placing the burden of proving holder in due course status upon the person asserting it, whether as a sword or shield.<sup>44</sup> There is no indication in the legislative history that the draftsmen of the UCC intended to change the law in this respect and therefore it can reasonably be assumed that under the UCC a holder must prove he is a holder in due course in order to avoid liability for a claim to the instrument or its proceeds.

Placing the burden on the holder means that he must prove a taking for value, good faith and a lack of notice of claims under UCC Section 3-302. Placing the burden on the holder is reasonable since the relevant facts are likely to be within his knowledge. However, the requirement of proving a lack of notice of claims may raise problems for the holder. If he introduces no evidence on the point he is probably deemed to have notice because of his failure to carry his burden of proving the contrary. UCC Section 3-304(2) provides in this connection that the purchaser from a fiduciary has notice of the principal's claim if he has actual knowledge of personal benefit or breach of duty by the fiduciary. It would seem therefore that such a purchaser's burden of proof is limited to establishing that he did not have actual knowledge of personal benefit or breach of duty. Even such a limited burden may be difficult to meet. A bare denial of knowledge of breach of duty may not be convincing to the trier of fact if the circumstances are suspicious. Additional evidence showing that the purchaser did not have such knowledge may be unavailable. The *Maley* case, for example, could have been rationalized as a failure of the bank to prove a lack of actual knowledge of misappropriation

44. *State Bank v. Bache*, 162 Misc. 128, 155, 293 N.Y.S. 667, 696 (Sup. Ct. 1937).

of corporate funds, in view of circumstances establishing the bank's gross negligence.

#### *5. Policy Considerations and Conclusions*

Competing policy considerations apply to the question whether notice of a corporation's claim should be imputed to a person taking from a corporate officer a check payable to the corporation or drawn by the corporation to the officer. On the one hand, actual knowledge of the officer's breach of duty to his corporation should always be grounds for notice, even if the purchaser is a bank with a resolution on file purporting to authorize the transaction. Moreover, even on facts short of actual knowledge, there is reason for requiring the purchaser to take such a check at his peril, since: (1) he is not required to take the check; (2) he can require a resolution authorizing such a transaction before taking the check; and (3) in the case of a check payable to the corporation, any transaction other than a deposit to the corporate account by an officer is unusual and gives rise to suspicion of diversion.

On the other hand, the "actual knowledge" test of UCC Section 3-304(2) has numerous policy justifications, including: (1) the probability that the officer is in fact acting properly in cashing or depositing a corporate check to his personal account, because the check may represent some form of compensation or reimbursement to him or because he may thereafter use the proceeds of the check for some corporate purpose; (2) the presumption that the officer is acting lawfully, in accord with the standard of fiduciary duty he owes to his corporation; (3) in the case of the one-man corporation, the likelihood that cashing or depositing a corporate check is simply loose procedure, not uncommon in a close corporation and that inquiry by the purchaser as to the officer's authority would be futile; and (4) the inappropriateness of imposing an insurer's liability for the fidelity of the corporate officer upon the purchaser rather than upon the corporation, which can protect itself with a fidelity bond. Moreover, the basic policy of the law of negotiable instruments favoring the ready negotiability of commercial paper applies to checks payable to or drawn on corporations. This basic policy is more important today than ever before because of the vast increase in the volume of checks negotiated in our modern economy.

On balance, the policy considerations justify the cashing or depositing in a corporate officer's personal account of checks payable to the corporation or drawn on the corporate account by the officer payable to himself, without the imputation of notice to the purchaser of the corporation's claim, if any. In the case of wayward corporate checks, the "actual knowledge" test of UCC Section 3-304(2) has eliminated the "bad faith" and "gross negligence" criteria for notice of corporate claims, and the courts should not be reluctant to recognize the change.