Michigan Law Review

Volume 65 | Issue 3

1967

Banks and Banking-Bank's Liability for Breach of Its Duty to Corporate Depositor-*Maley v. East Side Bank of Chicago*

Michigan Law Review

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Agency Commons, and the Banking and Finance Law Commons

Recommended Citation

Michigan Law Review, *Banks and Banking-Bank's Liability for Breach of Its Duty to Corporate Depositor*-Maley v. East Side Bank of Chicago, 65 MICH. L. REV. 531 (1967).
Available at: https://repository.law.umich.edu/mlr/vol65/iss3/7

This Recent Important Decisions is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

BANKS AND BANKING—Bank's Liability for Breach of Its Duty to Corporate Depositor—*Maley v. East Side Bank of Chicago**

The three stockholders of a close corporation contracted to sell all of the corporate stock to Shulman for $5,000 down and a balance of $17,000 in two notes payable in thirty days.[1] A resolution filed with the defendant depositary bank provided that Paul, the former president, was to act as the interim treasurer for the corporation and was to cosign, with Shulman, all checks drawn on the corporate account until the balance of the purchase price was tendered.[2] Ap-

* 361 F.2d 393 (7th Cir. 1966) [hereinafter cited as the principal case].

1. On the date of contract, the former officers and directors tendered their resignations which were held with the stock in escrow until Shulman had paid the balance. The company had been a going concern for three years, but at the date of the sale the liabilities greatly exceeded the assets.

2. In addition to the resolution requiring co-signatures, the prior corporate resolutions remained in effect. The relevant part of the prior resolutions reads as follows:
Be it Resolved by the Board of Directors of C. M. Paul Lumber Co.

1. That the East Side Bank of Chicago be and it is hereby designated as one

proximately one week after the agreement was made, the bank received an inordinate number of inquiries regarding the credit of the corporation, each inquiry being directed to the single executive officer of the bank.[3] Within thirty days Shulman paid the two outstanding notes, and Paul informed the bank of Shulman's payment and the fact that Paul was no longer interested in the corporation.[4] Shulman then signed a signature card as president and the only party entitled to negotiate corporate checks.[5] In the succeeding three weeks Shulman brought to the bank certified and cashiers checks payable to the corporation and endorsed by him either for cash or for deposit into his personal account.[6] At the end of this period creditors of the corporation filed an involuntary petition in bankruptcy, and the trustee in bankruptcy instituted an action against the bank on the creditors' behalf. The court held that because of the bank's violation of the corporate resolutions which it had on file and the breach of its duty to the corporate depositor, the trustee can recover the value of checks payable to the corporation but cashed by Shulman for his personal use.[7]

The relationship between a bank and its depositor is generally that of debtor and creditor.[8] When the depositor is a corporation,

---

of the depositaries of the funds of this Corporation and that the officers or employees of said Corporation are hereby authorized to endorse, in the name of this Corporation for the purpose of deposit and collection in and with said Bank, checks, drafts, notes . . . drawn to and owned by said Corporation . . . .

2. That said Bank be and it is hereby authorized, to pay out the funds of this Corporation on deposit with it from time to time upon checks drawn upon said depositary and signed in the name of this Corporation by its President . . . whether said checks are payable to cash, bearer, or the order of the Corporation . . . or to the order of any signing or counter-signing officer of the Corporation . . . in either their individual or official capacity.

3. That this Resolution shall be in full force and effect and binding upon this Corporation until it shall have been rescinded, and written notice of such rescission . . . delivered to said Bank.

Brief for Appellee, p. 3.

3. These inquiries were provoked by Shulman's efforts to purchase on credit large quantities of goods for sale. The executive officer of the defendant bank testified that he had received from 50 to 100 calls and that at no previous time had such frequent inquiries been made concerning the credit position of this corporation or of any other customers of the bank. Moreover, at least one inquirer informed the bank that he considered Shulman's behavior "highly irregular." Principal case at 397, 399.

4. Affidavit of Norman M. Paul, Appendix to Brief for Appellant, p. 469. Paul had previously advised the Bank that he was only acting as the treasurer of the company in order to cosign checks as a security measure until Shulman paid the balance of the purchase money.

5. The bank also gave Shulman a new resolution form. Shulman informed the bank that it might be "a little while" before he returned the form, since he did not know who would be the new officers or directors of the corporation. This resolution was never returned to the bank.

6. The checks were from customers who had purchased from Shulman the goods he had previously bought on credit. In all there were ten checks totalling over $46,000.

7. Principal case at 402.

8. See, *e.g.*, Blakey v. Brinson, 286 U.S. 254 (1931); United States Cold Storage v.

moreover, the bank has a duty to scrutinize the transactions of the corporate officers so as to insure that funds are disbursed only according to the approval and signature required by the deposit agreement.[9] Suspicious circumstances surrounding transactions may put the bank on inquiry, and breach of the duty to inquire may render the bank liable to the corporation for misappropriations.[10] The scope of the duty to inquire varies according to the facts. Certainly once the bank is given notice of possible misappropriation, the duty to inquire entails more than a questioning of the suspected officer.[11] Indeed, if a bank has reason to believe that an officer is appropriating corporate funds for his personal use, the courts have generally held that the bank will have an obligation to question the directors as to the officer's authority.

Three aspects of the bank-depositor relationship suggest that when the depositor is a one-man or close corporation, the traditional duty of the bank to inquire should be relaxed, if not eliminated completely.[12] First, although the bank has an obligation to protect its corporate depositor from defalcations by an officer, in a one-man corporation the officer, in a very real sense, is the corporation. Inquiry in the traditional manner may well be futile, since the officer is likely to be less than candid about his own misappropriations.[13] Second, if the depositor is a one-man corporation, the

Central Mfg. Dist. Bank, 343 Ill. 503, 175 N.E. 825 (1931); Speroff v. First-Central Trust Co., 149 Ohio St. 415, 79 N.E.2d 119 (1948). The Uniform Commercial Code retains the idea that a bank and its depositor have the relationship of debtor and creditor. See Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962).

9. *E.g.*, National City Bank v. Harbin Elec. Co., 28 F.2d 468 (9th Cir. 1928); Miller v. First Granite City Nat'l Bank, 349 Ill. App. 347, 110 N.E.2d 651 (1953). See also Weaver Constr. Co. v. Farmers Nat'l Bank, 253 Iowa 1280, 115 N.W.2d 804 (1962).

10. See Havana Cent. R.R. v. Central Trust Co., 204 Fed. 546 (2d Cir. 1913), holding that the bank was not liable because circumstances were not such as to put the bank on inquiry. The mere fact that a check drawn on a corporate account is made payable to the officer who signed the check is generally not notice that the funds are being misappropriated. See, *e.g.*, Havana Cent. R.R. v. Central Trust Co., *supra*; Fidelity & Deposit Co. v. Merchants Nat'l Bank, 223 Iowa 446, 273 N.W. 141 (1937). As the circumstances surrounding a transaction or series of transactions become increasingly suspicious, the courts tend to place on the banks the burden of inquiry to ascertain the officer's authority to transact. *Cf.* Mitchell v. First Nat'l Bank, 203 Ky. 770, 263 S.W. 15 (1924). See generally BRITTON, BILLS AND NOTES §§ 117-18 (2d ed. 1961). A bank which accepts checks payable to a corporation, endorsed by the president thereof, and deposited into the president's personal account is on notice of possible misappropriation of the proceeds. Mohr & Eichoff v. Marine Midland Trust Co., 237 N.Y.S.2d 71 (N.Y. City Ct. 1962); *cf.* Wagner Trading Co. v. Battery Park Nat'l Bank, 228 N.Y. 37, 126 N.E. 347 (1920); Weaver Constr. Co. v. Farmers Nat'l Bank, 253 Iowa 1280, 115 N.W.2d 804 (1962).

11. See Merrill, *Bankers' Liability For Deposits of a Fiduciary to His Personal Account*, 40 HARV. L. REV. 1077, 1100 (1927); *cf.* United States Fid. & Guar. Co. v. People's Bank, 127 Tenn. 720, 157 S.W. 414 (1913).

12. See generally Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373 (1938); Note, 100 U. PA. L. REV. 853 (1952).

13. A general corollary to the traditional duty to inquire is that the bank will

entire burden of inquiry and verification would be carried by the bank, whereas when a larger corporation is involved, at least some of the responsibility for discovering misappropriation by an officer lies with the corporation, and the bank may assert as a defense the corporation's contributory negligence in failing to discover and prevent the unauthorized transactions.[14] A third, and perhaps more fundamental consideration is that a corporation is generally bound by the acts of its sole stockholder, and when he purports to act on behalf of his corporation, no action may be brought by the corporation to recover property appropriated for the stockholder's personal use.[15] In *Field v. Lew*,[16] for example, the court concluded that the president and sole stockholder acting on behalf of his corporation ratified his own actions, and the effect of this self-ratification was to deprive the corporation of its right of action against either the officer or any other person participating in the misappropriations.[17] Thus, in the case of a one-man corporation, because (1) a sole-stockholder can ratify his own actions and bind his corporation; (2) the bank's defense of contributory negligence is foreclosed; and (3) reasonable inquiry seemingly would not reveal a fraud, it is difficult to contend that a bank should be liable for breach of a duty of inquiry *owed to the corporation* when the sole stockholder diverts corporate funds to his own purposes.

Putting to one side the question of the depositary bank's liability, the question also arises as to the existence of a cause of action in an insolvent corporation's creditors when the corporation itself would have no right to sue. Generally, the right of a trustee in bankruptcy to maintain an action on behalf of the creditors for

---

not be liable where reasonable inquiry would not have revealed a misappropriation or breach of fiduciary duty to the corporation. Moore & Co. v. Champaign Nat'l Bank, 13 Ill. App. 2d 232, 141 N.E.2d 97 (1957); Kinstlinger v. Manufacturers Trust Co., 280 App. Div. 729, 117 N.Y.S.2d 147 (1952). Compare Ward v. City Trust Co., 192 N.Y. 61, 84 N.E. 585 (1908).

14. *Cf.* Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962); Moore & Co. v. Champaign Nat'l Bank, *supra* note 13. See also UNIFORM COMMERCIAL CODE §§ 3-406, 4-406.

15. Cawthra v. Stewart, 109 N.Y. Supp. 770, 14 A.2d 634 (Sup. Ct. 1908). The trend of authority is to bind the corporation by acts on its behalf by a person or persons owning all the stock, even though there is a defect in some corporate step or action, 19 C.J.S. *Corporations* § 1004 (1940); see, *e.g., In re* Michael J. Hughes & Co., 110 F. Supp. 577 (D.N.J. 1953); Metropolitan Trust Co. v. Becklenberg, 300 Ill. App. 453, 21 N.E.2d 152 (1939). Where one man completely controls a corporation, he is deemed to have power to do all acts which the board of directors could have authorized. Renault v. L. N. Renault & Sons, 188 F.2d 317 (3d Cir. 1951); *accord,* Mid-Continent Constr. Co. v. Goldberg, 40 Ill. App. 2d 251, 188 N.E.2d 511 (1963).

16. 184 F. Supp. 23 (E.D.N.Y. 1960), *aff'd,* 296 F.2d 110 (2d Cir. 1961). Here the bank accepted a corporate check drawn by its president and sole stockholder and applied the proceeds to his personal indebtedness to the bank.

17. "In that case the unauthorized acts of the individual become the authorized acts of the corporation, the corporation loses its right of action against the officer . . . ." 184 F. Supp. at 27. *Accord,* Cunningham v. Jaffe, 251 F. Supp. 143 (D.S.C. 1966).

conversion or misappropriation is contingent upon a preexisting right in the corporation.[18] However, when the corporation is insolvent at the time of the misappropriations, there is considerable authority for the proposition that the rights of the creditors are superior to the rights of both the corporation and the corporate stockholders.[19] In the leading case of *McCandless v. Furlaud*,[20] the court conceded that unanimous shareholder approval could often legitimate the otherwise wrongful acts by corporate officers. The court added, however, that when the corporation is insolvent during the wrongful transactions, shareholder ratification would not legitimate the officers' fraud so as to preclude an action on behalf of the creditors.

Thus, it would appear that shareholder ratification cannot defeat the rights of the creditors of an insolvent corporation, and that the trustee in bankruptcy can maintain an action against the *corporate officers* on behalf of the creditors even though a one-man corporation would be bound by the ratified acts of its sole stockholder. It is not clear, however, that the trustee can maintain an action against the *corporation's bank*. Where trustees in bankruptcy have sued a depositary bank for negligence, the theory has generally been that the trustee's action is based on the rights of the corporation which have theoretically been transferred to him. But, as has been pointed out above, it would appear that in the case of a one-man corporation the bank should have no duty to the corporation, and therefore the corporation would have no right against the bank which could be transferred to the trustee. If the trustee can recover without having had any rights of the *corporation* transferred to him, his cause of action must depend on the bank's breach of some duty owed directly to the *creditors*.

Deferring for the moment questions of policy and allocation of

18. *E.g.*, Field v. Lew, 184 F. Supp. 23 (E.D.N.Y. 1960); Wilds v. Lebanon Nat'l Bank, 219 App. Div. 597, 220 N.Y. Supp. 480, *aff'd*, 245 N.Y. 629, 157 N.E. 886, *cert. denied*, 275 U.S. 568 (1927).

19. "Creditors, of course, are not prejudiced by the corporation's acts of ratification." Field v. Lew, *supra* note 18, at 27, *quoting from*, Barr & Creelman Co. v. Zeller, 109 F.2d 924, 927 (2d Cir. 1940). See also McCandless v. Furlaud, 296 U.S. 140 (1935); Bovay v. Byllesby & Co., 26 Del. Ch. 69, 22 A.2d 138 (Ch. 1941); Metropolitan Trust v. Becklenberg, 300 Ill. App. 453, 21 N.E.2d 152 (1939).

20. 296 U.S. 140 (1935). Defendant corporate officer had fraudulently obtained profits while rendering his company insolvent. It was asserted as a defense that all the stockholders had ratified his transactions. In discussing the question of the plaintiff receiver's standing, the Court stated:

> Consent in such conditions so far as it gives approval to conduct in fraud of the rights of others, is a word and nothing more . . . . Included in those assets are moneys fraudulently diverted to the prejudice of creditors . . . . There is power at the instance of the receiver to bring them back into the trust.

Id. at 160. Four Justices joined in a dissenting opinion which forcefully advances the theory that since all of the stockholders ratified the transaction, the receiver could not attack it. *Id.* at 168.

risks and burdens, there is legal justification for permitting the trustee, as the representative of the creditors of an insolvent one-man corporation and wholly apart from any rights of the corporation, to bring a direct action against the bank. According to one theory, the bank could, on the facts of the principal case, be held liable to the creditors for having misled them through assurances of the good credit of the company. The giving of assurances, without more, would not make the bank liable, but an inordinate number of inquiries coupled with a corporate officer's frequent cashing of relatively large checks payable to the corporation might be used to support the imposition of a duty on the bank to protect known creditors who might reasonably be expected to rely on the bank's assurances.[21]

A second, and perhaps more cogent, rationale for the imposition of a duty to the creditors is that because, as noted above, the inquiry of a sole stockholder regarding his authority to transact is an empty obligation, the bank's duty should be extended when its depositor is a one-man corporation. Thus, the combination of a one-man or closely owned corporation and patently suspicious circumstances surrounding its transactions would seemingly require the bank to investigate its corporate depositor's *financial condition*. When reasonable inquiry would reveal the insolvency of the corporation, the bank should be charged with knowledge of this insolvency. Since an officer's diversion of his insolvent corporation's assets is a fraud on the corporate creditors, the argument continues, a bank, on notice of the insolvency of its corporate depositor, should assume some obligation to protect the creditors from such fraud. This theory of liability presupposes that charging a depositary bank with notice of its depositor's insolvency is justifiable, a presupposition which is not without precedent. In *Field v. Lew*,[22] a trustee in bankruptcy sued the bankrupt corporation's depositary bank challenging three transactions between the corporate president and the bank. With respect to the first two transactions, accomplished while the corporation was solvent, the court adopted the ratification doctrine and held that the president, as sole stockholder, bound the corporation by his acts. The third transaction, however, involved a large corporate check which rendered the corporation insolvent and which the president drew payable to himself. After noting that creditors cannot be prejudiced by a corporation's acts of ratification, the court determined, primarily in light of a resolution which authorized the president to draw corporate checks payable to himself, that on the facts before it nothing "sufficiently" put the bank on inquiry so as to require it

21. On the duty to disclose information and liability for erroneous disclosure, see Annots., 92 A.L.R.2d 900 (1963); 48 A.L.R. 528 (1927). See also Comment, *Banking—Disclosure of Records*, 60 MICH. L. REV. 781 (1962).

22. 184 F. Supp. 23 (E.D.N.Y. 1960).

to ascertain the adequacy of corporate assets or to determine whether each transaction impaired the capital.[23] The implication of this reasoning is that had there been more suspicious circumstances, a bank would have a duty of inquiry to the extent of determining the corporate depositor's financial position. *Field* cited with approval *Ward v. City Trust Co.*,[24] although it distinguished *Ward* on its facts. In *Ward*, the court, holding that the bank *was* put on notice by the "extraordinary circumstances," asserted that reasonable inquiry meant an inquiry prosecuted with a degree of diligence commensurate with the circumstances. The court concluded that since an inquiry of the officers of the close corporation would have been insufficient because it was apparent that the officers were acting in their own interest,[25] the circumstances demanded an investigation of the financial condition of the company, which would have revealed its insolvency.[26]

In imposing on the bank a duty to the creditors, the court in the principal case seems to have relied primarily on the second theory discussed above, that is, the bank's obligation to discover the insolvency of its one-man corporate depositor. The court's decision suggests, by its effect if not by its language, that in this situation the duty of the bank to inquire transcends questioning the authority to transact. If the circumstances surrounding a series of transactions indicate a fraud on the creditors, the bank's duty extends to an investigation of the financial condition of the company.

Had the court in the principal case been reluctant to impose such a duty on the bank and then derive the bank's liability from the breach of this duty, there is little doubt that liability could have been based solely on the bank's failure to comply with the deposit resolutions.[27] However, rather than predicate liability for a $46,000

---

23. *Id.* at 28.

24. 192 N.Y. 61, 84 N.E. 585 (1908). The creditors sued the bank for accepting corporate checks from the sole stockholder-corporate officer in payment of his personal loan. The checks represented a large proportion of the corporation's assets, and the proceeds were obviously devoted to non-corporate purposes.

25. *Compare* Ward v. City Trust Co., *supra* note 24, *with* Reif v. Equitable Life Assur. Soc'y, 268 N.Y. 269 (1935), *and* Kinstlinger v. Manufacturers Trust Co., 280 App. Div. 729, 117 N.Y.S.2d 147 (1952).

26.
> The form of the check and its amount when compared with that of the capital stock required investigation or inquiry as to the solvency of the company .... The trust company had a right to assume that Umsted and Kiefer, as the sole owners of the stock, could lawfully use the assets of the corporation for their own purposes, still the assumption would necessarily be limited to the corporation itself. It could not extend to the creditors whose rights are supreme and which cannot be sacrificed even by the joint action of all the officers, directors and stockholders of the corporation.

Ward v. City Trust Co., 192 N.Y. 61, 75 (1908).

27. The circuit court found that the bank had failed in two ways to conform to the resolutions. First, the checks cashed by Shulman were not cosigned by Paul. Also, the checks were not endorsed "for deposit and collection in the corporate account," but were endorsed for cash or deposit into Shulman's personal account. See

judgment on such technical grounds,[28] the court determined that the bank was not a holder in due course under the Illinois Uniform Commercial Code,[29] and therefore that it took the checks cashed by Shulman subject to all valid claims against them.[30] Presumably the court could have concluded at this point that the trustee in bankruptcy, as successor to the corporation's claims, could recover the

---

note 2 *supra*. A bank cannot legally pay out its depositor's funds except on the approval and signature which it has been instructed is necessary. National City Bank v. Harbin Elec. Co., 28 F.2d 468 (9th Cir. 1928); Miller v. First Granite City Nat'l Bank, 349 Ill. App. 347, 110 N.E.2d 651 (1953). Although bank resolutions on file govern the bank's liability, such liability is not governed by resolutions which *might be* on file or which are received after the facts giving rise to liability have transpired. Barrett v. Continental Ill. Nat'l Bank, 2 Ill. App. 2d 70, 118 N.E.2d 631 (1954).

28. Principal case at 402. Although the original resolutions had never been rescinded by the requisite writing, apparently the court felt that to continue to require a second signature on the checks after Shulman was sole stockholder and Paul, the joint signatory, was no longer interested in the corporation, would have been contrary to the intent of the deposit agreement. Regarding the second alleged violation of the resolutions—unauthorized endorsements—the court may have been persuaded that Shulman's endorsement for cash was in effect tantamount to a two-step transaction of depositing in the account and then drawing corporate checks against the account. This two-step transaction would have conformed to the resolutions. It should be noted, however, that if Shulman had employed the two-step procedure, the transaction would have shown up in the bank's record of the depositor's account and would have constituted a more reasonable basis on which to charge the bank with notice. By merely cashing the checks for Shulman, the bank had no record of the frequency of Shulman's transactions.

29. ILL. REV. STAT. ch. 26 (1963). The relevant sections of the Code are as follows:

§ 3-302. Holder in Due Course.

(1) A holder in due course is a holder who takes the instrument

(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.

§ 3.304. Notice to Purchaser.

(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.

The court reasoned that the bank had notice of Shulman's breach of fiduciary duty from the resolutions which it had on file. Therefore, the bank could not be a holder in due course. ILL. REV. STAT. ch. 26, §§ 3-302(1)(c), 3-304(2) (1963). The court's conclusion is questionable inasmuch as § 3-304(4)(e) states that knowledge of an officer's fiduciary capacity is not the notice required by the section. These same words in the UNIFORM FIDUCIARIES ACT § 8 have been held to require actual notice of misappropriation. Colby v. Riggs Nat'l Bank, 92 F.2d 183 (D.C. Cir. 1937). If the court believed that the original resolutions continued to control any transactions, a more persuasive argument might have been that under § 3-419(1)(c), Shulman's unauthorized signature was a forgery. According to that section, the bank would then be a converter of the checks and liable to the real owner.

30. ILL. REV. STAT. ch. 26, § 3-306(a) (1963).

§ 3-306. Rights of One Not Holder in Due Course.

Unless he has the rights of a holder in due course any person takes the instrument subject to

(a) All valid claims to it on the part of any person . . . .

amount of the checks.[31] However, the court reasoned that to establish that the bank was not a holder in due course was not sufficient; rather, the trustee must also establish the validity of his claims. The court concluded that the bank's notice of a breach of fiduciary duty disqualifies it from being a holder in due course, but that in order to establish the validity of the claims, proof of gross negligence on the part of the bank was also required.[32] This latter element of proof is not incorporated in the Code itself, and this judicial grafting of gross negligence is one of the significant aspects of the principal case.

Gross negligence entails a serious breach of some duty. If the findings in the principal case were based on a theory of a breach of a duty owed to the *corporation,* creating a cause of action which passes to the trustee in bankruptcy, it has been suggested above that given the facts of this case, such reasoning will not withstand logical analysis.[33] If, on the other hand, the court was propounding a theory of liability based on a breach of a duty to the *creditors,* it should have more fully articulated the scope and extent of the duty.[34] Assuming, *arguendo,* that the bank does have a duty to discover the insolvency of its corporate depositor, it is unclear from the opinion whether the bank is required to take affirmative action to protect the creditors of its corporate depositor or whether its duty is a lesser one of refusing to allow its facilities to be used in suspected fraudu-

---

31. Had the court been more confident of its conclusion that the bank had the actual notice required by the Code, it could have held the bank liable simply because it was not a holder in due course. Since its finding of actual notice is contingent on the viability of the resolutions, the court apparently felt the need to find an additional basis of liability.

32. Principal case at 402. Not only is proof of gross negligence probably unnecessary if the bank were truly not a holder in due course, but a more logical argument might be that even if the bank were a holder in due course, it could still be held liable for negligence. Section 3-305, defining the rights of a holder in due course, does not appear to preclude liability for negligence. Thus, if the court is able to find gross negligence, the fact that the bank was not a holder in due course might have been irrelevant.

33. See notes 12-17 *supra* and accompanying text. Generally courts have been more sympathetic to the distinction between one-man and other corporations than have the legislatures. See Fuller, *The Incorporated Individual: A Study of the One-Man Company,* 51 HARV. L. REV. 1373 (1938). The Illinois Legislature has recently recognized that a one-man corporation can have a one-man board of directors. ILL. REV. STAT. Ch. 32, § 157.34 (1963) (adopted Aug. 14, 1963). The court in the principal case found it unnecessary to pass on the question whether the sole stockholder and the corporation were identical for the purposes involved in the case. Principal case at 398.

34. The court in the principal case intimates that the duty was owed to the creditors themselves. After deciding that the bank had notice the court added: "the defendant bank made absolutely no significant effort either to protect itself or *other creditors.*" Principal case at 399. The closest that the court comes to articulating the duty to discover the insolvency of the company is the statement that "the astounding volume of purchases that such an undertaking would entail would be considered together with the relative size of National Lumber of which the bank was duty-bound to have knowledge." Principal case at 399.

lent transactions. The precise action which the bank must take in order to escape liability to the creditors depends upon which of these two interpretations of the bank's duty is an accurate statement of the law.

If the obligation of the bank is to take affirmative action to protect the creditors, it may have two possible alternatives. First, the bank might admonish the known creditors, which would accelerate the petition for bankruptcy and might mitigate the loss to the creditors. This alternative, however, might violate the contract rights of the depositor for it is an implied term of the contract between a depositor and his bank that no information may be disclosed by the bank unless such disclosure is authorized by the depositor or compelled by law.[35] Viewed from another perspective, at least one case[36] has held that banks are under no duty at law to warn the investing public of the financial condition of their depositors.[37] The bank's second alternative is to refuse to honor the transactions of the suspected defalcator. But, *Cunningham v. Merchant's National Bank*[38] held that a bank is not relieved of its duty to honor its depositors orders, even though it may know that the depositor is insolvent.[39] Furthermore, as long as there are funds in the bank sufficient to meet the orders of the depositor, dishonor of an order might subject the bank to an action by the depositor for damages.[40] It is arguable that the bank in the principal case would merely be refusing to *cash* checks, so that it would not come within the wrongful dishonor

35. Peterson v. Idaho First Nat'l Bank, 83 Idaho 578, 367 P.2d 284 (1963); see Annot., 92 A.L.R.2d 900 (1963). See also Comment, *Banking—Disclosure of Records*, 60 MICH. L. REV. 781 (1962). One might argue that Shulman, by directing sellers to the defendant for a credit reference, consented to publication of whatever information the bank considered appropriate.

36. Cunningham v. Merchants Nat'l Bank, 4 F.2d 25 (1st Cir. 1925).

37. "Investors may be presumed to keep themselves reasonably informed as to the financial capacity of the persons with whom they are dealing in their investments." *Id.* at 30. See also Taylor v. Commercial Bank, 174 N.Y. 181, 66 N.E. 726 (1903), holding the bank not liable to a seller of goods on credit to insolvent depositor for erroneous information disclosed by the cashier, because such disclosure was not within the duty of the cashier. It should be noted that one of the logical implications of the decision in the principal case may be that once the bank is put on notice of possible misappropriation, it has a duty to disclose this information, and its disclosure will be "compelled by law." If this inference is accurate, the case casts considerable doubt upon the general rule of non-liability for erroneous disclosure. Several additional questions are left unanswered. If the bank is required to warn known creditors, how can it identify the creditors who are entitled to the information? Will the corporation have an action against the bank if the bank, mistakenly believing its corporate depositor to be insolvent, discloses this erroneous information to the creditors and damages the corporation's business and reputation?

38. 4 F.2d 25 (1st Cir. 1925).

39. *Id.* at 29.

40. Armstrong v. American Exch. Bank, 133 U.S. 433 (1890); *accord*, United States Cold Storage v. Central Mfg. Dist. Bank, 343 Ill. 503, 175 N.E. 825 (1931). See also UNIFORM COMMERCIAL CODE § 4-402 & comment.

rules; however, since the corporate president could have deposited the checks to the corporation's account and then drawn checks against the account, it may be argued that the rules should apply with equal force to the officer's chosen method of transacting.

If the bank's duty is not to take affirmative protective measures but merely to refuse to participate in the suspected fraudulent transactions, the dissent in *Cunningham* suggests other routes by which the bank might avoid liability. In response to the majority's contention that the threat of liability would place an intolerable burden on the banking machinery in that the bank would have to determine at its peril both insolvency and fraud, the dissenting judge argued that the bank could easily insulate itself from liability by refusing to open an account for the insolvent corporation or, if the insolvent is already a depositor, by closing the account.[41] Although neither course of action would satisfy an affirmative duty to protect the creditors of the corporate depositor, both would terminate the particular bank's involvement in the fraud and thus fulfill the lesser duty of refusing to participate in the suspected misappropriations. Although the court in the principal case fails to specify what the bank could have done to avoid liability, the decision seems to imply that the bank should have chosen one of these several uncomfortable alternatives.[42]

Clearly the approach of the dissent in *Cunningham* does not take account of many of the policy considerations which must be balanced in cases involving a bank's liability for negligence. Although this casenote does not purport to evaluate extensively the equities and policies that are relevant to these determinations, it is submitted that the following factors do deserve some consideration. In our computerized society, credit and commercial paper are the basic tools of business and finance, and it has been estimated that banks now handle 25,000,000 items in a business day.[43] In this context, the enormity of the burden placed on the bank in the principal case should be readily apparent. This burden is even more difficult to

41. Cunningham v. Merchant's Nat'l Bank, 4 F.2d 25, 45 (1925). A bank may select its customers arbitrarily, and its act in refusing an account is not open to question. A bank may receive deposits one day and the next day it may return the amount deposited and refuse to transact further with the depositor. Jaselli v. Riggs Nat'l Bank, 36 App. D.C. 159 (1911); Chicago Marine & Fire Ins. Co. v. Stanford, 28 Ill. 168 (1862); *cf.* Cunningham v. Merchant's Nat'l Bank, *supra.*

42. In its discussion of gross negligence, the court in the principal case stated that the defendant bank was required to treat "National Lumber and particularly Shulman with that degree of caution as it would any other new customer who to the bank would be no more than a stranger off the street." Principal case at 399.

43. UNIFORM COMMERCIAL CODE § 4-103, comment 3. See also Dunne, *Variations on a Theme by Parkinson or Some Proposals for the Uniform Commercial Code and the Checkless Society*, 75 YALE L.J. 788 (1966).

justify when it is examined in the light of modern banking procedures. In mere check cashing transactions such as those involved in the principal case, the bank is functioning as a collecting bank, and generally no evidence of the transactions or of the frequency of such transactions will appear in the records of the depositor's account. Also, the other factor which supposedly puts the bank on notice, the unusual number of credit inquiries, becomes less significant once it is realized that typically these inquiries will be received by several officers of the bank, each of whom may be totally unaware of similar inquiries which had been directed to the others. Finally it should be noted that except for the benefits of good will, banks perform their check cashing services gratuitously, and that to hold them to the standard of care required by the principal case would undoubtedly jeopardize the continuation of this practice.

Thus, as between a bank and a corporation, policy would seem to favor putting the burden on the corporation to scrutinize the acts of its own officers. However, where, as in the principal case, the corporate entity is at most a shadow, public policy may dictate the protection of the innocent creditors despite the possible adverse impact on banking operations.[44] The conclusion of the court in the principal case to hold the bank liable for the loss to the creditors may have been a reasonable resolution of the conflicting interests and may be justifiable in terms of the particular facts of the case; that is, a small bank in which all of the credit inquiries are directed to a single officer and in which it is likely that a series of transactions involving the cashing of checks for large amounts by one individual will come to the attention of one of the few tellers present. However, had the court thoroughly examined the issue of the duty to the creditors, and had it more clearly articulated the position it appears to have assumed, it would have seen the need to limit its holding to the facts, and it might therefore have offered a clearer standard by which banks, in the future, might safely conduct themselves.

---

44. For opposing views on whether the bank or the corporation should bear the risk of liability for misappropriation by a fiduciary, *compare* Merrill, *Bankers' Liability for Deposits of a Fiduciary to his Personal Account*, 40 HARV. L. REV. 1077 (1927), *with* Comment, *Responsibility of a Bank for Misappropriation by a Fiduciary*, 35 YALE L.J. 854 (1926).