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## Uniform Commercial Code -- Applicability of Section 3-405 to Federal Commercial Paper -- "Padded Payroll" Exception -- *United States v. Bank of America Nat'l Trust and Savings Ass'n*

Alexander M. McNeil

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## UNIFORM COMMERCIAL CODE COMMENTARY

**Uniform Commercial Code—Applicability of Section 3-405 to Federal Commercial Paper—“Padded Payroll” Exception—*United States v. Bank of America Nat'l Trust and Savings Ass'n.***<sup>1</sup>—Two enlisted men in the United States Navy, third party defendants in this action, illegally obtained the military identification card of a recently discharged shipmate for the purpose of fraudulently procuring and cashing payroll checks payable to the dischargee. The schemers worked in their ship's Disbursing Office, where they were able to prepare the necessary payroll records and obtain the Disbursing Officer's signature on the fraudulent checks. The enlisted men procured the required signature by representing to the Disbursing Officer that the dischargee had reenlisted. The schemers then cashed the checks at defendant bank, after signing the dischargee's indorsement and exhibiting the stolen identification card bearing the photograph of one of the third party defendants. The bank indorsed each check, expressly guaranteeing prior indorsements,<sup>2</sup> and presented them to the Federal Reserve Bank, which made payment accordingly.

Upon discovery of the fraudulent scheme, the United States brought suit against Bank of America to recover payment made on the checks.<sup>3</sup> The government argued that the defendant bank had breached its express and implied warranties of prior indorsements by presenting checks on which the payee's signature had been forged. It was further argued that existing “federal law,” as developed by the federal courts, gave the government a right to recover payments made on such instruments.

The defendant bank conceded that federal law controlled but urged that, in fashioning appropriate federal law, federal courts must look to current general commercial law.<sup>4</sup> The bank argued that the Uniform Commercial Code represents the general commercial law, since it is followed in forty-nine states, the District of Columbia and the Virgin Islands.<sup>5</sup> Specifically, the bank contended that the case should be decided according to Section 3-405(1)(c) of the U.C.C.,<sup>6</sup>

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<sup>1</sup> 438 F.2d 1213 (9th Cir.), cert. denied, 404 U.S. 864 (1971).

<sup>2</sup> “The presenting bank and the indorsers of a check presented to the Treasurer for payment are deemed to guarantee to the Treasurer that all prior indorsements are genuine, whether or not an express guaranty is placed on the check.” 31 C.F.R. § 360.4 (1971).

<sup>3</sup> *United States v. Bank of America Nat'l Trust & Savings Ass'n*, 288 F. Supp. 343 (N.D. Cal. 1968).

<sup>4</sup> *Id.* at 345.

<sup>5</sup> “Louisiana, the only state which does not have the U.C.C., does have the amended version of Section 9 of the Uniform Negotiable Instruments Act, which is similar to the U.C.C.” *Id.* at 345 n.2; see also 438 F.2d at 1214 n.1.

<sup>6</sup> U.C.C. § 3-405 provides:

which precludes recovery by the drawer in "padded payroll" cases—*i.e.*, where an employee of the drawer supplies the latter with names of payees in whom the drawer would not otherwise intend to have an interest in the checks. The named payee need not be an employee of the drawer, nor even an existing person;<sup>7</sup> the essential element of the fraud is not the padding of a *payroll*, but rather the inducement practiced upon the drawer by the employee.<sup>8</sup> Since the facts of *Bank of America* clearly fell within section 3-405(1)(c), the bank urged the United States District Court for the Northern District of California to adopt that provision "by analogy."<sup>9</sup> The defendant did not request that the U.C.C. be specifically adopted as federal law, but rather that the principles and reasoning of the Code provision be followed by federal courts.

The court refused to apply the U.C.C. provision by analogy and held that the defendant bank was liable to the government on its guarantee of prior indorsements under federal case law. The Court of Appeals for the Ninth Circuit affirmed the decision of the lower court and HELD: the defendant bank's guarantee of prior indorsements renders it liable to the government, even though the issuance of the checks was procured by fraud.

In reaching its decision the court relied upon *National Metropolitan Bank v. United States*,<sup>10</sup> decided by the Supreme Court in 1945, which held, contrary to Section 3-405 of the U.C.C., that the drawer of federal commercial paper should recover in cases involving "padded payroll" situations. The *Bank of America* court, although recognizing the persuasiveness of the defendant's arguments, refused to overrule the Supreme Court decision absent any indication by the Court that *Metropolitan* was no longer viable.<sup>11</sup> This note will trace the develop-

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- (1) An indorsement by any person in the name of a named payee is effective if
    - (a) an impostor by use of the mails or otherwise has induced the maker or drawer to issue the instrument to him or his confederate in the name of the payee; or
    - (b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument; or
    - (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.
  - (2) Nothing in this section shall affect the criminal or civil liability of the person so indorsing.

[All citations to the Uniform Commercial Code will be to the 1962 Official Text.]

<sup>7</sup> U.C.C. § 3-405, Comment 4.

<sup>8</sup> See, e.g., *May Department Stores Co. v. Pittsburgh Nat'l Bank*, 374 F.2d 109 (3d Cir. 1967), where an employee of the plaintiff caused the latter to issue checks payable to fictitious suppliers. The employee procured and negotiated the checks. In an action brought by plaintiff to recover amounts paid on the checks, the court applied Pennsylvania law, found that the facts placed the case within § 3-405(1)(c) of the U.C.C., and held for the defendant bank.

<sup>9</sup> 288 F. Supp. at 345.

<sup>10</sup> 323 U.S. 454 (1945).

<sup>11</sup> The court stated that "we cannot find that the Supreme Court has . . . since 1945, written anything which might cause us to conclude with reasonable assurance that its

ment of federal law regarding federal commercial paper and will examine application of that law by the *Bank of America* court in light of the nearly unanimous acceptance of the U.C.C. by the states. It will be shown that, of the various frauds incorporated within Section 3-405 of the Code, federal case law is in conflict with U.C.C. reasoning only in the padded payroll situation. Finally, it will be concluded that there is no compelling reason for continued toleration of this exception, as in *Bank of America*, since its continued application only serves to impede the circulation and negotiability of federal commercial paper.

In cases involving the commercial paper of the United States, federal courts have consistently followed principles of "general commercial law" in fashioning an appropriate federal rule.<sup>12</sup> However, this "general commercial law" has been derived from different sources at different periods of time. Prior to the 1938 Supreme Court decision in *Erie Railroad Co. v. Tompkins*,<sup>13</sup> no state law governed the liability of holders of federal commercial paper. Since *Erie* held that federal courts were bound by state court rules of decision, absent controlling state statutes, federal courts were free to develop their own rules.<sup>14</sup> The body of law which was thus developed became known as the "federal law merchant." These rules represented an attempt by the federal courts to arrive at some degree of uniformity in deciding the rights and duties of holders of federal commercial paper.<sup>15</sup> The federal law merchant was not in conflict with prevailing principles of commercial law developed by the states,<sup>16</sup> and it served as a "uniform code" for the federal courts to follow. The federal law merchant also eliminated the threat of conflicting decisions concerning federal commercial paper.

Use of the federal law merchant as the "general commercial law" was terminated by the *Erie* decision. From 1938 until 1943, federal courts followed the *Erie* doctrine in cases involving federal commercial paper and applied the pertinent substantive law of the state in which

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*Metropolitan* decision is no longer viable. This being so, we think that *Metropolitan* must now control the disposition of this appeal." 438 F.2d at 1214.

<sup>12</sup> See *Watson v. Tarpley*, 59 U.S. (18 How.) 517 (1855); *United States v. National Exch. Bank*, 45 F. 163 (7th Cir. Wis. 1891); *United States v. National Exch. Bank*, 214 U.S. 302 (1909); *United States v. National Exch. Bank*, 270 U.S. 527 (1926); *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943).

<sup>13</sup> 304 U.S. 64 (1938).

<sup>14</sup> The Supreme Court early held that:

The general commercial law being circumscribed within no local limits, nor committed for its administration to any peculiar jurisdiction, and the constitution and laws of the United States having conferred upon the citizens of the several States, and upon aliens, the power or privilege of litigating and enforcing their rights acquired under and defined by that general commercial law, before the judicial tribunals of the United States, it must follow by regular consequence, that any state law or regulation, the effect of which would be to impair the rights thus secured, or to divest [*sic*] the federal courts of cognizance thereof, in their fullest acceptance under the commercial law, must be nugatory and unavailing.

59 U.S. (18 How.) at 521.

<sup>15</sup> 318 U.S. at 367.

<sup>16</sup> *Id.*

each federal court was located.<sup>17</sup> In *Security-First Nat'l Bank v. United States*,<sup>18</sup> an impostor posing as a military veteran obtained a federal loan. In an action brought by the United States to recover the funds, the Court of Appeals for the Ninth Circuit applied the *Erie* doctrine and held that the United States, as drawer of the check, was precluded from recovery under California application and interpretation of the Negotiable Instruments Law (N.I.L.). The *Security* court noted that:

The Government neither has nor asserts a preferred status. "As against the United States, the rights of the holder of its checks drawn upon the Treasurer are the same as those accorded by commercial practice to the checks of private individuals."<sup>19</sup>

The *Security* court, in looking to state law for its rule of decision, followed the Negotiable Instruments Law, which by 1938 was the "general commercial law" of all the states. Like the "federal law merchant," the N.I.L. represented an attempt to establish uniform rules regarding transactions of commercial paper.<sup>20</sup> However, disparate construction of the N.I.L. by state courts substantially frustrated the desired uniformity.<sup>21</sup>

Section 23 of the N.I.L. allowed the drawer of a check to recover in most circumstances where the payee's signature had been forged.<sup>22</sup> The term "forgery" was not defined by the N.I.L., but the basic meaning of the term has been suggested to be the unauthorized signing of another's name.<sup>23</sup> In light of this interpretation, section 23 seemed broad enough to include fraudulent impersonation<sup>24</sup> and padded payroll schemes.<sup>25</sup> However, most state courts recognized an exception to sec-

<sup>17</sup> E.g., *United States v. Bank of America Nat'l Trust & Savings Ass'n*, 47 F. Supp. 279 (N.D. Cal. 1942).

<sup>18</sup> 103 F.2d 188 (9th Cir. 1939).

<sup>19</sup> *Id.* at 189.

<sup>20</sup> The suggested full title of the N.I.L. was "The Negotiable Instruments Law A General Act Relating to Negotiable Instruments (Being an Act to Establish a Law Uniform with the Laws of Other States on that Subject)." F. Beutel, *Brannan Negotiable Instruments Law* § 1 (7th ed. 1948) [hereinafter cited as *Beutel*].

<sup>21</sup> Several states had amended one or more provisions of the N.I.L. before adopting it. See N.I.L. §§ 1-198.

<sup>22</sup> N.I.L. § 23 provides:

When a signature is forged or made without the authority of the person whose signature it purports to be, it is wholly inoperative, and no right to retain the instrument, or to give a discharge therefor, or to enforce payment thereof against any party thereto, can be acquired through or under such signature, unless the party, against whom it is sought to enforce such right, is precluded from setting up the forgery or want of authority.

<sup>23</sup> *Beutel*, supra note 20, Annotations to N.I.L. § 23.

<sup>24</sup> For purposes of this discussion, fraudulent impersonation may be defined as the representation to the drawer by an impostor that he is someone entitled to have an interest in the instrument. See Annot. 22 A.L.R. 1228, 1230 (1923).

<sup>25</sup> See text at notes 6-8 supra.

tion 23 in situations where drawers issued checks to impostors.<sup>26</sup> In formulating this exception, courts relied upon the test of maker's intent.<sup>27</sup> They reasoned that the maker or drawer of a check, when dealing with an impostor, intends either to pay the impostor, regardless of the identity assumed by the impostor, or to pay the named payee. In fact, the former intention was always attributed to the drawer, except in cases where the named payee was already known to the drawer.<sup>28</sup> Thus, the courts reasoned that since the maker-drawer had intended to pay the impostor, he should not be allowed to set up the defense of forgery.<sup>29</sup>

The exception to section 23, commonly known as the "impostor rule,"<sup>30</sup> operated to deny recovery to the drawer of a check as against the subsequent holder of that instrument where the drawer had dealt with an impostor.<sup>31</sup> However, the "impostor rule" was not construed identically in all jurisdictions, and at least one jurisdiction seems not to have recognized the rule at all.<sup>32</sup> The varying interpretations of the rule meant that, although the N.I.L. was the "general commercial law" of all the states, that law was not uniform throughout the nation with regard to drawers' liability in cases involving fraudulent impersonation. Thus, under the *Erie* doctrine, federal court application of divergent

<sup>26</sup> A compilation of state court decisions which recognized the exception is provided in Beutel, *supra* note 20, Annotations to N.I.L. § 23.

<sup>27</sup> *Id.*

<sup>28</sup> *Rossi v. National Bank*, 71 Mo. App. 150 (1897).

<sup>29</sup> It should be noted that most jurisdictions which applied the test extended it to situations involving impersonation through correspondence with the maker-drawer. For cases extending the rule see *Uriola v. Twin Falls Bank & Trust Co.*, 37 Idaho 332, 215 P. 1080 (1923); *Market St. Title & Trust Co. v. Chelton Trust Co.*, 296 Pa. 230, 145 A. 848 (1929). For cases not extending the rule see *Moore v. Moultrie Banking Co.*, 39 Ga. App. 687, 148 S.E. 311 (1929). See generally Annot. 22 A.L.R. 1228, 1246-49 (1923).

<sup>30</sup> Cf. discussion of the "impostor rule" in *United States v. Continental-American Bank & Trust Co.*, 175 F.2d 271, 272 (5th Cir. 1949).

<sup>31</sup> The Ninth Circuit has ruled that:

In a certain sense, all forgers are impostors and, similarly, impostors in connection with commercial paper in a broad sense are usually forgers. But in the law merchant they are supposed to be separate people. Thus, if the payee is an impostor, a drawer-drawee (probably more properly considered as a maker) who pays a holder has no recourse on an endorser. If, however, he who signs the name of a payee may be classified as a forger, the drawer-drawee, after paying a subsequent endorser, may still recover his unfortunate payment from the endorser.

*United States v. Bank of America Nat'l Trust and Savings Ass'n*, 274 F.2d 366, 367 (9th Cir. 1959).

<sup>32</sup> *Tolman v. American Nat'l Bank*, 22 R.I. 462, 48 A. 480 (1901) (where the Supreme Court of Rhode Island refused to recognize the impostor rule); *Simpson v. Denver & Rio Grande R.R.*, 43 Utah 105, 134 P. 883 (1913), (where an impostor obtained a railroad employee's paycheck from the paymaster's window, the court applied the impostor rule and reasoned that the railroad had only intended to pay the employee-payee, not the impostor, thereby relieving the drawer of liability on the instrument); *Missouri Pacific R.R. v. M.M. Cohn Co.*, 164 Ark. 335, 261 S.W. 895 (1924) (involving facts similar to those in *Simpson*, the court applied the impostor rule and found the drawer liable on the instrument, reasoning that the railroad had intended to pay the impostor, not the named payee).

state interpretations under the N.I.L. precluded a uniform determination of the United States' obligations and liabilities in disputes involving federal commercial paper.

Recognizing the overriding national interest of providing certainty in transactions of federal commercial paper, and, in an attempt to provide federal courts with a uniform "general commercial law," the Supreme Court in 1943 ruled that the *Erie* doctrine should not be followed in decisions involving federal commercial paper. In *Clearfield Trust Co. v. United States*,<sup>83</sup> a government check had been stolen while in transit in the United States mail system; the indorsement of the payee was forged thereon. The check, dated April 28, 1936, was cashed at a store whose owner in turn cashed the check at the defendant bank. The bank then presented the instrument for collection to the Federal Reserve Bank. On May 10, 1936, the payee of the check informed the government that he had not received the instrument. Eight months later, the government notified the bank of the theft and forgery. In 1939 the government brought suit against the bank to recover the amount paid on the check. The United States District Court for the Western District of Pennsylvania dismissed the government's complaint. Following the *Erie* doctrine, the court concluded that under Pennsylvania law the government's unreasonable delay in giving notification of the theft and forgery barred recovery against the defendant bank.

The Court of Appeals for the Third Circuit reversed this decision,<sup>84</sup> holding that *Erie* did not extend to cases involving federal commercial paper since the issuance of negotiable instruments by the United States was a constitutional function, which should not be subjected to state law.<sup>85</sup> The appellate court reasoned that the bank had breached its warranty of indorsements when it had presented a forged check to the Federal Reserve and was thereby liable on that warranty to the government.

The Supreme Court, in affirming the decision of the appellate court, held that the *Erie* doctrine was inapplicable where obligations of the United States on its own commercial paper were involved.<sup>86</sup> Stressing

<sup>83</sup> 318 U.S. 363 (1943).

<sup>84</sup> *United States v. Clearfield Trust Co.*, 130 F.2d 93 (3d Cir. 1942).

<sup>85</sup> The Third Circuit ruled that:

In the absence of an authoritative decision by the Supreme Court . . . to the effect that *Erie R. Co. v. Tompkins* applies only in cases of diversity of citizenship a subordinate tribunal would be exhibiting uncalled for temerity in offering such generalizations. We do not do so here. But we do think, however, that in this case the facts in litigation originate . . . from the Constitution and statutes of the United States . . . and . . . the federal courts are not bound in their determination of the legal consequences of the transaction by what the courts of the states, where the operative facts occurred, have held with regard to the general question involved.

*Id.* at 95.

<sup>86</sup> Speaking for the majority, Justice Douglas stated that:

We agree with the Circuit Court of Appeals that the rule of *Erie R. Co. v.*

the need for uniformity in decisions involving federal commercial paper, the Court stated that the rights and duties of the federal government would be uncertain if "identical transactions [were] subject to the vagaries of the laws of the several states."<sup>87</sup> For this reason, the Court held that a "general commercial law," fashioned by federal courts, should apply in disputes involving federal commercial paper. The Court emphasized that, in choosing an appropriate federal rule, it was not attempting to create an exception for the government.<sup>88</sup> To the contrary, the Court stated that it chose to follow existing principles of commercial law, recognizing that the federal government merited no special protection as a drawer. In allowing the government to recover against the defendant bank, the Court established a federal rule of "general commercial law" that the government's negligent delay in notifying the bank of the theft and forgery did not necessarily preclude recovery against the defendant bank. The Court held that the government could only be denied recovery upon a showing that the delay caused actual damage.<sup>89</sup>

In holding that federally fashioned rules should govern transactions involving federal commercial paper, *Clearfield* marked the rebirth of a "federal law merchant." However, the Court in *Clearfield* indicated that the development of the new federal law merchant was to proceed in accordance with principles of general commercial law, as interpreted by federal courts. In effect, then, *Clearfield* held that federal courts were to follow general commercial law, which at that time included the N.I.L., without being bound by conflicting state court interpretations of the N.I.L.

The Supreme Court underscored the *Clearfield* rationale in *National Metropolitan Bank v. United States*.<sup>40</sup> In *Metropolitan*, a civilian employee of the Marine Corps had drawn up false travel vouchers in the names of existing Marine Corps personnel. Relying upon this false information, the government issued checks for the civilian employee to distribute to the named payees. The employee then forged the payees' indorsements and cashed the checks. As in *Bank of America*, the defendant bank in *Metropolitan* presented the checks to the Federal Reserve Bank for collection, guaranteeing the prior indorsements thereon. In an

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*Tompkins* does not apply to this action. The rights and duties of the United States on commercial paper which it issues are governed by federal rather than local law. When the United States disburses its funds or pays its debts it is exercising a constitutional function or power . . . .

318 U.S. at 366.

<sup>87</sup> *Id.* at 367.

<sup>88</sup> And while the federal law merchant, developed for about a century under the regime of *Swift v. Tyson*, represented general commercial law rather than a choice of a federal rule designed to protect a federal right, it nevertheless stands as a convenient source of reference for fashioning federal rules applicable to these federal questions.

*Id.*

<sup>89</sup> *Id.* at 370.

<sup>40</sup> 323 U.S. 454 (1945).



action brought by the government to recover the amount paid to the defendant bank, the Supreme Court, relying upon *Clearfield*, held that the defendant bank was liable on the breach of its express warranty of indorsements. The Court reasoned that:

No equitable principles require that one who, for his own reasons, guarantees a payee's signature after issuance of a check, shall be relieved of his voluntarily assumed obligation because others who owed the government obligations had previously defaulted in their obligations.<sup>41</sup>

Applying the principles of general commercial law, the Court in *Metropolitan* determined that a padded payroll scheme constituted a forgery under Section 23 of the N.I.L. since the drawer intended that the checks go to the named payees and not to the perpetrator of the scheme. This determination coincided with many state court interpretations under the N.I.L.<sup>42</sup> Padded payroll situations—at least where the named payee actually existed—did not come within the scope of the states' exception to section 23, the "impostor rule," because under the test of maker's intent,<sup>43</sup> the drawer intended to pay the named payees and not the perpetrator. There could be no imposture since no one had assumed the identity of any named payee in order to induce issuance of the checks, nor in order to obtain the instruments. Under federal and state interpretations of the N.I.L., it was irrelevant that the issuance of checks in padded payroll cases had been procured through fraud practiced upon the drawer. What the drawer would have intended, had he known all the facts, was considered immaterial, since the primary test was the drawer's "actual" intention under the circumstances. Thus, since there had been no imposture with respect to the issuance or delivery of the checks in padded payroll cases such as *Metropolitan* and *Bank of America*, subsequent indorsement by the fraudulent perpetrator was considered a forgery which entitled the drawer to recover.

While federal courts, under the *Clearfield* rule, sought a uniform application of existing general commercial law—the N.I.L.—the states began to abandon the N.I.L. and adopt the Uniform Commercial Code. The promulgators of the U.C.C. sought not only to distinguish fraudulent impersonation, including padded payroll schemes, from forgery, but also sought to reallocate the risk of loss in the former situations more equitably.<sup>44</sup> Section 3-404 of the Code,<sup>45</sup> based upon Section 23 of the

<sup>41</sup> Id. at 458.

<sup>42</sup> E.g., *Los Angeles Inv. Co. v. Home Savings Bank*, 180 Cal. 601, 182 P. 293 (1919); *City of St. Paul v. Merchants' Nat'l Bank*, 151 Minn. 485, 187 N.W. 516 (1922).

<sup>43</sup> See text at notes 27-29 supra.

<sup>44</sup> U.C.C. § 3-404, Comments. It should also be noted that prior to the promulgation of the U.C.C., nineteen states had already distinguished padded payroll schemes from forgeries by state amendments to N.I.L. § 9(3). Thus, in these jurisdictions, the drawer in a padded payroll situation was denied recovery. See Comment, *The Resolution of Padded Payroll Cases by the Uniform Commercial Code: A Pandora's Box*, 9 B.C. Ind. & Com. L. Rev. 379 (1968).

<sup>45</sup> U.C.C. § 3-404 provides:

N.I.L., generally operates to permit the drawer to recover money paid on checks where an "unauthorized signature" has been made thereon. The term "unauthorized signature" is vaguely defined as one made without authority, and "includes a forgery."<sup>46</sup> The term "forgery" is not defined. However, Section 3-405<sup>47</sup> of the Code indicates that the terms "unauthorized signature" and "forgery" do not include indorsements made by impersonators, or agents and employees of the drawer, who fraudulently induce the latter to issue checks payable to persons whom the agent-employee intends to have no interest in the instruments—*i.e.*, padded payroll schemes.

The rationale for including padded payroll situations within section 3-405 was that the loss in such cases should fall upon the employer, as a risk of doing business, rather than the subsequent holder of the fraudulently issued check. It was felt that the employer-drawer was in a better position to protect himself against such loss, either by exercising greater care in the selection of his employees or by obtaining insurance.<sup>48</sup>

In *Bank of America*, the federal district court interpreted this rationale as being limited to private employers. The court suggested that the federal government was a unique employer and that "[t]he Government, especially with respect to military personnel, cannot be expected to exercise the same control as private enterprise over its employees."<sup>49</sup> It is submitted that this reasoning is not justified by the Supreme Court's decisions in *Clearfield* and *Metropolitan*. In those cases, the Court made no attempt to exempt the government from liability under general commercial law, nor to create for it an exception to the principles of general commercial law. As the Court explicitly stated in *Clearfield*, and implicitly reaffirmed in *Metropolitan*, "[t]he United States does business on business terms," and "is not excepted from" the operation of general commercial law "by the largeness of its dealings."<sup>50</sup> The Court unequivocally indicated that federal rules regarding the commercial paper of the United States were to be fashioned in accordance with existing principles of commercial law. Thus, in light of *Clearfield* and *Metropolitan*, the claim in *Bank of America* that the United States deserves special or preferential treatment in disputes involving its commercial paper is unfounded. Moreover, if it is accepted that the United States deserves the special treatment granted in *Bank of America*, then it would follow that the government should be allowed

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- (1) Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any person who in good faith pays the instrument or takes it for value.
  - (2) Any unauthorized signature may be ratified for all purposes of this Article. Such ratification does not of itself affect any rights of the person ratifying against the actual signer.

<sup>46</sup> U.C.C. § 1-201 (43).

<sup>47</sup> See note 6 *supra*.

<sup>48</sup> U.C.C. § 3-405, Comment 4.

<sup>49</sup> 288 F. Supp. at 348.

<sup>50</sup> 318 U.S. at 369; see also 438 F.2d at 1214.

recovery not only in padded payroll cases, but whenever it has been the victim in a fraudulent check-issuing scheme. However, federal courts have generally denied recovery to the government, as drawer, in all but padded payroll schemes.<sup>51</sup>

In *United States v. Continental-American Bank & Trust Co.*,<sup>52</sup> an impostor posed as the widow of a veteran entitled to receive benefits from the Veterans' Administration. The impostor fraudulently induced the VA to issue checks payable to the widow, but addressed to the impostor's place of residence. The impostor then indorsed and cashed the checks at the defendant bank, and the bank subsequently presented the instruments to the Federal Reserve Bank for collection. In an action instituted by the government to recover monies paid on the checks, the Court of Appeals for the Fifth Circuit applied the "impostor rule" and found for the defendant bank.<sup>53</sup> It concluded that no forgery had occurred, since the VA had intended that its checks go to the impostor, even though that intent had been fraudulently procured. *Metropolitan* was distinguished as a forgery case, since the drawer there had intended that the reimbursement checks go to the named payees. The test of maker's intent controlled the outcome of *Continental*.

In *Atlantic Nat'l Bank v. United States*,<sup>54</sup> a deputy tax collector had prepared refund returns in the names of nonexistent persons. He then acquired the refund checks, indorsed the names of the fictitious payees, and cashed the checks. The bank presented the checks for collection, and the Federal Reserve Bank made payment. The government subsequently brought an action to recover the monies paid on the instruments. As in *Continental*, the Court of Appeals for the Fifth Circuit found for the defendant bank. The court reasoned that a bank could not reasonably be expected to ascertain whether everyone who presents a government check has a legitimate claim to the proceeds thereof. Furthermore, the court noted that:

If through fraud . . . a check is delivered to one upon the mistaken belief that it is due such person, the endorsement of that impostor, whether in that name or in another, is not a forgery . . . .<sup>55</sup>

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<sup>51</sup> *United States v. Bank of America Nat'l Trust & Savings Ass'n*, 274 F.2d 366, 367 (9th Cir. 1959).

<sup>52</sup> 175 F.2d 271 (5th Cir. 1949).

<sup>53</sup> The banks do not have the burden of correcting a mistake made or detecting a fraud committed. If the banks see that the very person to whom the check was issued and delivered has indorsed it in the form required, the indorsement is a genuine one, although the name used is a wrong one. They guarantee that the person to whom a check was issued has indorsed it, but not that the check was honestly procured from the drawer. Such is the so-called "impostor rule". . . .

. . . .  
[In *Metropolitan*, the perpetrator] had never presented himself as the person entitled and persuaded the drawer of the checks that he was entitled to be paid. He was not an impostor, but a forger.

*Id.* at 272.

<sup>54</sup> 250 F.2d 114 (5th Cir. 1957).

<sup>55</sup> *Id.* at 118.

This reasoning coincides with Section 3-405 of the U.C.C., which declares that forgery does not include indorsements made by impersonators. Further, the use of the words "mistaken belief" by the *Atlantic* court seems to represent a departure from the traditional concept of maker's intent since, under the latter test, it made no difference whether the maker's "belief" was "mistaken" or not. *Atlantic* would appear to indicate that the primary consideration in fraudulent check-issuing schemes should be the defrauder's intent.

In a 1959 decision involving the Bank of America, *United States v. Bank of America Nat'l Trust and Savings Ass'n*<sup>56</sup> (hereinafter referred to as *Bank of America* (1959) in order to distinguish it from the principal case), the Court of Appeals for the Ninth Circuit followed the *Atlantic* decision. *Bank of America* (1959) involved a scheme in which federal income tax refund returns were filed in the names of fictitious persons. The scheme was effected by certain private employers who had padded their payrolls by adding the names of nonexistent persons to their employee records. The refund checks were negotiated at the defendant bank by the perpetrators of the scheme. Upon presentation of the checks, the Federal Reserve Bank made payment, and the government subsequently brought suit. In finding for the defendant bank the court noted the similarity of the facts to those in *Atlantic*, and followed that decision. As did the *Continental* court, the *Bank of America* (1959) court distinguished *Metropolitan* as a "true forger case."<sup>57</sup> The court reasoned that in *Metropolitan* the drawer had intended to pay the named payees, whereas here the drawer had intended that the impostors receive the checks. To support this reasoning the court noted that the difference between the concepts of forgery and imposture as developed under general commercial law—the N.I.L.—was based upon the "intent of the maker, something not to be found on the face or back of the instrument."<sup>58</sup> Relying on that test, the court found that the government had intended to pay the impostors,<sup>59</sup> reasoning that, in a sense, the fictitious payees actually existed as the perpetrators operating under aliases.<sup>60</sup> Thus the court concluded that the government intended to pay the perpetrators, and that it could not "cancel every check and get recourse on every endorser because of fraud in the inception."<sup>61</sup>

<sup>56</sup> 274 F.2d 366 (9th Cir. 1959).

<sup>57</sup> *Id.* at 367.

<sup>58</sup> *Id.* at 368.

<sup>59</sup> Of course, what makes the difference between the impostor in law and the forger in law is the intent of the maker. . . . We think those in the government chain responsible for issuing the check, while they had no man or woman in the flesh standing before them or even a mental picture of his or her dimensions, did have an intent to issue the check to the person who wrote the name on the spurious return and who eventually endorsed the check.

*Id.* at 368-69.

<sup>60</sup> *Id.* at 369.

<sup>61</sup> *Id.* at 368-69. The court noted further that:

If the law for federal commercial paper is to be fashioned differently than the usual law merchant, it will have to be on a basis of a judicial rule that a govern-

The *Continental, Atlantic, and Bank of America* (1959) decisions indicate that federal courts have not given the federal government special treatment in disputes involving its commercial paper. Further, none of these decisions indicates that the United States is a unique employer, as was suggested by the court in the principal case. The decisions show not only that the "impostor rule" was followed by federal courts after *Clearfield*, but also that at least two federal appellate courts expanded the scope of the rule to cover fictitious payee situations, as was done by Section 3-405 of the U.C.C. In addition, since section 3-405 specifically accords padded payroll situations the same treatment as other schemes of fraudulent impersonation, then, in light of the *Bank of America* decision, federal law is in conflict with Code reasoning only in padded payroll situations.

In permitting the government, as drawer, to recover in padded payroll cases, the *Bank of America* court continued the practice of federal courts relying on the N.I.L. as the general commercial law. However, if federal courts continue to follow N.I.L. reasoning in these situations, the federal government will be placed under no duty to guard against the padded payroll fraud. Assured that it will always prevail upon discovery of a padded payroll scheme, the government has little incentive to initiate preventive measures to avoid continued perpetration of such schemes. Although it is not made clear in *Bank of America* how the schemers obtained the identification card of the discharged shipmate, or whether that card bore an expiration date, the opportunity for perpetration of the fraud might have been sharply reduced if the Navy had employed an effective system of collecting and promptly invalidating the cards of all discharged personnel.

More importantly, if the padded payroll exception continues to be recognized by federal courts, it is submitted that the negotiability of federal commercial paper will be seriously impaired. Individuals, including federal employees, in most circumstances may not cash government checks at Federal Reserve Banks,<sup>62</sup> private institutions provide this service. Commercial banks, which already place restrictions on the cashing of government checks to guard against negotiating stolen and altered instruments, must, in the padded payroll situation, assume the additional burden of ascertaining the "maker's intent" in issuing the instrument. In other words, if federal employee A goes to the bank carrying federal employee P's identification card (with A's photograph thereon), and cashes a government check payable to P, the bank's liability to the government will depend upon the circumstances under

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ment agent acting for his government cannot pass title to the paper he issues in line with his accustomed authority, if in the transaction the government has been defrauded, even when the government agent, as here, is wholly innocent of the fraud and deals with an impostor. That the Supreme Court will so rule we have been unable to find a harbinger thereof in its cases.

Id. at 369.

<sup>62</sup> "Federal Reserve Banks shall not be expected to cash Government checks presented direct to them by the general public." 31 C.F.R. 360.6(a)(2) (1971).

which A procured the check. If A impersonated P in dealing with the government, then the bank is relieved of liability on its warranty of indorsements. But if A provided the government P's name, without actually impersonating P, then the bank will be liable.

Commercial banks which cash payroll checks for military personnel as a courtesy, relying upon the genuineness of military photo-identification cards, may no longer honor such checks. This result is inevitable if banks cannot rely on the authenticity of the bearer's identification, and if they know that they must sustain the loss as innocent victims of a padded payroll scheme. Thus the fear of being compelled to make repayment to the government in padded payroll situations will impede the circulation of federal commercial paper. Furthermore, only the government will be adversely affected by continued application of the padded payroll exception since, where private commercial paper is involved, the banks owe no such obligation to drawers under Section 3-405 of the U.C.C. This result is contrary to the policy considerations of the United States government in facilitating the circulation of federal commercial paper:

The necessity for unfettered circulation of the Government's negotiable paper not only does not require—it actually forbids—that such loss should be visited on the collecting banks.<sup>63</sup>

It is submitted that technical variations as to the manner in which a fraud has been perpetrated should not control the determination of liability in these situations. Federal courts should apply section 3-405 (1) (c) by analogy. In this way, padded payroll frauds would be treated as any other fraud involving federal commercial paper, and the drawer would be denied recovery. There exists ample federal precedent in other areas of commercial law for federal court adoption by analogy of Code reasoning. In *United States v. Wegematic Corp.*,<sup>64</sup> the Court of Appeals for the Second Circuit accepted defendant manufacturer's suggestion that the U.C.C. serve as a source for the "federal law" of sales. The defendant had been unable to comply with its promise to supply a computer system to the federal government. Thereupon, the government brought an action for breach of contract. The defendant maintained that it should be excused from performance on the grounds of extreme impracticability as provided in Section 2-615 of the Code.<sup>65</sup> Although

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<sup>63</sup> 250 F.2d at 118.

<sup>64</sup> 360 F.2d 674 (2d Cir. 1966).

<sup>65</sup> U.C.C. § 2-615 provides:

Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:

- (a) Delay in delivery or non-delivery in whole or in part by a seller who complies with paragraphs (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

the court was persuaded that the U.C.C. should be viewed as a source for the federal law of sales, it held that the concept of impracticability in section 2-615 did not extend to the circumstances of the *Wegematic* case. In its discussion of the applicability of Code standards to cases involving the United States government, the court noted that it would be a "distinct disservice" not to follow the U.C.C. in the area of sales.<sup>66</sup>

The Second Circuit Court of Appeals again espoused federal reliance upon U.C.C. reasoning in *In re Yale Express System, Inc.*<sup>67</sup> In this bankruptcy proceeding, the court rejected technical distinctions, which had been developed by federal courts, between creditors' rights to reclaim property under conditional sales contracts and under chattel mortgages. The court noted:

We would indeed be myopic if we failed to recognize the revolution in commercial law that the Uniform Commercial Code has occasioned in the states. It would be incongruous for the federal courts, historically the leaders in the development of the law, to continue to employ anachronistic distinctions . . . when the overwhelming number of states have succeeded in bringing their laws more into line with commercial reality.<sup>68</sup>

In a subsequent proceeding,<sup>69</sup> the court noted that the *ratio decidendi* of a pre-Code precedent "had been undermined" by the more recent adoption of the U.C.C. by the states.<sup>70</sup> It is submitted that the *ratio decidendi* of *Metropolitan*, dictating recovery for the government in padded payroll cases, has likewise been undermined by the adoption of the U.C.C.

A more striking, and more germane, example of federal judicial adoption by analogy of a U.C.C. provision is to be found in *United States v. First Nat'l Bank*.<sup>71</sup> There the United States brought suit to recover payments made by the government to defendant bank on a series of stolen postal money orders. The United States District Court

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(b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable.

(c) The seller must notify the buyer seasonably that there will be delay or non-delivery and, when allocation is required under paragraph (b), of the estimated quota thus made available for the buyer.

<sup>66</sup> "When the states have gone so far in achieving the desirable goal of a uniform law governing commercial transactions, it would be a distinct disservice to insist on a different one for the segment of commerce, important but still small in relation to the total, consisting of transactions with the United States." 360 F.2d at 676.

<sup>67</sup> 370 F.2d 433 (2d Cir. 1966).

<sup>68</sup> Id. at 437.

<sup>69</sup> *In re Yale Express System, Inc.*, 384 F.2d 990 (2d Cir. 1967).

<sup>70</sup> Id. at 991.

<sup>71</sup> 263 F. Supp. 298 (D. Mass. 1967).

for the District of Massachusetts admitted that domestic postal money orders are technically not negotiable instruments, due to the limitation of indorsements which may be made thereon. However, deciding in favor of defendant bank, the court found that the money orders were "sufficiently like a negotiable instrument"<sup>72</sup> to be governed by the principles of Section 3-418 of the U.C.C. Section 3-418, which declares that payment on any negotiable instrument "is final in favor of a holder in due course,"<sup>73</sup> operates to deny recovery to a drawer or drawee who pays on a forged instrument. However, it should be noted that the section does not absolve a holder in due course from liability on his guarantee of prior indorsements. Thus a bank in a padded payroll situation, as in *Bank of America*, would be unable to avail itself of the protection offered by section 3-418.

The court in *First National* cited three major policy considerations in support of its decision in favor of the defendant bank: first, that the desirable goal of finality in commercial transactions is thereby promoted; second, that the Post Office Department was chargeable with knowledge of the theft and thus had the duty to protect itself by instructing the Treasury not to make payment; and third, that a "bona fide purchaser" of a money order merits the same protection as a holder in due course of an ordinary negotiable instrument since the Post Office Department seeks to promote use of the items as quasi-negotiable instruments.<sup>74</sup>

It is submitted that the court's imposition of a duty upon the Post Office Department to protect itself against illicit schemes should similarly have been imposed upon the Navy Department in *Bank of America*. Section 3-405 of the U.C.C. impliedly places a duty on the employer to take precautions against the perpetration of frauds by obtaining insurance or by exercising supervisory control over its employees. When the "precaution" argument was suggested in *Bank of America*, the court maintained that the government, by reason of its size, could not exercise this type of control at an interdepartmental level. However, the vast bulk of federal governmental operations is conducted on a departmental basis—each unit functions in many respects like a private employer. In recognition of this fact, a duty to police governmental operations was imposed at the departmental level in *First National*. This basis for determining the obligations of the United States on its commercial paper seems more amenable to the federal court determination that "the United States does business on business terms." Once it is accepted that precautionary measures must be taken on a department-

<sup>72</sup> Id. at 301.

<sup>73</sup> U.C.C. § 3-418 provides:

Except for recovery of bank payments as provided in the Article on Bank Deposits and Collections (Article 4) and except for liability for breach of warranty on presentment under the preceding section, payment or acceptance of any instrument is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment.

<sup>74</sup> 263 F. Supp. at 301-02.



by-department basis, rather than at a higher level, exceptions to general commercial practice granted to the government "by reason of its size" need no longer be tolerated.

Unfortunately, *Bank of America* is representative of the reluctance of federal courts to overrule the Supreme Court's *Metropolitan* decision and to decide padded payroll cases according to present-day commercial law.<sup>75</sup> The lower courts are unsure that the Supreme Court would affirm such a decision<sup>76</sup> and they recognize that a decision to overrule *Metropolitan* would disrupt the federal uniformity that exists with respect to padded payroll cases.<sup>77</sup> However, the federal uniformity, developed when the N.I.L. was in force, is at odds with the state uniformity that now exists under the U.C.C.

It is submitted that *Metropolitan* should no longer be followed by federal courts since that decision is an anachronism. It compels the federal courts to apply N.I.L. concepts only in the area of padded payrolls, while U.C.C. reasoning is otherwise followed by federal courts. Further, the interpretation by the court in *Bank of America* that *Metropolitan* dictates recovery to the government in padded payroll situations constitutes a violation of the underlying principles which led to the *Metropolitan* decision. *Metropolitan* was decided in accordance with general commercial law, not in accordance with a theory that the United States merited special protection in the padded payroll situation. The Uniform Commercial Code, now the general commercial law of forty-nine states, provides a workable set of guidelines regarding transactions in commercial paper. To exempt federal paper from the operation of these rules not only detracts from the uniformity sought by the widespread adoption of the Code, but also weakens the negotiability of federal commercial paper.

Unfortunately, the Supreme Court has denied certiorari in the *Bank of America* case.<sup>78</sup> The Court has thereby declined to decide whether padded payroll situations should be brought into harmony with U.C.C. reasoning, or whether the lower court in *Bank of America* is correct in its assertion that the government should be granted an exception to general commercial law in this area. Notwithstanding the Supreme Court's inaction, it is submitted that the federal appellate court in *Bank of America* should have interpreted *Metropolitan* as allowing a result based on prevailing principles of general commercial law. A decision to follow U.C.C. reasoning in padded payroll cases would have promoted three desirable goals: the government would have been induced to initiate precautionary measures against the continued perpetration of padded payroll schemes; federal law would have been

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<sup>75</sup> See *United States v. Philadelphia Nat'l Bank*, 304 F. Supp. 955 (E.D. Pa. 1969), decided in favor of the government, involving facts similar to *Bank of America*. See also note 11 supra.

<sup>76</sup> 438 F.2d at 1214.

<sup>77</sup> 288 F. Supp. at 348.

<sup>78</sup> 404 U.S. 864 (1971).

brought into harmony with uniform state law; and, the circulation and negotiability of federal commercial paper would have been promoted.

ALEXANDER M. McNEIL