



UNC  
SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

---

Volume 47 | Number 1

Article 22

---

12-1-1968

# Uniform Commercial Code -- Estoppel -- Forged Indorsements

H. Irwin Coffield III

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>



Part of the [Law Commons](#)

---

## Recommended Citation

H. I. Coffield III, *Uniform Commercial Code -- Estoppel -- Forged Indorsements*, 47 N.C. L. REV. 256 (1968).

Available at: <http://scholarship.law.unc.edu/nclr/vol47/iss1/22>

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact [law\\_repository@unc.edu](mailto:law_repository@unc.edu).

## Uniform Commercial Code—Estoppel—Forged Indorsements

In a recent New Jersey decision, *Gast v. American Casualty Co.*,<sup>1</sup> the court had to decide the extent to which the estoppel provisions of the UNIFORM COMMERCIAL CODE<sup>2</sup> precluded recovery of a check paid over a forged indorsement. Under a standard clause in a real estate contract, the buyer, Hanna, was required to carry fire insurance. Upon loss, the moneys jointly receivable by seller and buyer were to be put in escrow by the seller's attorney; the buyer was to order the necessary repairs; and the seller's attorney was to pay for them out of the escrow funds.<sup>3</sup> In settlement of a fire claim, the insurance company drew a draft upon itself,<sup>4</sup> jointly payable to the seller, Gast, the buyer, Hanna, and the public adjuster involved.<sup>5</sup> Having obtained the adjuster's indorsement, the seller's attorney mailed the draft to the buyer's attorney with instructions to obtain the buyer's indorsement, then return it for deposit in the escrow account.<sup>6</sup> Apparently the buyers, upon gaining possession of the draft, forged the indorsement of the sellers, cashed the check, and absconded. Shortly thereafter the sellers were advised by the buyer's attorney that he had not heard from his clients and no longer considered himself representing them.<sup>7</sup> The sellers, however, waited for more than a month<sup>8</sup> to notify the insurance company of this irregularity and to

---

<sup>1</sup> 99 N.J. Super. 538, 240 A.2d 682 (Super. Ct. 1968).

<sup>2</sup> UNIFORM COMMERCIAL CODE § 3-406 [hereinafter cited as U.C.C.].

<sup>3</sup> Exhibit DA-8, Brief for Respondent at 12a, *Gast v. American Cas. Co.*, 99 N.J. Super. 538, 240 A.2d 682 (Super Ct. 1968).

<sup>4</sup> The draft stated that it was "payable through the Berks County Trust Co., Reading Pa., upon acceptance by American Casualty Company," making the insurance company both drawer and drawee. The bank involved was merely a collecting bank. That the bank was not a drawee is made clear by U.C.C. § 3-120, which provides:

An instrument which states that it is "payable through" a bank or the like designates that bank as a collecting bank to make presentment but does not of itself authorize the bank to pay the instrument.

<sup>5</sup> The draft was made payable to three persons, thus requiring multiple indorsement, to insure discharge of multiple claims. It is somewhat inconsistent, therefore, for the insurance company to later assert payment of plaintiff's claim by reason of draft made out to multiple payees, for had the draft been made out only to the Gasts, the forgery would probably never have occurred.

<sup>6</sup> Brief for Respondent, note 3 *supra*, at Exhibit DA-8.

<sup>7</sup> Brief for Respondent, note 3 *supra*, Exhibit DA-7 at 12.

<sup>8</sup> Had plaintiff been a merchant fully cognizant of the provisions of the U.C.C., his delay in notification of the insurance company would have had more serious consequences than were levied by the court. See U.C.C. §§ 2-602(1), 1-204(2), (3).

request cancellation of the draft.<sup>9</sup> The notice was too late, for the insurance company had already accepted the draft and paid it. In a contract action by the sellers on the fire insurance policy,<sup>10</sup> the court held the insurance company liable for conversion of the draft,<sup>11</sup> and the sellers free from any negligence within the meaning of the New Jersey Statute.<sup>12</sup>

Negligence is usually not a defense to a contract action; one either performs a contract or not, and the *method* itself makes no difference to the *fact* of performance.<sup>13</sup> The defense has been allowed, however, when the negligence is offensive to a rational sense of justice and fair play. The U.C.C. seems to adopt this position, providing:

Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.<sup>14</sup>

Yet neither the U.C.C. nor most of the courts that have considered this problem<sup>15</sup> provide a clear definition of the phrase "substantially contributes."<sup>16</sup> The court in *Gast* attempted to resolve the problem by adopting a definition offered by the Oregon court in *Gresham State Bank v. O & K Construction Co.*:<sup>17</sup>

<sup>9</sup> Brief for Respondent, note 3 *supra*, Exhibit DA-5 at 8a. This delay from May 10 to June 21 is the basis of defendant's charge of negligence.

<sup>10</sup> The contract action was against the insurance company on the policy rather than one against the bank because:

(a) If action is brought first against the bank, plaintiff will probably lose his rights against the insurance company.

(b) Bringing action against the bank would increase discovery problems.

(c) If action is brought first against the bank, the bank might lose some of its defenses, which it could have asserted against the insurance company. For a discussion of this problem, see *Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust*, 345 Mass. 1, 184 N.E.2d 358 (1962).

<sup>11</sup> N.J. REV. STAT. § 12A: 3-419 (1962). In effect this section imposes absolute liability for conversion, subject only to certain U.C.C. defenses.

<sup>12</sup> N.J. REV. STAT. § 12A: 3-406 (1962).

<sup>13</sup> A possible exception is the contract doctrine of substantial performance, where the method of performance may bear upon the decision.

<sup>14</sup> U.C.C. § 3-406.

<sup>15</sup> See, e.g., *Park State Bank v. Arena Auto Auction, Inc.*, 59 Ill. App. 2d 235, 207 N.E.2d 158 (1965); *Jackson v. First Nat'l Bank*, 55 Tenn. App. 545, 403 S.W.2d 109 (1966).

<sup>16</sup> REPORT OF THE NEW YORK LAW REV. COMM'N FOR 1955: STUDY OF THE UNIFORM COMMERCIAL CODE, 247 (1955) [hereinafter cited as 1955 REPORT].

<sup>17</sup> 231 Ore. 106, 370 P.2d 726 (1962).

[T]he requirement that the negligence 'substantially contributes' to the making of the unauthorized signature is necessary to satisfy the test of factual causation; it is the equivalent of the 'substantial factor' test applied in the law of negligence generally.<sup>18</sup>

If the above definition is used in conjunction with the statute, a twofold method of determining whether the defense of estoppel is available emerges.<sup>19</sup> The one against whom the estoppel is sought must have: (1) been negligent and (2) that negligence must have been a "substantial factor" in contributing to the forgery.<sup>20</sup>

The statute omits the usual third step of proximate cause analysis—a policy limitation on liability determined by the court. The omission raises at least two implications: that proximate cause analysis is to be assumed and used if necessary, or that proximate cause analysis is not necessary in the cases that will foreseeably arise under Section 3-406. The latter seems more logical, although it does not appear to be supported by any declared statement of intent by the draftsmen of the U.C.C., nor specifically recognized by any court considering the question.<sup>21</sup>

As a general rule, for conduct to be negligent it has to be foreseeable that the conduct involved will create an "unreasonable risk of causing damage to others."<sup>22</sup> In addition, the risk involved has to be one to the particular class or individual injured, not merely one to the community generally.<sup>23</sup> The question of foreseeability on a proximate cause level, in contrast to that on the negligence level, "means a foreseeability much more closely identified with the particular plaintiff or the class of which he is a member and the interest of the plaintiff which is actually invaded."<sup>24</sup>

To a large extent, therefore, foreseeability analysis on a proximate cause level is a refinement of that conducted on the negligence level. Yet, in the restricted situation usually encountered with Section 3-406, is such a policy limitation on liability needed at all? For instance, in the *Gresham* case, where a principal gave his agent the appearance of author-

---

<sup>18</sup> *Id.* at 120, 370 P.2d at 732.

<sup>19</sup> The test has an additional step; the party seeking to use the estoppel must have paid the instrument "in good faith and in accordance with the reasonable commercial standards" of its business. U.C.C. § 3-406.

<sup>20</sup> *Id.*

<sup>21</sup> Only five courts appear to have considered the question in any depth, and of these, only two have defined the term.

<sup>22</sup> W. PROSSER, *LAW OF TORTS* § 31, at 149 (3d ed. 1964).

<sup>23</sup> For the initial analysis of "negligence in the air," see *Palsgraf v. Long Island R.R.*, 248 N.Y. 334, 162 N.E. 99 (1928).

<sup>24</sup> *Campbell, Duty, Fault, and Legal Cause*, 1938 WIS. L. REV. 402, 408-09.

ity<sup>25</sup> to cash checks, when actually no such authority existed,<sup>26</sup> the risk was clearly that the agent would convert the checks to his own use. The only way to accomplish the conversion is by a forged indorsement, and the checks must be paid or purchased by some party convinced of the agent's authority. In other words, the possible methods of accomplishing the conversion are extremely limited. If those methods are inherent in the act and can be clearly ascertained by the two-step negligence analysis, of what use is a proximate cause step?

Even though the statute may simplify the analytical steps needed to reach a conclusion of negligence and estoppel, the problem remains, for what type of negligence will the actor be liable? The Official Comment to Section 3-406<sup>27</sup> points out that the statute "adopts the doctrine of *Young v. Grote*, 4 Bing 253 (1827), which held that a drawer who so negligently draws an instrument as to facilitate its material alteration is liable to the drawee who pays the altered instrument in good faith."<sup>28</sup>

In *Young*, a businessman, leaving London on a trip, left five signed drafts, drawn on his bank, with his wife, who knew nothing about his business. Her instructions were to use the drafts as was necessary. In the course of business it became necessary to use a draft and the wife instructed her husband's agent to fill in the proper sum on the draft. The agent did so, but left obvious spaces where alterations could be made. The agent showed the draft to the wife, who apparently approved it. The agent then altered the draft, cashed it, and absconded.<sup>29</sup> The arbitrator charged *Young* with "gross negligence"<sup>30</sup> for giving the agent the opportunity to alter the draft.<sup>31</sup> The majority of the court on appeal agreed with the judgment of the arbitrator, one of the justices calling the negligence of *Young* "great."<sup>32</sup> The inference of *Young* and Comment One,<sup>33</sup> therefore, is that simple or ordinary negligence will not raise the defense of estoppel under Section 3-406.

In both *Gresham* and *Gast*, however, the court took a softer line than

---

<sup>25</sup> The negligence of the principal consisted of giving his agent the appearance of the authority in spite of the absence of it.

<sup>26</sup> 231 Ore. at 109, 370 P.2d at 728.

<sup>27</sup> U.C.C. § 3-406, Comment 1.

<sup>28</sup> *Id.*

<sup>29</sup> *Young v. Grote*, 4 Bing 253, 254, 255 (1827).

<sup>30</sup> *Id.* at 256.

<sup>31</sup> Note here the application of the negligence-estoppel concept to contract law.

<sup>32</sup> 4 Bing at 260.

<sup>33</sup> U.C.C. § 3-406, Comment 1 further states: "It should be noted that the rule as stated in this section requires that the negligence 'substantially' contribute to the alteration."

did *Young* or the Official Comment, by adopting the "substantial factor" formula propounded in *Anderson v. Minneapolis, Saint Paul & Sou Saint Marie Railroad*<sup>34</sup> by the Minnesota court. The formula, as Prosser notes, is closely related to the old "but for" rule, while being "clearly an improvement"<sup>35</sup> over it. Even granting the improvement, in the majority of cases the rule means little more than "the defendant's conduct is not a cause of the event, if the event would have occurred without it."<sup>36</sup> The language of the formula indicates that the conduct necessary to qualify as a cause of an event does not have to be the dominant cause, it must merely be a cause without which the event would not have happened.

It appears that the reasoning of the *Gast* and *Gresham* courts is in conflict with that of the statute. The language of the statute and the Official Comment would not qualify all negligent conduct as estoppable under the statute, but only conduct that was more than simply negligent and that was a major cause of the event.<sup>37</sup> The language adopted by the two courts in question seems to let the statutory estoppel fall on any negligent conduct that was an actual cause of the result complained of.

Although the court in *Gast* varies from the Comment and *Young*, the more practical method of determining the cause in fact issue seems to be the substantial factor test. To decide whether one cause contributed more to an event than another results in the loss of the objectivity that should necessarily be present in the determination of the cause in fact issue.<sup>38</sup> The same applies in determining whether one sort of negligence is of a higher degree than another.<sup>39</sup> Moreover, in a study of the U.C.C. and its possible effect on New York law, the New York Law Revision Commission approved the comment that "[T]he Code Section [3-406]

<sup>34</sup> 146 Minn. 430, 179 N.W. 45 (1920). The rule is that "defendant's conduct is a cause of the event if it was a material element and a substantial factor in bringing it about."

<sup>35</sup> W. PROSSER, LAW OF TORTS § 41, at 244 (3d ed. 1964).

<sup>36</sup> *Id.* at 242. The quoted material explains the "*sine qua non*" or "but for" rule, which Prosser indicates tended to break down in certain limited fact situations. The "substantial factor" test was adopted by the Minnesota court to cover one of these. Except for these particular cases, the operation of the "substantial factor" formula is basically the same as the "but for" test.

<sup>37</sup> This conclusion is drawn from the language of *Young* and U.C.C. § 3-406, Comment 1.

<sup>38</sup> See generally Green, *The Causal Relation Issue in Negligence Law*, 60 MICH. L. REV. 543 (1962).

<sup>39</sup> For an example of the confusion that can occur in trying to determine degrees of negligence, note the problems the courts have run into in trying to apply degrees of negligence to the guest passenger area. See W. PROSSER, LAW OF TORTS § 34, at 186 (3d ed. 1964).

would substitute a principle of complete estoppel by negligence. . . . The negligent person is made fully liable and can only pursue the wrongdoer."<sup>40</sup> This statement may represent a change in the original position of the writers of the U.C.C. If so, the position of the court in *Gast* is not only judicially sound, but is in line with the "intent" of the framers of the statute.

Section 3-406 thus presents a two-fold problem of statutory interpretation in deciding whether the section cuts off proximate cause analysis and in interpreting the meaning of "substantially contributes"—is it a test of factual causation, or does it modify "negligence" and call for "substantial" and not "simple" negligence for estoppel. The court did not reach the proximate cause issue, but it was not faced with a set of facts that called for its resolution. The negligence issue was properly solved and further analysis, which would have contributed little to the decision of the case, was suspended. In addition the court seems to have correctly resolved the "substantial-simple" negligence conflict, in favor of the substantial factor test.

H. IRWIN COFFIELD, III

---

<sup>40</sup> 1955 REPORT at 248.