Big Money

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Banks Not Liable. Yes, It's True . . .

Payee's Malfeasance is Not Bank's Liability

By Timothy A. Lambirth and Joseph Catmull

Many attorneys experience a sort of Pavlovian response when we hear the phrase "UCC," or "Commercial Code," or "Articles 3 and 4." Eyes become glassy, eyelids heavy, and say, watching the paint peel off the wall is kind of interesting, if you really, really concentrate. . . .

For those who represent banks and financial institutions, however, the UCC is the roadmap when it comes to guiding Big Money out of spurious lawsuits, and very often by dispositive motion. After drilling down through a few "check cases," the symmetry and cohesiveness of the Commercial Code shows its classical form of quality, along the lines of Robert M. Pirsig's description in the book Zen and the Art of Motorcycle Maintenance. The California Commercial Code is the motorcycle, but it is the motorcycle mechanic who sees its complex beauty.

In this treatment, counsel is reminded of a certain bar-preparation professor, one who simplified what it means to "endorse" a check under the Uniform Commercial Code (UCC). He explained that an endorsement is simply a statement to others, one that says, "take it to the person who is supposed to pay. If they don't pay, tell me, I'll pay." Clean, simple, and down to earth. This is a good illustration, as well as the example given us by Justice Joan K. Irion, who wrote the recent opinion in *Mills v. U.S. Bank* (2008) 166 Cal.App.4th 871 (McConnell, P.J and O'Rourke, J. concurring).

In *Mills,* plaintiff investors (Investors) wrote about a dozen checks to payee "Third Eye Systems, LLC" (a couple of the checks were written to "Third Eye" and "Third Eye Systems"), to purchase investment units in the company. The checks were marked with various endorsements (remember, "take it to the person who's supposed to pay . . ."), but they were not properly endorsed to transfer title from Third Eye Systems, LLC to Third Eye Systems Holdings, Inc.

One need not be a psychic to see where this is heading. The two principals of Third Eye Systems, *LLC*—named Miller and Hovde—were also principals in a corporation called "Third Eye Systems Holdings, Inc." Instead of depositing the checks from the Investors into the LLC account, where the checks belonged, someone instead presented the checks for deposit with U.S. Bank, in the account of Third Eye Systems Holdings, Inc.

And so the games begin.

The Investors sued everyone (including the brokerage firms and banks that issued the checks). And there is no more attractive target to a plaintiff than any defendant with a name that either begins or ends in "Bank." Plaintiffs claimed that they were injured when funds from their checks were deposited into the account of corporation instead of the LLC because, among other things, the LLC was worth 75 percent less without the diverted investment money. Plaintiffs also claimed that because they did not have an ownership interest in Third Eye Systems Holdings, Inc., they could not access its assets (purchased with plaintiffs' funds) to recoup their eventual investment loss.[1]

> Thus, *the Mills* Court found that by presenting the checks for payment to plaintiffs' banks, U.S. Bank was making certain warranties to plaintiffs' banks, but not to plaintiffs themselves.

Why was U.S. Bank—the depositary bank—a target (apart from the fact it was a bank)? The answer lies in large part on plaintiffs' misapprehension of the law as it pertains to the presentment and transfer warranties in the California Commercial Code. Plaintiffs' ninth cause of action was titled "Third Party Beneficiaries of U.S. Bank's Presentment and Transfer Warranties under the Uniform Commercial Code §§ 4207- 4208 to the Payor Banks." There is no such animal, as *Mills* makes clear (discussed infra). Accordingly, the *Mills* court rejected plaintiffs' re-write of the Commercial Code. In the past, bank counsel have successfully defended lawsuits of this nature without the benefit of the *Mills* opinion. But now the path to success is far smoother.

In *Mills,* Plaintiffs made a number of claims against U.S. Bank under the Commercial Code, two of which involved presentment and transfer warranties. Plaintiffs asserted that whenever a bank accepts a check for deposit, the law provides that the

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Bank grants the check-writer (the "drawer" of the check) certain presentment and transfer warranties under sections 4207 and 4208 of the Commercial Code. Under section 4207, a transfer warranty exists between a "customer or collecting bank that transfers [a check]," on the one hand, and the transferee of the check on the other hand.

The warranties, in plain English, are these:

(1) As transferor, I am entitled to transfer this to you;
(2) The signatures on this piece of paper are real and signed by someone with authority to do so;
(3) No one has been fiddling around with the numbers on the "amount" entry of the check;
(4) No one is making any claim against the check for any kind of set-off;
(5) The person who wrote the check has not declared bankruptcy as far as we know, and neither have we.

But, as the *Mills* opinion now makes clear, those warranties could not run to the check-writer/drawer (the plaintiffs in *Mills*) because the check-writer is not a ***transferee*** of the check. Nor is the check-writer/drawer a "subsequent collecting bank."

With respect to the presentment warranties under Section 4208, these apply when a check is presented for payment to the bank of the person who wrote the check (the "drawee" bank, of the "drawer" check-writer). The presenter of the check (generally the person seeking payment from the bank of the check-writer), warrants to the bank of the person that wrote the check, that:

(1) He/she or it is entitled to enforce the check;
(2) The check has not been altered;
(3) The warrantor has no knowledge that the signature on the draft is unauthorized; and
(4) If the draft is a demand draft (in essence, a check that does not require a signature), that it too was authorized by the check-writer.

In *Mills,* plaintiffs were trying to characterize themselves as "third-party beneficiaries" of the presentment warranty from U.S. Bank (the presenting bank), which in reality ran only to the banks of the plaintiffs.

Plaintiffs were inspired by *Sun 'n Sand v. United California Bank* (1978), 21 Cal.3d 671, 682, which held that under prior law, presentment warranties inured to the check-writer of the check. The *Mills* court pointed out, however, that that result was expressly rejected in the official comment to the revised Uniform Commercial Code:

"There is no warranty made to the drawer [check-writer] . . . when presentment is made to the drawee. . . . In [*Sun 'n Sand*] the court held that under [the former statute] a warranty was made to the drawer of a check with the check was presented was presented to the drawee [bank of the check-writer]. The result in that case is rejected."

(*Mills v. U.S. Bank, supra,* 166 Cal.App.4th at 883, citing 2 West's U. Laws. Ann. (2004) U. Com.Code, com. 2 to § 3–417, p.275 [footnote omitted].)

Thus, the Mills Court found that by presenting the checks for payment to plaintiffs' banks, U.S. Bank was making certain warranties to plaintiffs' banks, but *not* to plaintiffs themselves.

The balance of the opinion is a clear-cutting of the thicket of legal theories presented by the plaintiff Investors, why their additional causes of action for negligence under the UCC should survive demurrer.

- No, a depositary bank does not warrant to the payee of the check that it paid, or made a deposit on behalf of, the payee of the check under section 4205 of the Commercial Code.
- No, the checks did not concern imposters or fictitious payees, so section 3404 of does not apply.
- No, the checks did not involve altered instruments or forged signatures, so section 3406 does not apply.
- No, U.S. Bank was not negligent in its presentment of the checks that were missing proper endorsements, and section 4202 does not apply.

In short, the *Mills* opinion is a well-written roadmap to clarity by Justice Irion, and an effort for which bank counsel should be grateful. Sometimes the best kind of tort reform reveals itself in an appellate court's clear analysis and straightforward communication of same. If counsel is defending Big Money in an Article 3 or 4 check case, be sure this one is in the arsenal.

Endnote

1. We think the Uniform Fraudulent Transfer Act may have provided some aid to plaintiffs here.