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Banks and Banking--Duty to Third Parties--Holder in Due Course [*Maley v. East Side Bank*, 361 F.2d 393 (7th Cir. 1966)]

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BANKS AND BANKING — DUTY TO THIRD PARTIES — HOLDER IN DUE COURSE

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

A depository bank has traditionally been held to a high standard of care in its dealings with depositors, both as a fiduciary and as an agent.[1] It has also been uniformly decided that this duty of care, being contractual in nature, extends only to the contracting party, the depositor,[2] so that recovery for a breach of this duty by the bank is available only to him.[3] The Uniform Commercial Code (UCC) affirms the liability of a payor bank to its customer for damages arising out of the "wrongful dishonor of an item."[4] However, the question of a bank's liability to third parties for losses incurred by the fraudulent acts of a corporate depositor where the bank might have prevented the fraud has not, until recently, been seriously considered.[5]

In *Maley v. East Side Bank*,[6] the trustee in bankruptcy of a corporation sued the defendant bank on behalf of its creditors to recover the cost of building materials which the corporation had purchased with funds supplied by the creditors. The corporation's previous owners had contracted to sell the entire business to an individual who, for the month preceding completion of the contract of sale, was named president of the corporation, the previous owners being allowed to remain as secretary and treasurer. A resolution was filed with the defendant bank stating that during this period the president could cash only those corporate checks which bore the indorsement of the treasurer. When the contract of sale was completed approximately one month later, the previous owners withdrew from the corporation and the president became sole owner of the company. No new deposit resolution was filed with the bank at that time, nor was the old resolution requiring the treasurer's indorsement formally withdrawn. However, the new owner gave

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1 See Bernhard v. Bank of America Nat'l Trust & Sav. Ass'n, 114 P.2d 661 (Cal. Dist. Ct. App. 1941), *aff'd*, 19 Cal. 2d 807, 122 P.2d 892 (1942); 9 C.J.S. *Banks & Banking* § 1007 (1938).

2 *Id.* § 290.

3 *Ibid.*

4 UNIFORM COMMERCIAL CODE § 4-402 [hereinafter cited as UCC].

5 *Cf.* Field v. Lew, 184 F. Supp. 23 (E.D.N.Y. 1960), *aff'd sub nom.*, Field v. Bankers Trust Co., 296 F.2d 109 (2d Cir. 1961), *cert. denied*, 369 U.S. 859 (1962).

6 361 F.2d 393 (7th Cir. 1966).

the bank a signature card, containing only his signature, as authorization for his future transactions as head of the corporation.[7]

During the several weeks preceding completion of the sale, the bank was inundated with inquiries concerning the credit of the president and the corporation. On the basis of the favorable information supplied by the bank, large amounts of building materials were sold to the president on credit, and he resold these materials to other concerns in return for checks made payable to the corporation. During the month following completion of the sale of the corporation, the defendant bank cashed and credited to the president's *personal* account $46,000 worth of these checks. None of the proceeds were ever credited to the corporate account, nor were the creditors ever paid. The corporation thereafter was adjudicated bankrupt, and the trustee in bankruptcy brought an action against the defendant bank to recover the amount due the defrauded creditors.[8]

The court in *Maley* found the bank liable to the creditors on several grounds. The first of these was that the bank was negligent in cashing and crediting the checks to the president personally, this act being a direct violation of the resolution on file with the bank.[9] The court emphasized the bank's lack of due care in the transactions; however, there was no discussion regarding the party to whom the initial duty was owed.[10] Thus it would be helpful to examine the question of what duty is owed by banks to their depositors.

The courts have always treated deposit agreements as being for the benefit of the depositor rather than third parties.[11] Thus, the duty of care owing and hence the possible liability is to the depositor. Because the terms of a deposit agreement are binding upon a bank, it cannot legally pay out funds except upon the approval and signature required by the agreement,[12] and to do otherwise might result in liability *to the depositor* for conversion.[13]

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7 *Id.* at 395-98.

8 *Id.* at 397-98.

9 *Id.* at 400-01.

10 *Id.* at 395-402.

11 *Cf.* Field v. Lew, 184 F. Supp. 23 (E.D.N.Y. 1960), *aff'd sub nom.*, Field v. Bankers Trust Co., 296 F.2d 109 (2d Cir. 1961), *cert. denied*, 369 U.S. 859 (1962); UCC § 4-402; 10 AM. JUR. 2D *Banks* § 494 (1963).

12 See National City Bank v. Harbin Elec. Joint-Stock Co., 28 F.2d 468 (9th Cir. 1928); Speasl v. National Bank, 37 Ill. App. 2d 384, 186 N.E.2d 84 (1962); Miller v. First Granite City Nat'l Bank, 349 Ill. App. 347, 110 N.E.2d 651 (1953); 10 AM. JUR. 2D *Banks* § 493, at 462 (1963).

13 *Accord*, Wagner Trading Co. v. Battery Park Nat'l Bank, 228 N.Y. 37, 126 N.E. 347 (1920).

Since the initial contractual and fiduciary duty of care is owed to the depositor, one who has a claim against the bank must place himself in the position of a depositor, in other words, in privity with the bank. For example, in *Hoffman v. First Nat'l Bank*,[14] one joint depositor forged the required signature of the other. The bank honored the check. The court said that the aggrieved joint depositor, in order to recover from the bank for breach of its contractual duty, must first prove an interest in the bank account upon which to base the action.[15]

The duty has been found owing, however, to the assignee in interest of a partnership[16] on the ground that the bank, in violating an existing partnership resolution by cashing partnership checks for the personal use of one member, was an active participant in the fraud perpetrated on the partnership. The assignee in interest was found to stand in the shoes of the partnership and therefore was the party to whom the duty was owing.[17] The duty was based on a *contractual* relationship, which is in turn a prerequisite for a finding of negligence.

One case, *Seaman v. Muir*,[18] considered the issue in *Maley*, that is, the nature of a bank's liability to the creditors of its depositors. In *Seaman*, a company sold all its assets in order to pay its creditors. The money from the sale was deposited in the defendant bank, and the creditors then sued the bank for the money owing them. In holding that the creditors had no title to or interest in the bank's debt to the company, except by attachment or execution,[19] the court failed to consider the question of negligence. However, it was indicated that the relationship between the bank and the depositor was merely that of debtor-creditor and that thus the bank had no affirmative responsibility either to pay its depositor's debts to third party creditors or to close the transaction. Inasmuch as the bank owed no duty to the non-contracting third party creditors, they could claim no injury due to the bank's negligence.[20]

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14 299 Ill. App. 290, 20 N.E.2d 121 (1939).

15 *Id.* at 296, 20 N.E.2d at 124.

16 McIntosh v. Detroit Sav. Bank, 247 Mich. 10, 225 N.W. 628 (1929).

17 *Ibid.* (by implication).

18 72 Ore. 583, 144 Pac. 121 (1914).

19 *Id.* at 590, 144 Pac. at 123.

20 *Ibid.* Furthermore, the duty of a bank has not only been traditionally limited to the depositor but also that depositor must prove that there has been a violation of a deposit agreement. Only then does the burden shift to the bank to prove that it exercised due care in fulfilling the terms of the agreement. Duncan v. National Bank, 285 Ill. App. 305, 1 N.E.2d 902 (1936).

With this background in mind, it should be noted that the court in *Maley v. East Side Bank*[21] reasoned that because no new deposit resolution had been submitted to the bank when the corporation changed hands, the old resolution continued to be binding.[22] The court reached this conclusion despite the fact that the president had become the sole officer and stockholder, which would indicate that the treasurer's indorsement would no longer be required. Nevertheless, by force of logic, once the court found that the resolution was still binding, it became necessary to hold the bank liable for negligently breaching the resolution. But *even if* some duty were owing by the bank to the third party creditors, it seems unreasonable to presume that the bank and the sole owner intended that the treasurer's indorsement would still be required after the treasurer had left the corporation.[23]

In general, a bank pays checks in accordance with the signature card filed by the depositor.[24] Although an unsigned memo is an insufficient contract,[25] in *Maley* the bank had both the signature card signed by the president and the knowledge that he had acquired sole ownership of the corporate account. These two factors should have convinced the court that the parties did not intend to be bound by the old resolution, especially because it has been held that a bank can rely on a corporate president's presumed authority to cash corporate checks, absent notice or knowlege that he lacks such authority.[26] In *Maley* this authority was not merely presumed — it was a known fact. Even more compelling is the fact that payment to a sole stockholder has been deemed payment to the corporation itself.[27]

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21 361 F.2d 393 (7th Cir. 1966).

22 *Id.* at 401.

23 Note that all the checks were cashed or credited to the president's personal account *after* ownership of the corporation had passed entirely to him. *Id.* at 398. It is interesting to note that the original purpose of the resolution in *Maley* requiring the treasurer's indorsement of all checks cashed by the president was for security purposes, to insure that the president would pay the balance of the contract price to the outgoing officers. Brief for Appellant, p. 46, Maley v. East Side Bank, 361 F.2d 393 (7th Cir. 1966); See 361 F.2d at 396.

24 10 AM. JUR. 2D *Banks* § 540, at 515 (1963).

25 *Cf.* Thornton v. Athens Nat'l Bank, 252 S.W. 278 (Tex. Cir. Ct. App. 1923).

26 Krantz v. Oak Park Trust & Sav. Bank, 16 Ill. App. 2d 331, 335, 147 N.E.2d 881, 883 (1958). *Cf.* Renault v. L. N. Renault & Sons, Inc., 188 F.2d 317 (3d Cir. 1951), wherein the court recognized the authority of a depositor to waive the restrictive character of a special indorsement by collecting as though the instrument had been generally indorsed.

27 See Lapp v. Loufek, 113 F. Supp. 65 (D. Minn. 1953); 19 C.J.S. *Corporations* § 1004, at 471-72 (1940), wherein it is stated that the trend is to uphold as binding the acts of a person who owns all or most of the stock in a corporation, even though

In light of the preceding discussion, it can be seen that the bank in *Maley*, according to traditional authority, neither breached a contractual duty to its corporate depositor nor owed a duty of care to the creditors upon which liability for negligence could be based.

The court in *Maley*, however, did not rest its finding of liability solely upon breach of a contractual duty (if any truly existed as to the creditors), but rather it found a second ground for recovery in the Uniform Commercial Code. The court reasoned that due to the bank's knowing violation of the deposit agreement, it lost its holder-in-due-course status and was therefore subject to the claims of the corporation and its creditors.[28] The UCC provides that "unless he has the rights of a holder in due course any person takes the instrument subject to all valid claims to it on the part of any person."[29]

A definition of holder-in-due-course status could be determinative of the bank's liability for negligence. The UCC defines a holder in due course as one who takes the negotiable instrument for value, in good faith, and without notice of any defense or claim to it on the part of any person.[30] Good faith is defined as "honesty in fact in the conduct or transaction concerned."[31] One has the requisite notice of a fact when he has actual knowlege, has received notice or notification of it, or from all the facts and circumstances known to him at the time in question, has reason to know that it exists.[32]

The court in *Maley* found that the circumstances surrounding negotiation of the checks placed the defendant bank on notice and revealed its lack of good faith, thereby defeating its status as holder in due course. Accordingly, the bank was subject to the claims of the creditors despite the lack of a contractual relationship with them.[33] The court indicated that the bank's liability arose from the negotiation of the checks in knowing violation of the old deposit agreement. This interpretation implies that the creditors had a prior valid claim on the instruments at the time they were negotiated

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there has been a technical defect in the action (*e.g.*, the violation of an old deposit agreement). *But see id.* § 1044.

28 361 F.2d at 401.

29 UCC § 3-306(a), as adopted in Illinois: ILL. ANN. STAT. ch. 26, § 3-306(a) (Smith-Hurd 1963).

30 UCC § 3-302.

31 UCC § 1-201(19).

32 UCC § 1-205(25).

33 361 F.2d at 401.

and further implies that the bank violated a duty *to them* when it credited the checks, *payable to the corporation*, to the president's personal account. Such reasoning seems untenable, for although the creditors did have an interest in the corporation insofar as there was a debt owing them for the materials obtained on credit, they had no legal interest in, or right to, the checks payable to the corporation.

The court's approach conflicts with the idea that a bank, from the moment it negotiates an instrument, is in a debtor-creditor relationship with its depositor.[34] The discrepancy arises because holder-in-due-course questions occur only when the action is on the instrument itself. The holder in due course must take for value, that is, for fair consideration.[35] It is the lack of value in the exchange which distinguishes the debtor-creditor relationship from the instances in which holder-in-due-course status arises.

This distinction is well illustrated by *Field v. Lew*,[36] a case quite similar to *Maley*, wherein a depositor's trustee in bankruptcy sued various banks for their alleged participation in fraudulent transfers of corporate funds to the corporate president for his personal use. The court held that because insolvency occurred when the instruments were fraudulently transferred, creditors had an action against transferees of the instruments who had not given fair consideration. However, since no corporate property was transferred to the banks, they were not transferees but rather agents of the corporation, and as such they might be liable to the corporation for breach of a fiduciary duty if they had knowledge of the fraudulent intentions of the president. In any event, they did not fall into the category of holders in due course, for there was no fair consideration exchanged upon the negotiation of the instruments.[37]

The same reasoning, if applied to the facts in *Maley*, would achieve an identical result, which demonstrates that the question of holder-in-due-course status was erroneously decided. However, the court did adopt holder-in-due-course reasoning and in fact broadened the possible instances of liability of a non-holder in due course.

As a third ground for recovery the court asserted that regardless of a showing that the bank lost its status by negotiating the instruments in violation of the deposit resolution, the bank also forfeited

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[34] See Speroff v. First Cent. Trust Co., 149 Ohio St. 415, 79 N.E.2d 119 (1948).

[35] UCC §§ 3-302(1)(a), 3-303(a).

[36] 184 F. Supp. 23 (E.D.N.Y. 1960), *aff'd sub nom.*, Field v. Bankers Trust Co., 296 F.2d 110 (2d Cir. 1961), *cert. denied*, 369 U.S. 859 (1962).

[37] *Id.* at 28-29.

this status due to its negligence in the transactions whereby the creditors were defrauded.[38] The lack of good faith was so flagrant and the notice so obvious from the circumstances that holder-in-due-course status was never achieved, thus making the bank liable to the creditors' claims.[39]

The Uniform Negotiable Instruments Law[40] employed an objective test of what constituted sufficient bad faith to destroy holder-in-due-course status;[41] negligence alone was never determinative of bad faith.[42] Constructive notice was determined objectively and extended only to that which a reasonable inquiry might reveal. As to a bank, there was ordinarily no duty of active inquiry.[43]

As we have seen, the UCC expands the area in which constructive notice is sufficient to destroy the potential holder-in-due-course status.[44] The objective test has been superseded by a subjective test (applied by the court in *Maley*), for there can be no good faith on the part of the taker if he had constructive notice of any infirmities.[45] This subjective standard would seem to indicate shifting standards of good faith depending upon particular business standards, as well as particular facts and circumstances.[46]

To require a prudent taker to question virtually every aspect of a possibly defective instrument does not seem unreasonable, especially where the taker is a bank — a fiduciary with great responsibility and knowledge. However, the court in *Maley* seems to have done away with the distinction between the degrees of negligence necessary to create liability as a non-holder in due course. The court implies that the slight degree of negligence involved in the failure to respond to constructive notice of a suspicious circumstance creates the same liability as the gross negligence involved in a knowing breach of a contractual agreement. The court would say that in either case the bank lost holder-in-due-course status and is no

38 361 F.2d at 401-02.

39 *Ibid.*

40 UNIFORM NEGOTIABLE INSTRUMENTS LAW §§ 52(1), 56.

41 See Britton, *Holder in Due Course — A Comparison of the Provisions of the Negotiable Instruments Law With Those of Article 3 of the Proposed Commercial Code*, 49 NW. U.L. REV. 417 (1954).

42 See Moore v. Potomac Sav. Bank, 160 Va. 597, 169 S.E. 922 (1933).

43 See Empire Trust Co. v. Cahan, 274 U.S. 473 (1927); Continental Nat'l Bank & Trust Co. v. Stirling, 65 Idaho 123, 140 P.2d 230 (1943). See also 11 AM. JUR. 2D *Bills & Notes* § 432 (1963).

44 UCC §§ 1-201(5), 3-304.

45 That is, he has constructive notice, if, due to facts and circumstances, he should have known at the time that infirmities existed.

46 Britton, *supra* note 41, at 429-30.

less liable to the creditors than it would be had it violated a contractual duty to them.

The *Maley* decision may have far-reaching consequences. Although the contractual liability of a bank has traditionally been limited to the depositor, and has not been extended beyond those debts or liabilities incurred or contracted in the ordinary course of conducting a banking business,[47] the decision in *Maley* indicates that the definition of what constitutes the ordinary course of conducting a banking business may be extended far beyond the traditional limits. The result reached here would, in fact, make a depository bank a virtual auditor for all corporate banking transactions. The bank would be required to ascertain not only that all corporate checks are credited to the corporate account but also that no corporate check is paid out on a fraudulent basis. It would make the bank an auditor for all corporate disbursements and thus liable to the charge of constructive notice if it failed to detect possible fraudulent activities of its corporate depositor. Hence, the bank would be liable to any third parties should the fraud succeed.

This decision alters yet another traditional privilege of a bank. As a fiduciary, "A national bank has no power to engage in the business of furnishing to depositors or to others gratuitously or for compensation, direct or indirect, information as to the solvency, or condition or reputation, financial or otherwise, of persons, firms, or corporations."[48] This precept of inviolate secrecy is fundamental to the bank-depositor relationship.[49] However, because commercial practice does recognize that a bank is often called on to give credit ratings to businessmen, it might well be asked: what of contributory negligence? Are the creditors in *Maley* held to no duty of checking potential business dealings beyond seeking a credit rating from a bank? Of the forty-one creditors allowed to recover from the bank in *Maley*, only eleven had actually contacted the bank.[50] Would not this new commercial responsibility to the business community destroy the bank's traditional fiduciary relationship with its depositor? It would surely give the bank the additional responsibility not only of auditing all corporate accounts but also of serving in a "Dun and Bradstreet" capacity.

Even if this increased responsibility were demanded by the UCC,

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47 9 C.J.S. *Banks & Banking* § 79, at 153 (1938).

48 People's Nat'l Bank v. Southern States Fin. Co., 192 N.C. 69, 77, 133 S.E. 415, 419 (1926).

49 See Peterson v. Idaho First Nat'l Bank, 83 Idaho 578, 367 P.2d 284 (1961).

50 Brief for Appellant, *supra* note 23, at 55.