

A close-up photograph of a hand holding a pen, writing on a check. The check is slightly out of focus, but the words "Pay to the order of" are visible. The background is a solid blue color.

CAN THE UCC'S PROVISIONS PROTECTING Check Writers from Fraud ALSO PROTECT THEM FROM PONZI SCHEMES?

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FAST FACTS

The Uniform Commercial Code (UCC) generally imposes strict liability on banks that pay on checks that are forged, altered, or improperly indorsed.

The "intended payee" defense is an important exception to bank liability in cases involving forgeries, alterations, or improper indorsements.

Ponzi scheme victims cannot rely on the UCC to recoup lost investments from their banks.

It is well publicized that identity theft is on the rise.¹ One common type of identity theft is the alteration, forgery, and improper indorsement of checks, which affects individuals and corporations alike. As discussed below, the Uniform Commercial Code (UCC) provides certain protections to victims of such schemes by, in most cases, making banks that pay on altered, forged, or improperly indorsed checks, which are not "properly payable" under the UCC, strictly liable for re-crediting the check writer's account.

Another type of fraud that has been brought back into the spotlight recently by the Bernie Madoff scandal is the Ponzi scheme. In a Ponzi scheme, investors are frequently coaxed into writing checks to place their money into fraudulent investments, only to find out later that the entire investment was a house of cards that has collapsed. The "investment" offered by the fraudster is a sham, and any distributions of payments made to investors are simply

paid out of the money obtained from other investors, not real investment returns.² But when the number of new investors starts to diminish, there are no more funds to distribute and the Ponzi scheme collapses.³ As with most fraudulent schemes, “when the curtain rises on the last act, the wrongdoer will either be off the scene or insolvent,”⁴ and there is rarely any money left over after the collapse to reimburse the investors for their losses. This leaves the defrauded Ponzi scheme investors searching for someone else from whom they can try to recoup their losses.

With the downturn in the economy, the funds available to fraudsters to keep Ponzi schemes going have diminished and more such schemes are being discovered, leading to more lawsuits being filed by angry investors, some of whom have lost their life savings.⁵ In fact, in 2009, the U.S. Commodity Futures Trading Commission stated that it expected to file 25 percent more cases against Ponzi schemers than it did in 2008.⁶

Because the perpetrator in the scenarios described above uses fraudulent methods to steal the victims’ money through obtaining checks and presenting checks for payment under false pretenses, some creative plaintiffs, who have no real hope of collecting from the fraudster, will try to proceed against their banks by relying on the protections provided to check writers under the provisions of Articles 3 and 4 of the UCC for alteration, forgery, or improper indorsement. The following is a discussion of whether those protections are available to Ponzi scheme victims.

The UCC Protections for Check Fraud Victims in Cases of Alteration, Forgery, or Improper Indorsement

Frequently, check fraud occurs when the victim writes a check that is intercepted by a fraudster who alters the named payee on the check, alters the amount of the check, or places a fraudulent or otherwise improper indorsement on the check.⁷ Sometimes the fraudster just uses the information on the check to create an entirely new (but fraudulent) check using the account information that was on the original check, and then forges the payor’s signature.⁸ As discussed below, in any of these scenarios, the UCC makes the bank charging the payor’s account for the check proceeds strictly liable to make the payor whole, unless one of the statutory exceptions applies.

The policy basis for placing liability on the bank rests on the bank’s agreement to pay the customer’s money out of the account only according to the customer’s orders.⁹ “[I]n the eyes of the law, the customer has ‘lent’ the amount in the account to the bank and the bank is obliged to pay it out on order.”¹⁰ Accordingly, when the customer’s bank has not performed in accordance with the customer’s orders, it should reasonably expect to be held liable to the customer for that failure. Indeed, White and Summers note in their treatise on the UCC that a theft or alteration of a check may spawn two or three lawsuits among payees, drawers, depository banks, and collecting banks, but “[a]bsent negligence or its like on the part of the owner of a check and irrespective of the sequence of suit or settlements, the loss should normally come to rest upon the first solvent party in the stream after the one who forged the indorsement.”¹¹ This typically results in the drawee bank (the bank that charges its customer’s account) having to re-credit the customer’s account and then seeking to recover from one of the other banks in the check processing stream under a warranty theory.¹² But it does not usually result in the customer or the intended payee ultimately bearing the financial loss.¹³

Michigan has adopted Uniform Commercial Code §4-401(a), which states the following:

A bank may charge against the account of a customer an item that is properly payable from [the customer’s] account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank.¹⁴

In accordance with this statute, courts have upheld an implicit rule that “a bank may not charge against the account of its customer a check or item that is *not* ‘properly payable.’”¹⁵ If the name of the payee has been altered without the customer’s authorization, the drawer’s signature is forged, or the indorsement is forged or otherwise improper, the check is not properly payable.¹⁶ Therefore, by simply paying on a check on which the named payee has been altered without the payor’s permission or that has been otherwise forged or improperly indorsed, the bank will usually bear responsibility to make the customer whole.

Although the UCC provides broad protection to check writers from fraud by alteration, forgery, or improper indorsement, it is important to note that the UCC also provides some defenses for a bank being sued for charging its customer’s account for a check that is not “properly payable.” For example, if the check writer’s



failure to exercise ordinary care “substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument,” the check writer is precluded from asserting a claim against the bank that paid the instrument if the bank was acting in good faith.¹⁷ But if the bank’s conduct also “substantially contributes to the loss,” the amount of the loss is apportioned between the customer and the bank to the extent that each party’s failure to exercise ordinary care contributed to the loss.¹⁸ Under this statute, each party has the burden to show that the other party failed to exercise ordinary care.¹⁹

Can Ponzi Scheme Victims Rely on the UCC to Recoup Their Losses?

Victims of Ponzi schemes who write checks believing they are making a legitimate investment but who have nowhere to turn to get their money back after the fraudster has disappeared with or spent all of it may try to recoup their losses from their banks by claiming that the checks written to the fraudster were not “properly payable.” For example, depending on the circumstances, a Ponzi scheme victim might argue that the fraudster, who may have personally indorsed the checks so that he could pocket the money, was not authorized to indorse the checks if they were made payable to the entity (perhaps an LLC or an investment fund) in which the victim thought he was investing and not directly to the fraudster who later indorsed the check in his own name.²⁰ In such a case, the victim would argue that the bank is strictly liable for paying on a check that was not “properly payable” because it lacked a proper indorsement from the specific entity to which it was written.²¹

This argument is, at first blush, appealing, because the victim did not intend for the fraudster to ultimately receive the money personally and the indorsement may indeed suffer from some technical deficiency if the fraudster did not arrange to make himself a person directly authorized to receive payment or indorse checks during the course of the scheme. But the courts interpreting the UCC have recognized an “intended payee” defense, which will likely shield a bank from liability under such circumstances.²² Under the intended payee defense, “a drawee bank is not liable to the drawer of a check for an improper payment if (1) the proceeds of the check reach the person the drawer intended to receive them and (2) the drawer suffers no loss proximately caused by the drawee’s improper payment.”²³

This defense can be problematic for the typical Ponzi scheme victim. The entity to which the victim wrote the checks is unlikely to complain that it did not receive payment from the victim because the fraudster controls the entity (which is likely an empty shell, if it exists at all), and the fraudster obviously will not want to draw attention to the fact that he or she has diverted the funds. In other words, in a Ponzi scheme situation, there will be no aggrieved payee who will state that it did not receive the check. Indeed, absent a demand from an aggrieved payee that the plaintiff issue a new check to replace the fraudulent check, a court will likely presume that the intended payee received the payment.²⁴ Thus, the bank’s conduct of paying on the check, even if the indorsement is technically improper, will not have directly caused the victim to suffer any loss because the victim, in fact, intended to pay someone the amount of the check and the bank carried out that order.

Further, even if the fraudster’s indorsement was unauthorized or improper, the Ponzi scheme victim will likely be deemed to have ratified the payment. Under MCL 440.3403, “[a]n unauthorized signature may be ratified for all purposes of this article.” Frequently, Ponzi scheme victims receive some distribution payments from the fraudster while the scam is ongoing as funds continue to come in from new victims. But by receiving and retaining distribution payments, the victim will have ratified the fraudster’s indorsement on the checks.²⁵ Indeed, the victim cannot reasonably argue that it believed the intended payee was not paid if the victim was receiving distribution payments from the investment for which the victim wrote the checks.²⁶ Thus, ratification of the unauthorized indorsement will be, standing alone, a barrier to success for most Ponzi scheme victims. One exception to the ratification defense might be victims who invested shortly before the scheme collapsed and may not have received any distribution payments. But even then, those late investors would have to overcome the intended payee defense discussed above.

The “investment” offered by the fraudster is a sham, and any distributions of payments made to investors are simply paid out of the money obtained from other investors, not real investment returns.



Does the UCC Strike a Fair Balance Between the Two Types of Cases?

The differing outcomes in cases of forged, altered, or improperly indorsed checks on the one hand and Ponzi scheme cases on the other hand appear equitable. In the former situations, the fraud typically occurs after the check has left the victim's control and the victim is not in a position to prevent it through reasonable due diligence. Further, based on the agreement between the bank and the customer that the bank will only pay as ordered, the bank has freely assumed the responsibility for carrying out the customer's orders, and it should have measures in place to prevent fraud from alterations, forgeries, or improper indorsements or otherwise bear the risk of loss.

But in the latter case, there is no check alteration or forgery and perhaps not even an improper indorsement. Moreover, the victim, who can perform due diligence on the investment and the people involved in it, is much better positioned than the bank to prevent the fraud before the check is even written. Having the risk of loss under these circumstances rest with the check writer rather than the bank is consistent with the exception under the UCC's exception to bank liability, where the victim's conduct substantially contributed to the loss.²⁷

Stretching the UCC's protections to hold banks liable for checks that are written for Ponzi scheme investments would extend far beyond the banks' obligation to pay checks according to their customers' orders. It would essentially transform banks into guarantors of their customers' unfortunate investment decisions, which was certainly not the intent of the drafters of Articles 3 and 4 of the UCC. ■

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FOOTNOTES

- Digital Transactions, *Fraudsters Beef Up Attacks On Checks As The "Weakest Link"* <<http://www.digitaltransactions.net/newsstory.cfm?newsid=2133>>. All websites cited in this article were accessed October 16, 2010.
- Id.*
- Id.*
- 2 White & Summers, *Uniform Commercial Code* (4th ed), §18-1, p 207; Waggoner, *Madoff's Gone But Ponzi Schemes Go On*, USA Today (October 2, 2009) <<http://www.usatoday.com/money/markets/2009-10-02-other-ponzi-schemes-after-madoff>>.
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- Reuters, *Q&A: U.S. Regulator Sees Big Increase in Ponzi Schemes* (February 4, 2009) <<http://www.reuters.com/assets/print?aid=USTRE51354420090204>>; Waggoner, n 4 *supra*.
- National Check Fraud Center <<http://www.ckfraud.org/ckfraud.html>>.
- Id.*
- 2 White & Summers, *Uniform Commercial Code* (4th ed), §21-1, p 349.
- Id.*
- 2 White & Summers, *Uniform Commercial Code* (4th ed), §18-1, p 210.
- See *id.*
- See *id.*
- MCL 440.4401(1).
- See *Pamar Enterprises, Inc v Huntington Banks of Michigan*, 228 Mich App 727, 735; 580 NW2d 11 (1998); *Trans-American Steel Corp v Federal Ins Co*, 535 F Supp 1185, 1189 (ND GA, 1982); *Ambassador Financial Serv's, Inc v Indiana Nat'l Bank*, 605 NE2d 746, 751 (Ind, 1992).
- MCL 440.4401; MCL 440.4401, cmt 1; see also *Nat'l Credit Union Admin v Michigan Nat'l Bank of Detroit*, 771 F2d 154 (CA 6, 1985).
- MCL 440.3406(1).
- MCL 440.3406(2).
- MCL 440.3406(3).
- See *Morof v United Missouri Bank, Warsaw*, 2009 WL 1260015 (ED Mich, April 30, 2009).
- Id.*
- Id.* at *7.
- Pamar Enterprises*, 228 Mich App at 737, citing *Ambassador Financial Serv's, Inc*, 605 NE2d at 752-54.
- Morof*, 2009 WL 1260015 at *7.
- Id.* at *8.
- Id.*
- MCL 440.3406(1).