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Financial Services Litigation
ALERT

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Check Fraud Litigation – Realizing the UCC's Goal of Quick and Inexpensive Resolution of Commercial Disputes

By Nicole Reimann and Alison C. Finnegan

Quick and inexpensive resolution of commercial disputes is the touchstone of the Uniform Commercial Code's (UCC) comprehensive statutory scheme governing negotiable instruments. Courts have concluded that "vigorous application of the statute of limitations is a reasonable means of achieving certainty in commercial transactions." *Menichini v. Grant*, 995 F.2d 1224, 1231 (3d Cir. 1993). Determining whether any portion of a claim for wrongful payment of checks is barred by the UCC statute of limitations is critical to an initial assessment of potential exposure. Moving to dismiss common law claims is often a necessary first step to obtaining the benefit of the UCC statute of limitations.

Under the UCC, the statute of limitations for wrongful payment of a check is three years and begins to run when the check is negotiated. 13 Pa. C.S. § 3118(g). *Estate of Hollywood v. First National Bank of Palmerton*, 859 A.2d 472, 482 (Pa. Super. 2004), *appeal denied*, 583 Pa. 672, 876 A.2d 396 (2005). Very importantly, the UCC mandates "mechanical" application of the statute of limitations in the context of bank collections. *Menichini*, 995 F.2d 1224. Thus, so long as Depository Bank has not participated in the fraud, the statute of limitations begins to run from the moment the check is deposited – even if the check fraud scheme goes on completely undetected for years afterwards.

By way of illustration: Company sues Depository Bank for UCC conversion and common law negligence and conversion, claiming that Depository Bank wrongfully took for deposit 12 checks on the forged endorsements of Company's faithless employee (the "Fraudster"). Company claims damages of $600,000. The Fraudster's scheme was hatched six years before Company sues Bank. In the first two years, Fraudster forges endorsements on 9 checks totaling $450,000 and deposits them at Depository Bank. Two years before Company sues Bank, Fraudster deposits 3 additional checks totaling $150,000 at Depository Bank. Depository Bank had no knowledge of Fraudster's embezzlement scheme and Depository Bank's only involvement was to accept properly endorsed checks for deposit.

Mechanical application of the statute of limitations bars $450,000 of Company's $600,000 claim. So how might the entire $600,000 claim against Depository Bank survive summary dismissal? Answer: The common law negligence and conversion claims.

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Under the so-called "discovery rule", several jurisdictions might permit Company to maintain common law claims that otherwise would be barred by the statute of limitations applicable to the common law claims, if the Company through reasonable diligence could not have discovered the Fraudster's embezzlement. In other words, under the common law, if Company is able to satisfy the strictures of the jurisdiction's discovery rule, all or part of the $450,000 claim that would otherwise be barred by "vigorous" and "mechanical" application of the UCC statute of limitations, might survive at least through fact discovery.

This result is easily avoided by moving to dismiss the common law claims in the complaint on the ground that those claims are displaced by the UCC. *Mack v. CTC Illinois Trust Co.*, 2004 U.S. Dist. LEXIS 13997, 54 U.C.C. Rep. Serv. 2d (Callaghan) 295; *Nestlé USA, Inc. v. Wachovia Corp.*, 2006 Phila. Ct. Com. Pl. LEXIS 215; 59 U.C.C. Rep. Serv. 2d (Callaghan) 920. In other words, all claims for wrongful payment of checks are governed by and must be brought under the UCC. The practical implications of disposing of the common law claims at the motion to dismiss stage are highly significant. In our illustration only 25 percent of Company's $600,000 claim, or $150,000 would survive mechanical application of the UCC, thereby limiting Depository Bank's potential liability from the outset.

The benefits of successfully moving to dismiss Company's common law claims extend well beyond the substantial benefit that inures from mechanical application of the 3-year statute of limitations. Narrowing Company's complaint against Depository Bank to claims cognizable under the UCC places the commercial dispute squarely within the comprehensive loss allocation scheme of the UCC. That loss allocation scheme includes defenses codified under the UCC that severely limit Company's "ability to externalize the costs of employee embezzlement," *Menichini*, 995 F.2d 1233, "on the notion that the payee-employer is normally in a better position to prevent fraudulent endorsements by its own employees through reasonable care in the selection or supervision of employees – than a collecting bank." *Id.* ◆

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