

THE INTERNAL CONTROLS DEFENSE

David E. Kronemyer*

Banks are often defendants in litigation involving an employee of one of the bank's depositors who has altered his employer's check and received payment from the bank. The employer sues the bank for wrongful payment to a thief. This article describes an affirmative defense that is available to the bank: the internal controls defense. The defense makes the reasonableness of the plaintiff's business practices the central issue in the case instead of what the bank did or did not do. The author tells banks how to successfully deploy this defense with reference to relevant case law, sections of the Uniform Commercial Code, and accounting standards.

Employees of businesses often come into contact with negotiable instruments representing large sums of money. Two ways in which this can happen are in connection with a payment of funds by the business (e.g., in the normal course, to retire an outstanding account); or a payment of funds to the business (e.g., in the normal course, resulting in the satisfaction or realization of an outstanding account). Both of these instances provide ample opportunities for theft, embezzlement, or defalcation by a dishonest employee.¹

Keeping in mind the job descriptions of employees who are in a position to steal, typical modus operandi can be grouped into two generic types, along the above lines: those pertaining to the *disbursement function*, and those pertaining to the *receipt function*. Disbursement-function-type thefts include: forged drawer's signatures, fictitious payees, and so-called raised checks, in which the amount to be paid is altered

* Attorney, Los Angeles and New York; Associate Professor, Southwestern University School of Law.

¹ Classic common law distinguishes between the separate crimes of larceny, embezzlement and false pretenses, depending upon whether the thief is entitled to possession or title (or neither or both) at the time of the taking. See, e.g., W. LaFare & A. Scott, *Handbook on Criminal Law* §§ 84 et seq. (1972). These distinctions, while important in other contexts, will not concern us here, and the above terms will be used interchangeably.

upward in some clever or skillful way. Funds flow out of the business, but to the thief instead of to an intended payee, in a desired amount. The most common receipt-function-type theft is a forged indorsement. Funds come into the business but are diverted by the thief instead of being applied to a legitimate purpose.

Things being what they are, there generally comes a time when employee thefts are discovered, though not before considerable sums have been taken. As the thief has either absconded from the jurisdiction or purports to be insolvent, employers often seek redress against others presumptively more able to satisfy their alleged loss.

The purpose of this article is to discuss some of the contexts in which such suits arise; some of the claims that are capable of being asserted; and two key defenses thereto. As will be explained, the essential component of these defenses is the failure of the employer to devise and implement a system of *internal controls* that would either have prevented the theft, or facilitated its earlier discovery. The complicated relationships that arise when an employer has delegated this important responsibility to an independent accountant will also be discussed.

The Problem of Poor Internal Controls

The books are full of cases that illustrate the dynamic of an internal controls deficiency. Two famous examples follow.²

Disbursement-Function Thefts

Carlo Basch owned a drugstore in San Francisco, California. He maintained the store's checking account at the Bank of America. Basch employed a bookkeeper named Herbert Lahr. Lahr's duties included preparing checks for Basch's

² Others are collected at H. Bailey, *Brady on Bank Checks*, § 26.8 (5th ed. 1979), B. Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶¶ 6.2[2], 6.2[3], 6.3[3], 6.4[5][d], 6.4[7] (rev. ed. 1981). The concept of internal controls finds expression in cases going all the way back to the reign of George IV; see the famous decision of *Young v. Grote*, 4 Bing. 253, 130 E.R. 764 (1827).

signature, entering receipts and disbursements into an accounting ledger or journal, and reconciling the balance with statements from the bank. Unbeknownst to Basch, Lahr was a notorious embezzler. Shortly after he began working for Basch, Lahr began stealing funds. Over a ten-month period, he forged Basch's signature on 137 separate checks, each payable to himself, all but a few of which were for the same amount. He cashed the checks at various places and, in due course, they were presented to the bank. The bank paid them, and charged Basch's account.

Basch, of course, knew nothing about Lahr's fraudulent scheme. He had delegated to Lahr not only the task of preparing the checks but also responsibility for examining his bank statement. When the bank statement came in, it was a simple matter for Lahr to remove the forged checks, and make appropriate adjustments in Basch's accounting records.

By coincidence, Basch eventually discovered the theft. He sued the bank for breach of contract. On appeal, the California Supreme Court³ found:

Plaintiff did not examine the bank's monthly statements or inspect the accompanying canceled checks as they were forwarded to him at regular intervals, but he delegated that duty to his bookkeeper Lahr. Consequently the forgeries were not discovered by plaintiff until . . . after Lahr had absconded. . . . Prior thereto plaintiff had realized that his profits were decreasing, but inasmuch as no monthly profit and loss statements were made and a physical inventory was taken only once a year, he had simply assigned the decline to poor business.

On this basis, the court concluded as follows:

[T]he undisputed facts in this case establish beyond doubt the plaintiff was guilty of negligence not only in failing to exercise ordinary care and prudence in entrusting his employee Lahr with his banking affairs, but in disregarding the duty imposed upon him by law to examine and verify the bank's monthly statements and corresponding returned checks in relation to his own books of account.

³ Basch v. Bank of America, 22 Cal. 2d 316, 320, 139 P.2d 1, 4 (1943). For a more recent California decision involving similar issues, see Kiernan v. Union Bank, 55 Cal. App. 3d 111, 127 Cal. Rptr. 441 (1976). The *Basch* opinion is written backwards, in that the second half of the opinion could have preceded the first half, thereby obviating the need for the second half; see note 17 *infra*.

Receipt-Function Thefts

Joseph Stell was an attorney. His bookkeeper was named Bernice Ruff. Like Lahr, Ruff had a forgery habit. Instead of forging Stell's signature as a drawer, though, Ruff intercepted incoming checks payable to Stell and then forged his indorsement on the reverse side of the check. She cashed some of the checks at various banks, including Union Bank; she deposited the rest into a personal account that she maintained at Crocker National Bank. Prior to the discovery of the forgeries, the entire amount of the deposits was withdrawn. Ruff eventually stole twenty-nine checks over a period of approximately eighteen months.

Stell's suit (for conversion) against the banks involved also reached the California Supreme Court,⁴ which stated:

Plaintiffs do not dispute the trial court's finding that their negligence substantially contributed to the conversion of these instruments, and it appears, viewing the evidence in the light most favorable to the judgment, substantial evidence existed to justify such a finding. Stell had been retained by Ruff in 1963 because of her insolvency and because of litigation instituted against her by several creditors. She had informed Stell at that time that her financial difficulties were primarily due to considerable gambling losses she had sustained. A short time thereafter he hired her as a secretary and bookkeeper. He exercised practically no supervision over her, never reviewed the books, and never checked the bank reconciliation of deposits on the accounts she handled. Only during an annual examination made for tax return purposes by one of Stell's partners were Ruff's records reviewed, and even then, despite the suspicious absence of an entry, her accounts were accepted without checking for accuracy or veracity.

The Nature of Internal Controls

What problem did Carlo Basch and Joseph Stell have in common? Quite simply, both of their businesses had an *internal controls* deficiency.⁵ In this, they are not alone; a recent

⁴ Cooper v. Union Bank, 9 Cal. 3d 123, 134, 507 P.2d 609, 618, 107 Cal. Rptr. 1, 10 (1973).

⁵ The California Supreme Court also chastised both employers for failing to adequately investigate their employees' backgrounds prior to hiring them. While this is undoubtedly an act of employer negligence, it is not an internal controls deficiency, as that shall be defined. Therefore, this particular type of employer negligence will not be considered further herein.

study of 122 small businesses identified serious internal control weaknesses in a large percentage of them. The authors of that study concluded by stating that "no one would doubt that improved internal control procedures might lower the rate of failures among this important segment of the business community."⁶

This should not be taken to mean that internal control problems are unique to small businesses. Indeed, quite the contrary is true. The smaller the business, the easier it should be for the owner(s) to keep track of what is going on. To employ a phrase, the owner of a small business is in an ideal position to "keep his finger on the pulse" of its activities and operations. The larger the organization, though, the more this logic breaks down. Layers of employees are inserted, procedures are formalized, duties are delegated, and accountability diminishes. Top management, which ought to be most concerned with internal controls, becomes distanced from the situs where potential problems are most likely to occur. Whatever information that actually reverberates upward from the bottom echelons is in the form of a dry report or a computer printout, accompanied by a deviation large enough to camouflage all but the most egregious abuses.⁷ The need for internal controls does not vary with the size of the business; only the means for implementing the objective might be different.

"Internal Control" Defined

To properly define "internal control," we must turn to the accounting profession, which has long been interested in the subject in connection with the responsibilities and functions of the independent auditor.⁸ In 1949, the Committee on Auditing Procedure of the American Institute of Certified Public

⁶ Leitch, Dillon & McKinley, "Internal Control Weaknesses in Small Businesses," *J. Accountancy* 97 (1981).

⁷ For a provocative analysis of the etiology of this phenomenon, the reader's attention is directed to C. Stone, *Where the Law Ends* (1975).

⁸ The liability of the independent accountant for failure to properly advise management regarding internal controls is discussed at p. 62 *infra*.

Accountants (AICPA) propounded a special report titled "Internal Control—Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant." That report stated:

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

This definition has since been revised and expanded. In October 1958, the AICPA issued Statement on Auditing Procedure (SAP) No. 29, which subdivided internal controls into "accounting controls" and "administrative controls." SAP 29 itself was superseded in November 1972 by SAP 54, "The Auditor's Study and Evaluation of Internal Control," which contains the most current authoritative pronouncements.⁹ Paragraph 28 of SAP 54 states:

Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:

- a. Transactions are executed in accordance with management's general or specific authorization.
- b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- c. Access to assets is permitted only in accordance with management's authorization.
- d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

SAP 54 recognizes that these definitions are but "points of departure" for further analysis, and that they are not mutually exclusive.

⁹ SAP 54 has since been embodied as §§ 320 et seq. of the *Codification of Statements on Auditing Standards* (1976).

Examples of Internal Controls

It is beyond the scope of this article to list all of the internal controls that might be necessary or desirable for a given business.¹⁰ The key concept is that of *segregation of duties*. As expressed at paragraph 36 of SAP 54:

Incompatible functions for accounting control purposes are those that place any person in a position both to perpetrate and to conceal errors or irregularities in the normal course of his duties. Anyone who records transactions or has access to assets ordinarily is in a position to perpetrate errors or irregularities. Accordingly, accounting control necessarily depends largely on the elimination of opportunities for concealment. For example, anyone who records disbursements could omit the recording of a check, either unintentionally or intentionally. If the same person also reconciles the bank account, the failure to record the check could be concealed through an improper reconciliation. This example illustrates the concept that procedures designed to detect errors and irregularities should be performed by persons other than those who are in a position to perpetrate them—i.e., by persons having no incompatible functions.

In other words, the person responsible for the custody of an asset should be different from the person who accounts for it, creating a system of checks and balances.

The other critical aspect of an internal control is *independent evidence*. It is not enough that a procedure be executed; the fact of its execution must also be verifiable by some third person. As expressed at paragraph 39 of SAP 54:

The possibilities for obtaining assurance that transactions have been properly recorded depend largely on the availability of some independent source of information that will provide an indication that the transactions have been executed. These possibilities vary widely with the nature of the business and the transactions. . . .

Independent evidence can be as sophisticated as a statistical sampling or as practical as a requirement that initials appear on a ledger. In any event, there should be some easy way to check that a specific internal control procedure has actually been followed.

¹⁰ An extensive checklist appears in Rea, "A Small Business Internal Control Questionnaire," J. Accountancy 53 (1978).

Using these concepts, we can see how a system of internal controls would have helped Basch. The “asset” of Basch’s business that was embezzled was money in the bank. Basch failed to safeguard his supply of unused checks, the medium of access to these funds. While Basch was the only one authorized to sign checks, this obviously failed to deter a skillful forger. If Herbert Lahr had only been given checks on an “as needed” basis, or if Lahr’s inventory of checks had been regularly monitored (by somebody other than Lahr), perhaps the theft could have been avoided. More significantly, the same person who had access to the checks also maintained the books of account, and reconciled the bank statement to those records. This enabled Lahr to “cover up” his theft, unhindered by third-party review.¹¹

Mr. Stell could also have taken steps to protect himself. The “asset” of Stell’s business that was embezzled was accounts receivable. Bernice Ruff not only opened the mail and culled incoming checks, but also was responsible for recording receipts, preparing deposit slips, and taking items to the bank. On top of that, she was responsible for reconciling Stell’s books of account with his bank statement, which (as we have seen) is the accounting equivalent of putting the fox in charge of the chicken coop.¹²

Internal Controls and the UCC

Two provisions of the Uniform Commercial Code (UCC) which often present the key issues in litigation involving checks tacitly comprehend the subject of internal controls. They are UCC Section 3-406 and UCC Section 3-404. The reason why these sections often present the key issues is because, in most check litigation, the plaintiff’s *prima facie*

¹¹ Other common disbursement-function internal control deficiencies involve failures to: make all disbursements by check; use only prenumbered checks; properly void, retain, and account for spoiled checks; restrict check-signing privileges; require proper completion of checks before signing; require approval (and cancellation) of supporting documentation; send checks directly to the payee after signing; and follow up on uncashed checks.

¹² Other common receipt-function internal control deficiencies involve failures to: properly record receipts; check status of customers prior to extending credit; follow up on past-due accounts; promptly indorse checks for deposit; use an indorsement stamp; promptly deposit receipts in the bank; exercise physical control over cash; and adequately bond employees.

case is relatively simple. The nub of the plaintiff's case is simply that the signature relied on by the bank is not his own; that is, that a particular signature appearing on an instrument is inauthentic and not what it purports to be, that of the plaintiff. More often than not, this proposition can be established by the plaintiff's own testimony, or through other equally available means of proof. In fact, if circumstances warrant, counsel representing the bank should consider stipulating that the plaintiff's signature has been forged.

The defendant bank must then bear the burden of demonstrating an appropriate affirmative defense. An affirmative defense, if proven, will defeat or diminish the plaintiff's recovery, even if everything that the plaintiff says is true. Put another way, the plaintiff can successfully prove every aspect of his prima facie case, including a forged signature, yet still not recover, because the bank successfully establishes an affirmative defense.

If properly handled, this will focus the trier of fact's attention on the plaintiff and make the reasonableness of the plaintiff's business practices the central issue in the case, instead of what the bank did or did not do. This is precisely where internal controls come in, for rare is the business involved in check litigation that did not get there because of an internal control deficiency. Internal controls make common sense. By highlighting that deficiency and explaining it in a way that will be understood by the trier of fact, the bank will be able to position itself for success on the merits.

Disbursement-Function Thefts and Preclusion

"The drawer of a check is the person who signs it."¹³ His bank is the payor bank, that is, "the bank by which an item is payable as drawn or accepted."¹⁴ The relationship between the drawer and his payor bank is established by contract—most often, a signature card. If the payor bank fails to perform according to that contract (by, for example, debiting the drawer's account to pay a check bearing a forged drawer's

¹³ *Black's Law Dictionary* (rev. 5th ed. West, 1979) (hereinafter referred to as *Black's*).

¹⁴ U.C.C. § 4-105(b).

signature or a forged indorsement), then the drawer has a cause of action against the payor bank for breach of contract.¹⁵

The payor bank's key defense to such an action is set forth in UCC Section 3-406, which provides as follows:

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.

Assuming that the plaintiff can establish a prima facie case, Section 3-406 contemplates several separate but interrelated inquiries. First, the bank must establish that it was a holder in due course.¹⁶ Even if it is not a holder in due course, it will still be entitled to proceed further if it is 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."¹⁷

¹⁵ U.C.C. § 4-401. For further explanation of this dynamic, see J. White & R. Summers, *Uniform Commercial Code* § 17-3 (2d ed. 1980).

¹⁶ Defined at U.C.C. § 3-302(1) as "a holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." Each component term is itself separately defined: "holder" at § 1-201(20); "instrument" at § 3-102(1)(e), which itself refers to § 3-104(1); "for value" at § 3-303; "good faith" at § 1-201(19); "notice" at § 1-201(25); and "of a claim or defense" at § 3-304. The cases discussing these concepts are legion, and no attempt is made to review them here. For a discussion of their interaction, see White & Summers, note 15 *supra*, ch. 14. The bank should not simply assume that it can meet any of the criteria set forth. Even the otherwise obvious concept of "holder," for example, raises the issue of whether or not the signature purporting to pass title must be valid in order for the transferee to attain "holder" status; see, e.g., *Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co. of Greenfield*, 345 Mass. 1, 184 N.E.2d 358 (1962).

¹⁷ Significantly, such an "other payor" must establish compliance with reasonable commercial standards—a requirement not imposed on a holder in due course. While it can be argued that compliance with reasonable commercial standards is functionally equivalent to the "absence of notice" requirements set forth in U.C.C. § 3-302(1)(c), even slight analysis will reveal subtle but distinct differences between the two. "Reasonable commercial standards" is not defined in connection with § 3-406. Official Comment 4 to § 4-103 and § 1-205(2) both offer tentative definitions; see also *Bullis v. Security Pac. Nat'l Bank*, 21 Cal. 3d 801, 809, 582 P.2d 109, 114, 148 Cal. Rptr. 22, 26 (1978), another decision from the California Supreme Court. The ambiguity of "reasonable commercial standards" (and the need for expert testimony to prove what they might be in a given community) suggests that, if at all possible, the defendant bank first try to establish that it is a holder in due course. Carlo Basch, in fact, ultimately prevailed in his action against the Bank of America because the court found that there was "substantial evidence indicating that by the exercise of proper care and skill the bank's employees could and should have discovered some of the

Once either of these requirements has been met, the bank can move on to show that the plaintiff was negligent, a term not defined in the UCC. In a certain sense, it is tremendously confusing to encounter a tort-based concept (such as negligence) as a defense to a contract-based liability (that imposed by UCC Section 4-401). Tort and contract are generally regarded to be different if not diametrically opposite areas of the law.¹⁸ Boiled down to its essentials, Section 3-406 says

forgeries." In other words, the bank failed to make it over the "reasonable commercial standards" hurdle, a condition precedent to showing the plaintiff's own negligence.

In some circumstances, however, the "other payor" approach may be the only one available. *Sun 'N' Sand, Inc. v. United Cal. Bank*, 21 Cal. 3d 671, 683, 582 P.2d 920, 927, 148 Cal. Rptr. 329, 338 (1978), was such a case. There, the California Supreme court held that a drawer could maintain a direct cause of action against a collecting bank for breach of warranty. In exchange, if you will, the collecting bank was entitled to assert the benefit of § 3-406 as a defense, because it was held to be an "other payor" for the purposes of that section and § 4-207(1)(a). The court did not discuss if the collecting bank involved in that case would also qualify as a holder in due course, nor did it discuss a possible application of § 3-404 (see note 29 *infra*).

¹⁸ Though more and more these distinctions are starting to blur. Illustrative of the point of intersection is *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984). For some time, California law recognized that a covenant of "good faith and fair dealing" is implied in every contract. In the event of a breach of the covenant, a party is limited to ordinary contractual remedies, just like for breach of any other promise set forth in a contract. Gradually, however, the courts extended a tort-based cause of action for violation of the covenant of good faith and fair dealing to insureds under contracts of insurance. This radically expanded the scope of available remedies to include damages for emotional distress, lost profits, punitive damages, and literally anything else meeting a proximate cause test. The issue in *Seaman's* was whether or not these tort-based remedies should be extended to every contract. The court said "no," stating that to interject tort remedies into ordinary contracts would "intrude upon the expectations of the parties" *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363. A tort remedy would be available only if a party denied in bad faith that a contract existed to begin with.

Citing the "special relationship" existing between an insurer and its insured, the court in *Seaman's* reaffirmed that a tort action for breach of the covenant of good faith and fair dealing remained available in that context. The court stated that "No doubt there are other relationships with similar characteristics and deserving of similar legal treatment" (36 Cal. 3d at 769), a remark interpreted in subsequent court of appeal decisions as authority for extending a tort action for breach of the covenant of good faith and fair dealing to the employment relationship (*Wallis v. Kroehler Mfg. Co.*, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984)) and, most disturbingly, the bank-depositor relationship (*Commercial Cotton Co. v. United Cal. Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985)).

This last decision is especially puzzling as it completely contradicts U.C.C. § 4-401 and the entire theory of the relationship between a payor bank and its customer, the drawer ("The relationship is one of debtor and creditor: the bank is indebted to the customer and promises to debit his account only at his direction," *Cooper v. Union Bank*, 9 Cal. 3d 129, 507 P.2d 613, 107 Cal. Rptr. 5 (1973)). Ironically, this principle was strongly reaffirmed by a different California court of appeal in a decision handed down within several days of *Commercial Cotton*, *Lawrence v. Bank of America*, 163 Cal. App. 3d 431, 437, 209 Cal. Rptr. 541, 545 (1985): ("however, under ordinary circumstances the relationship between a bank and its depositor is that of debtor-creditor, and is not a fiduciary one . . ."), leaving the law on this important point in a state of uncertainty.

Quite obviously, it would be a disaster for commercial banks if they were suddenly transformed into fiduciaries vis-à-vis their depositors; among other obligations, this might

that the plaintiff's own negligence is a defense in a breach of contract case, which is conceptually incongruous.

It also seems odd that the "negligence" specified by Section 3-406 does not depend upon the existence of a duty, ordinarily a necessary prerequisite to be established by a negligence plaintiff.¹⁹ Indeed, the "duty" is already built in by the statute itself; the only question for resolution by a trier of fact is whether or not it has been breached.

Finally, Section 3-406 says nothing about comparing the bank's conduct with that of the plaintiff. In many jurisdictions, an injured individual's recovery is simply proportionately diminished, rather than completely eliminated, when he is partially responsible for the injury.²⁰ It is unclear whether that somewhat nebulous concept ought to be imported into the literal language of Section 3-406. The way the section reads, negligence sufficient to "substantially contribute" will disqualify the plaintiff, regardless of what the bank did or did not do, provided the bank has met the threshold requirements. A comparative fault regimen, on the other

make a bank responsible for monitoring its customers' sources and applications of funds and insuring the integrity of its customers' dealings with third parties. As observed by the *Seaman's* court, "when we move . . . to consideration of the tort remedy in the context of the ordinary commercial contract, we move into largely uncharted and potentially dangerous waters" (36 Cal. 3d at 770, 686 P.2d at 1166, 206 Cal. Rptr. 362), an aphorism apparently overlooked in *Commercial Cotton*.

On this issue, see also *Sacramento Regional Transit Dist. v. Grumman Flexible*, 158 Cal. App. 3d 289, 204 Cal. Rptr. 736 (1984), where the court declined to extend a tort-based remedy (a cause of action for products liability) under Article 2 of the UCC to a plaintiff whose sole damages consist of "economic loss" (e.g., inadequate value, costs of repair, and replacement of the defective product or consequent loss of profits), as opposed to claims for personal injury or damages to other property. At 158 Cal. App. 3d at 294, 204 Cal. Rptr. at 739, the court stated: "We believe the line between physical injury to property and economic loss reflects the line of demarcation between tort theory and contract theory."

The damages sustained by the plaintiff in *Commercial Cotton* were strictly "economic"—a check paid against unauthorized signatures. In fact, the court of appeal expressly overturned an award made by the trial court on account of "emotional distress" allegedly suffered by the principal shareholder of the owner of the account (163 Cal. App. 3d at 517, 209 Cal. Rptr. at 554), conclusively eliminating any claim for personal injury, however expectant it might have been. Given this, under the rationale of *Sacramento Regional Transit District*, the court in *Commercial Cotton* should have gone on to hold that no tort-based cause of action was available. The court's holding that there was insufficient evidence to sustain a claim for intentional infliction of emotional distress removed the only conceptual underpinning on which a tort-based remedy could be supported.

¹⁹ W. Prosser & P. Keaton, *The Law of Torts* § 43 (5th ed. 1984); *Restatement (Second) of Torts* § 435 (1965).

²⁰ In California, this principle was established by *Li v. Yellow Cab Co.*, 13 Cal. 3d 804, 532 P.2d 1226, 119 Cal. Rptr. 858 (1975); a review of cases from other jurisdictions appears at Annot., 78 A.L.R.3d 393 (1975).

hand, would give the trier of fact more flexibility and discretion to evaluate and adjust the equities between the parties, depending upon its evaluation of their relative culpability. Given the more or less strict nature of the bank's liability, this could not help but work to its advantage, especially if there is any doubt as to the bank's entitlement to assert the benefit of the section to begin with.

These reservations having been expressed, it seems fundamental that the negligence referred to in Section 3-406 has quite a lot to do with internal controls. Not every failure to devise and implement an adequate system of internal controls might count as negligence, and it is certainly possible that there are negligent acts that do not involve internal control deficiencies. As expressed by two prominent commentators, the nature and quality of acts sufficient to "substantially contribute" to a material alteration or to the making of an unauthorized signature are bounded "only by the limits of man's capacity for conducting slovenly business transactions."²¹ Slovenly business transactions, nonetheless, describes the very essence of an internal controls failure, and a review of the reported decisions under Section 3-406 corroborates that the vast majority of them have been decided on an internal controls rationale, if only *sub silentio*.²²

Receipt-Function Thefts and Estoppel

The payee of a check is "the person in whose favor a . . . check is made or drawn; the person to whom or to whose order a . . . check is made payable."²³ After he steals that check and forges the payee's indorsement, the thief will negotiate it at his bank. Because it is "the first bank to which an item is transferred for collection," the thief's bank is the "depository bank."²⁴ Since the depository bank is also a bank

²¹ White & Summers, note 15 *supra*, § 16.6.

²² For a review of those cases, see Lechner, "The Drawer's Negligence: A Powerful But Underutilized Defense in Forged Check Cases," 15 U.C.C.L.J. 291 (1983); Whaley, "Negligence and Negotiable Instruments," 53 N.C. L. Rev. 1 (1974).

²³ *Black's*, note 13 *supra*.

²⁴ U.C.C. § 4-105(a). As used here, the term "depository" does not necessarily mean that the thief "deposits" the check bearing the forged indorsement. He could simply cash it, with the same legal consequences.

“handling the item for collection,” it is also a “collecting bank.”²⁵

The real payee whose indorsement was forged has a cause of action against the depositary bank—the thief’s bank—for conversion.²⁶ Once again, the nuts and bolts of the payee’s case are remarkably simple. “Any unauthorized signature is wholly inoperative as that of the person whose name is signed.”²⁷ That having been established, “the measure of lia-

²⁵ U.C.C. § 4-105(d). “Collecting bank” in this context refers to a collection of the “proceeds” of the check from the payor bank. In the ordinary course, the drawer signs the check, transfers it to the payee, who indorses it and deposits it to his account at the depositary bank. The depositary bank then presents the check to the payor bank, most often through various intermediaries. The payor bank then debits the drawer’s account, and forwards the proceeds of the check, most often through various intermediaries, back to the depositary bank, which as a result, metamorphosizes into a collecting bank.

²⁶ Pursuant to U.C.C. § 3-419(1)(c), which provides simply that “an instrument is converted when it is paid on a forged indorsement.” If the payee instead sues the payor bank, the payor bank has a cause of action back over against the depositary bank for breach of warranty, pursuant to U.C.C. § 4-207(1).

The theory of § 3-419(1)(c) is not without controversy, best illustrated by *Cooper v. Union Bank* itself. Therein, the California Supreme Court drew a distinction between the liability of the collecting banks and the liability of the payor banks. As regards the payor banks, the court stated that “the amounts a payor bank remits on a forged indorsement are not considered the proceeds of the instrument” (9 Cal. 3d 123, 128, 107 Cal. Rptr. 1, 5, 507 P.2d 609, 613 (1973)). Therefore, U.C.C. § 3-419(3),

which provides that “a representative . . . who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands”

does not apply. When it pays such an instrument, the payor bank “merely remits other funds from its own account” (9 Cal. 3d at 129). The payor bank is afforded a complete defense, however, if the true owner also sues the collecting bank, as then he “is deemed to have ratified the collection of the proceeds from the payor bank” (9 Cal. 3d at 129).

The collecting bank must still deliver the proceeds to the right person, for whose benefit the proceeds are held. Any other disposition constitutes conversion. This is true even though the collecting bank might simply accept the item for deposit, and “is quite clear in the case of an instrument cashed over the counter. At the time the bank takes such an instrument it has obviously not made any prior collection and, thus, has nothing that could be considered proceeds. The money paid over the counter is, consequently, the bank’s own money” (9 Cal. 3d at 130).

The court concluded by stating that both collecting banks and payor banks are “in effect strictly liable to the true owner” of an instrument paid on a forged indorsement, subject, of course, to available affirmative defenses (9 Cal. 3d at 133).

The other leading case adopting an analogous interpretation of UCC § 3-419(3) is *Ervin v. Dauphin Deposit Trust Co.*, 84 Dauph. 280, 38 Pa. D. & C.2d 473 (Pa. C.P. 1965). For commentary and discussion of these decisions and their rationale, see Bailey, note 2 *supra*, § 24.5; Clark, note 2 *supra*, § 6.4[5][b][i]; White & Summers, note 15 *supra*, § 15-4.

²⁷ U.C.C. § 3-404(1). “Unauthorized signature” in turn is defined by § 1-201(43) as “one made without actual, implied or apparent authority and includes a forgery.” U.C.C. § 3-307(1)(a) goes on to provide that “when the effectiveness of a signature is put in issue, the burden of establishing it is on the party claiming under the signature,” in other words, the depositary bank. Because the indorser’s signature is forged, the payor bank acquires no

bility is presumed to be the face amount of the instrument.’’²⁸

The depository bank’s first line of defense against the true payee is set forth in UCC Section 3-404, which provides in part that “any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it.” Official Comment 4 adds the following explanation:

The words “or is precluded from denying it” are retained in subsection (1) to recognize the possibility of an estoppel against the person whose name is signed, as where he expressly or tacitly represents to an innocent purchaser that the signature is genuine; and to recognize the negligence which precludes a denial of the signature.

In other words, the payee’s negligence may be sufficient to constitute a de facto ratification of the forged indorsement. Generally, ratification is thought of as involving a somewhat more express approval or confirmation. It also, though, has a different sense, and Section 3-404 makes clear that unintended errors or omissions can constitute a ratification that will bar or estop the payee from recovery.

In *Cooper v. Union Bank*, the California Supreme Court applied Section 3-404 to relieve the collecting banks involved in that case from liability on instruments transferred approximately six months after the fraud began. “Plaintiffs’ negligence, however, bars them from recovering for conversion of instruments received after that date.” The court continued:

Plaintiffs’ negligent failure to discover Ruff’s patent defalcations was directly responsible for defendant depository bank’s detrimental change of position in paying Ruff the amount of the instruments. Defendants acted entirely in good faith, and, though their conduct with respect to certain of the instruments may have fallen somewhat below reasonable commercial standards, it was not sufficiently egregious to shift the balance of the scales in plaintiffs’ favor.²⁹

rights in the instrument; its liability is akin to that of a buyer of stolen goods. See C. Weber & R. Speidel, *Commercial Paper* (3d ed. 1982), White & Summers, note 15 *supra*, § 15-4.

²⁸ U.C.C. § 3-419(2).

²⁹ *Cooper v. Union Bank* analyzed § 3-404 as a defense available to a depository bank in a payee’s suit for conversion. Without saying why, the court analyzed UCC § 3-406 as a defense available to a payor bank, excluding (by implication) a depository bank (or a collecting bank) from the scope of that section. The reason why the court did this is because it ran up against the literal language of § 3-406 that limits that section’s application to a “drawee or other payor,” a problem that the court later solved in *Sun ’N Sand, Inc. v.*

Put another way, an internal controls failure was sufficient to transform Ruff's theft into an act attributable directly to the entity of the plaintiffs' business. The plaintiffs may not have authorized Ruff to supply their indorsement, but because she was their employee, her signature became effective as their own. The indorsement, while forged, became ratified as a result of the plaintiffs' negligence. Ruff therefore became a holder, and (as expressed by the court) "Good faith payment or satisfaction to the holder of an instrument discharges a party to the extent of his payment or satisfaction, even though the holder may have acquired the instrument by theft."³⁰

Whose Responsibility Is It?

It might appear as though the alignment of the parties to this point is threefold. That is, there is the business; the thief; and the bank, whichever one the business has seen fit to sue. The business might be tempted to take the position that it is

United Cal. Bank, 21 Cal. 3d 671, 683, 582 P.2d 920, 929, 148 Cal. Rptr. 329, 336 (1978), by extending the term "other payor" to also include a collecting bank (which could also be a depository bank). See note 17 *supra*. *Sun 'N Sand, Inc.* therefore significantly expanded the defenses available to a collecting bank to include not only § 3-404, but § 3-406 as well.

This being so, § 3-404 is still the preferred negligence defense for the collecting (or depository) bank, for three reasons. First, only a handful of courts have adopted *Sun 'N Sand, Inc.*'s "other payor" rationale. See, e.g., *Insurance Co. of N. Am. v. Purdue Nat'l Bank of Lafayette*, 401 N.E.2d 708 (Ind. App. 1980); *Insurance Co. of N. Am. v. Atlas Supply Co.*, 121 Ga. App. 1, 172 S.E.2d 632 (1970); see also Bailey, note 2 *supra*, § 23.28; Clark, note 2 *supra*, ¶ 6.4[5][b][iii]; White & Summers, note 15 *supra*, § 15-5. Second, what counts as plaintiff negligence should not change, as far as a depository or collecting bank is concerned, regardless of whether § 3-404 or § 3-406 is used as a defense. Third, § 3-404 negligence sounds easier for the bank to prove than § 3-406 negligence. Compliance with "reasonable commercial standards" is not set forth as a threshold requirement; indeed, § 3-404 seems to contemplate an absolute balancing of the relative positions of the parties. If anything, the extract from *Cooper v. Union Bank* set forth implies that the bank would have to act in bad faith (or at least, not in good faith) before it could be found liable. At the very least, the bank would have to be guilty of gross negligence; the court acknowledged that the bank's conduct had "fallen somewhat below reasonable commercial standards" but this was still "not sufficiently egregious to shift the balance of the scales in plaintiffs' favor" (9 Cal. 3d at 135, 507 P.2d at 619, 107 Cal. Rptr. at 11). Under § 3-406, on the other hand, a failure to meet the "reasonable commercial standards" test could disqualify the bank from asserting the benefit of that section.

There would not appear to be a good reason why the ratification sense of negligence expressed in § 3-404 could not also be used by a payor bank in addition to the negligence of § 3-406. Such an approach would eliminate some of the difficult hurdles presented by § 3-406 (such as compliance with reasonable commercial standards) yet achieve the same operative result.

³⁰ See also U.C.C. § 3-603(1).

not at fault—after all, it was the dishonest employee (now a former employee) who perpetrated the fraud. Because the employee's acts were not within the course and scope of his or her agency vis-à-vis the business, the business is not responsible therefor, and can conscientiously shrug its shoulders when the bank attempts to attribute to it the employee's conduct.³¹

Such an argument, however, is not open to the business, which is and remains responsible for its employee's acts. This is true not only under specialized rules of bank law, but also under general agency principles. In the final analysis, the finances of a business are the responsibility of that business' owners, regardless of to whom the owners may have delegated specific accounting tasks. While they may have their differences inter se, as far as the bank is concerned, the business and its employees are one operating unit.

The Business and Its Employees

Illustrative is Section 213(c) of the *Restatement (Second) of Agency* (1958), which provides that "a person conducting an activity through servants or other agents is subject to liability for harm resulting from his conduct if he is negligent or reckless in the supervision of the activity."³² This provision is fleshed out by Sections 214, 216 and 261 (which deal with the failure of the principal to perform a nondelegable duty, unauthorized tortious conduct by the agent, and when the agent's position enables him to deceive, respectively). According to Section 228(1), an employee's conduct is within the "scope of employment" if:

- a. It is of the kind he is employed to perform;
- b. It occurs substantially within the authorized time and space limits; [and]

³¹ The business, of course, would still be directly responsible for any failure to adequately investigate the employee's background, ab initio. See note 5 *supra*.

³² In the class of cases envisioned by this article, there is no third person suing the business seeking to attribute to it the acts of an employee. Rather, the issue is simply whether or not the business is precluded from asserting a claim because of its employee's acts. While the *Restatement* is phrased so as to accommodate the former type of case, it is quite clear that the principles that it sets forth also apply to the latter. On this subject generally, see W. Seavey, *Law of Agency* § 91 (1964).

- c. It is actuated, at least in part, by a purpose to serve the master.

Significantly, this definition of “scope of employment” contemplates “consciously criminal or tortious” acts, Section 231.³³

The doctrine of *respondeat superior* articulated by these sections departs from the principle that liability follows fault, a fundamental concept of tort law. Nonetheless, it is well established. Its rationale is as follows:

What has emerged as the modern justification for vicarious liability is a rule of policy, a deliberate allocation of risk. The losses caused by the torts of employees, which as a practical matter are sure to occur in the conduct of the employer’s enterprise, are placed upon that enterprise itself, as a required cost of doing business. They are placed upon the employer because, having engaged in an enterprise, which will on the basis of all past experience involve harm to others through the torts of employees, and sought to profit by it, it is just that he, rather than the innocent injured plaintiff, should bear them; and because he is better able to absorb them, and to distribute them, through prices, rates or liability insurance, to the public, and so to shift them to society, to the community at large.³⁴

In other words, the employer’s liability extends beyond the domain of his actual control over his employees to include risks inherent in or created by the business enterprise itself. To some extent, this involves resource allocation. Underlying this, though, is the primordial notion that a business ought to be responsible for its own conduct and that one who is in a position to exercise control, however amorphous or diffuse, must do so or suffer the consequences. As expressed in a leading decision:

A policy analysis thus is not sufficient to justify this proposed expansion of vicarious liability. This is not surprising since *respondeat superior*, even within its traditional limits, rests not so much on policy

³³ Section 244 of the UCC goes on to expressly provide that “a master is subject to liability for a trespass or a conversion caused by an act done by a servant within the scope of employment”; this definition is broad enough to encompass UCC-style conversion, even though it obviously was originally intended to apply only to common-law conversion, defined in *Black’s*, note 13 *supra*, as “unauthorized and wrongful exercise of dominion and control over another’s personal property, to exclusion of or inconsistent with rights of owner.”

³⁴ Prosser & Keaton, note 19 *supra*, § 69.

grounds consistent with the governing principles of tort law as in a deeply rooted sentiment that a business enterprise cannot justly disclaim responsibility for accidents which may fairly be said to be characteristic of its activities.³⁵

What is "characteristic of the activities" of a business receiving and disbursing funds? The handling of checks, for one thing, which brings both the types of thefts that have been discussed right within the *respondeat superior* rationale.

The business is therefore called on to respond for two different types of fault. The first is its own negligent failure to devise, implement, and maintain a system of internal controls that would have either prevented the theft or facilitated its earlier detection. If an employer negligently employs a person who is incapable of honestly performing the task for which he is hired, or negligently fails to exercise proper supervision and control over the employee's performance, he is directly liable as a result of his own fault without reference to the doctrine of *respondeat superior*. But the liability imposed upon the business as a result of *respondeat superior* does not rest upon its own fault. Rather, the fault for which the business is required to respond is that of the employee, committed within the course and scope of his employment. The business is held liable as a matter of policy, on the theory that by employing a person it holds that person out as being competent and fit to be trusted, in effect warranting the employee's good conduct and fidelity. In order to impose liability, it is necessary only that the risk fall within the scope of the business enterprise.

One way to determine whether a risk is inherent in or created by an enterprise is to ask whether the actual occurrence was a generally foreseeable consequence of the activity. However, foreseeability in the context of *respondeat superior* is not the same thing as foreseeability as a test for negligence.

In the latter sense "foreseeable" means a level of probability which would lead a prudent person to take effective precautions whereas "foreseeability" as a test for *respondeat superior* merely means that

³⁵ *Ira S. Bushey & Sons, v. United States*, 398 F.2d 167, 171 (2d Cir. 1968).

in the context of the particular enterprise an employee's conduct is not so unusual or startling that it would seem unfair to include the loss resulting from it among other costs of the employer's business. . . . In other words, where the question is one of vicarious liability, the inquiry should be whether the risk was one "that may fairly be regarded as typical of or broadly incidental" to the enterprise undertaken by the employer.³⁶

It is submitted that, in the vast majority of cases, this criterion will be met. Employee thefts perpetrated with negotiable instruments can only be considered as risks inherent in and incidental to a failure of internal control.

The Employer's State of Mind

Principles unique to bank law also confirm this result. We have previously examined the sorry case of Carlo Basch and his pharmacy. After criticizing Basch's system of internal controls, the court went on to hold that as a result of his own negligence, Basch would actually participate (albeit vicariously) in the state of mind of his dishonest employee. In assessing his relative culpability, he would not be charged with Herbert Lahr's actual knowledge. Such an alternative, which would in essence involve the attribution of a specific intent or mens rea to someone who was merely careless, would be too radical under the circumstances. Basch would, however, be deemed to be in constructive possession of the knowledge that an honest employee would have acquired through a diligent and thorough examination of his books.

Nor does the fact that plaintiff delegated the duty thus imposed upon him by law to a faithless employee serve as a legal excuse for not discharging this duty himself. According to the generally adopted rule, when the agent to whom the duty of examination is entrusted is a dishonest employee who by forgery has obtained funds of his employer from the bank, and whose consequent adverse interest causes him to conceal from his employer the circumstances which would naturally have been disclosed in the course of a proper verification, the employer, though not imputed with knowledge of the fraud of his faithless agent, is, as principal, chargeable with such information as an honest employee, unaware of the wrongdoing, would have ac-

³⁶ Rogers v. Kemper Constr. Co., 50 Cal. App. 3d 608, 618, 124 Cal. Rptr. 143, 148 (1975).

quired from the examination of the canceled checks and bank statements.³⁷

The court explained the rationale for this rule as follows:

Consistent with the settled principles upon which the relation of bank and depositor is founded, this rule reasonably imposes upon the depositor the further duty of properly supervising the conduct of his trusted employee, for "aside from its own diligence, a bank's only protection against forgeries by a confidential agent to whom settlement of the bank account has been delegated is verification of statements by the depositor himself, who in such case is clearly responsible for the acts and omissions of his agent in the course of duties with which he had entrusted him." . . . Thus, in the absence of such reasonable supervision, the mere designation of an agent to discharge a duty resting primarily upon the principal—the depositor—cannot be deemed the equivalent of performance by the latter.³⁸

While *Basch* involved the case of a drawer's suing his own bank, the payor bank (on account of a disbursement-function theft), the principles set forth therein are equally applicable to the case of a payee suing a collecting bank (on account of a receipt-function theft). Indeed, *Basch* makes clear that every person, no matter who he is, is charged with a minimum degree of diligence regarding his own financial affairs. That duty of care cannot be delegated by a business to its employees; if a business makes such a delegation, it does so at its peril, because it will be charged with the consequences thereof. While the employer will not be charged with actual notice of an employee's theft, he is "chargeable with such information as an honest employee, unaware of the wrongdoing, would have acquired" from an examination of pertinent financial records. It does not involve a tremendous inferential leap to conclude that if the business actually has or should have knowledge that it is the victim of an embezzlement, it can take steps to protect itself, such as terminating the dishonest employee.

What is the significance of the employer being charged with the knowledge of the honest employee? In order to answer this question, one must hypothesize the existence of

³⁷ *Basch v. Bank of America*, 22 Cal. 2d at 327, 139 P.2d at 8.

³⁸ *Id.* at 328, 139 P.2d at 8.

two employees, an honest one and a dishonest one. The dishonest employee is busy embezzling funds, while the honest one reviews the books. The employer will be liable if, as a result of his (or her) competent and conscientious examination of the employer's financial records, there would come a time when the honest employee would have discovered the dishonest employee's theft. If the theft was so subtle and perfect that even the honest employee would not have uncovered it, then the employer should escape liability. Under such circumstances, it would not be reasonable to charge the employer with the dishonest employee's conduct as a risk of his business. On the other hand, if the honest employee would have been able to detect or uncover the fraud, then the business ought to be held responsible. The advantage of this standard is that it attenuates responsibility for internal controls to the expectations of the business itself.

Obviously, this leaves some room for maneuvering. It is not a question of discovering the theft, because the theft has already been discovered. (If such was not the case, the employer would not be suing the bank to begin with.) The question therefore becomes whether or not the theft should have been detected at some earlier date. The earlier that the theft ought to have been detected, the better the bank's chances of triggering the running of an applicable statute of limitations.³⁹

³⁹ On disbursement-function thefts, one year (U.C.C. § 4-406(4)); for conversion, not specified by the UCC and thus a matter of state procedure. In *Cooper v. Union Bank*, (9 Cal. 3d 123, 507 P.2d 609, 107 Cal. Rptr. 1 (1973)), the court held that Joseph Stell could not recover for items negotiated more than six months after the date on which the thefts commenced (9 Cal. 3d at 135, 507 P.2d at 618, 107 Cal. Rptr. at 10). After that point, he should have suspected that Bernice Ruff was stealing from him. The court did not establish six months as statute of limitations, per se; indeed, the applicable California statute (Cal. Civ. Proc. Code § 338(3)) is three years. See *Bank of America v. Security Pac. Nat'l Bank*, 23 Cal. App. 3d 638, 642, 100 Cal. Rptr. 438, 442 (1972); *Fabricon Prods. v. United Cal. Bank*, 264 Cal. App. 2d 113, 114, 70 Cal. Rptr. 50, 52 (1968). Rather, the court held that this was the point after which the plaintiff's negligence would bar him from any further recovery.

If it is assumed that each item that is negotiated gives rise to a separate cause of action (a reasonable assumption; see, e.g., *Sun 'N Sand, Inc. v. United Cal. Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978), note where the court treated each check separately for statute of limitations purposes), an item negotiated prior to the date of the filing of the plaintiff's complaint plus the statute of limitations period should be barred.

Although there is no particular reason why it should be, the question of when a statute of limitations begins to run can be complicated. Generally, the right to bring and prosecute a cause of action arises immediately upon the commission of the claimed wrong. Courts in several jurisdictions have held that this concept applies to a cause of action for conversion,

An empirical test remains a possibility. Without indicating that anything is suspicious, turn another employee (without prior knowledge of the problem) loose on the books, and see how long it takes for that person to come up with an inclination that there might be something amiss. Since we are dealing with *hypothetical* honest employees, though, such a test would ultimately not be dispositive, and the issue will resolve itself along the trier of fact's belief as to what type of review that it would be reasonable for the business to conduct, and the level of knowledge that it ought to have.

What About Hiring an Accountant?

Businesses often hire independent accountants, who are sometimes certified public accountants, whose task is often to "audit" the company's books. As SAP 54 (at ¶ 49) makes clear, "accounting control is within the scope of the study and evaluation of internal control contemplated by generally accepted auditing standards." One of those auditing stan-

which accrues at the time that the instrument is paid on a forged indorsement. See, e.g., *United States v. Bankers Trust Co.*, 17 U.C.C. Rep. 136 (E.D.N.Y. 1975); *Fuscellaro v. Indus. Nat'l Corp.*, 117 R.I. 558, 368 A.2d 1227 (1977). Many statutes of limitations are not absolute, however, but rather of the "when one had reason to know" variety. Statutes of limitations like these can present a problem, especially if the bank is sued on noncontractual or extra contractual theories (such as negligence) in addition to UCC causes of action, or if there is a choice between competing statutes of limitation that may apply to the same set of circumstances.

A delayed accrual statute can be successfully asserted as an affirmative defense only if no items were negotiated within whatever period is specified by the statute after the business should have known that it was being taken advantage of. Even under such a statute, it should remain the plaintiff's burden to show that he "should not have known" so as to activate the statute upon the date of the commission of the wrong, instead of at some later time. This ties us right back in with Carlo Basch, for if the employer is charged with the knowledge of an honest bookkeeper, it will be difficult for him to assert that he "should not have known" for delayed accrual purposes.

This connection was made explicit by the California Supreme Court in *Sun 'N Sand, Inc. v. United Cal. Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978), where the court held (citing *Basch*) that "discovery" for the purposes of a statute that did not begin to run "until the discovery, by the aggrieved party, of the facts constituting the fraud or mistake" occurred when the wrong was committed. At 21 Cal. 3d at 702, 582 P.2d at 94, 148 Cal. Rptr. at 350, the court stated:

That its dishonest employee may have concealed her perfidy by manipulating and destroying records does not exonerate Sun 'N Sand of its negligent omission. . . . Sun 'N Sand's failure to discover its mistake within three years of the issuance of the first three checks thus derived from its failure to discharge with reasonable care its duty to supervise its employees. Because it permitted the fraud to be concealed by its lack of reasonable supervision, Sun 'N Sand may not assert such concealment to justify its delay in commencing this action.

dards, the “second standard of field work,” is set forth in SAP 33, propounded in December 1963: “There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.”

In other words, when an independent auditor expresses the opinion that a company’s financial statements have been examined in accordance with generally accepted accounting principles, this statement comprehends within itself a proper study and evaluation of internal control. In fact, the system of internal control must be validated to give the accounting data any meaning to begin with. If there is a sound system of internal control, and the procedures that it establishes are being complied with, the data presented by the company’s financial records can be regarded with a higher degree of certitude. As expressed at paragraph 19 of chapter 5 of SAP 33: “Adequate evaluation of a system of internal control requires knowledge and understanding of the procedures and methods prescribed and a reasonable degree of assurance that they are in use and are operating as planned.”

In order to fulfill this mandate, the independent auditor must undertake two tasks: a review of the system of internal controls that is actually in place, and tests of compliance to make sure that it is working properly. “The review of the system is primarily a process of obtaining information about the organization and the procedures prescribed” (paragraph 51, SAP 54). “The purpose of tests of compliance is to provide reasonable assurance that the accounting control procedures are being applied as prescribed” (§ 55, SAP 54). At paragraph 65 of SAP 54, it is stated:

A conceptually logical approach to the auditor’s evaluation of accounting control, which focuses directly on the purpose of preventing or detecting material errors or irregularities in financial statements, is to apply the following steps in considering each significant class of transactions and related assets involved in the audit:

- a. Consider the types of errors and irregularities that could occur.
- b. Determine the accounting control procedures that should prevent or detect such errors and irregularities.

- c. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
- d. Evaluate any weaknesses—i.e., types of potential errors and irregularities not covered by existing control procedures—to determine their effect on (1) the nature, timing, or extent of auditing procedures to be applied and (2) suggestions to be made to the client.

This having been accomplished, the independent auditor will be in a position to conclude whether or not the prescribed procedures and compliance therewith “provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions” (§ 68, SAP 54).

The accounting profession has what might best be described as a schizophrenic attitude toward ultimate responsibility for internal controls. Paragraph 16 of chapter 5 of SAP 33 states:

Management has the responsibility for devising, installing and supervising an adequate system of internal control. Any system, regardless of its fundamental soundness, may deteriorate if not reviewed periodically. The system of internal control must be under continuing supervision to determine whether (1) prescribed policies are being interpreted properly and are being carried out, (2) changes in operating conditions have made the procedures cumbersome, obsolete or inadequate, and (3) effective corrective measures are taken promptly where breakdowns in the system appear.

Paragraph 21 of SAP 54: “The ultimate authority for business transactions rests with stockholders or other classes of owners except as circumscribed by law, and is delegated by them to directors, trustees, officers and other management personnel. The delegation of authority to different levels and to particular persons in an organization is a management function”; and paragraph 31 of SAP 54: “The establishment and maintenance of a system of internal control is an important responsibility of management,” are in the same vein.

Yet, paragraph 17 of chapter 5 of SAP 33 goes on to provide: “While the responsibility for the establishment and

enforcement of internal control rests with management, the degree to which such controls exist and are carried out is of great concern to the independent auditor.” Paragraph 18 of chapter 5 of SAP 33 continues:

A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records. The independent auditor’s review of the system of internal control assists him in determining other auditing procedures appropriate to the formulation of an opinion on the fairness of the financial statements.

Paragraph 23 concludes chapter 5 of SAP 33 by stating that “the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.”

Obviously, these generalizations are not very useful when it comes to assigning responsibility for an internal controls breakdown. Accountants have long been held liable to their clients for failure to discover fraud, either on breach of contract or professional negligence theories.⁴⁰ Although infrequently articulated as such, perhaps the key factor impacting on the accountant’s liability is the *scope of his engagement*. Accountants, like other professionals, are hired by their clients to perform specific tasks. The more general the description of just what it is that the accountant is supposed to do—e.g., “take care of all of the financial aspects of my business”—the more likely it is that the accountant’s duties will be found to encompass responsibility for internal controls. More often than not, the owners or management of a business that has retained an accountant on such a basis will have no knowledge or desire to find out about internal controls, and will readily testify that they expected their trusted accountant to implement appropriate safeguards. Under such circumstances, the accountant (who holds himself out as having superior knowledge, skill and expertise) will bear a

⁴⁰ Illustrative cases are collected at R.J. Gormley, *The Law of Accountants and Auditors* ch. 5 (1981); Annot., 92 A.L.R.3d 396 (1979); see especially, *Nat’l Surety Corp. v. Lybrand*, 256 App. Div. 226, 9 N.Y.S.2d 554 (1939), and *1136 Tenants’ Corp. v. Max Rothenberg & Co.*, 36 A.D.2d 804, 319 N.Y.S.2d 1007 (1971).

difficult burden, indeed, in persuading a trier of fact to the contrary.⁴¹

On the other hand, the more knowledge that the owners or management have about the financial condition of their business, and the more involved that they are, the more likely it is that the accountant will be able to raise a successful defense on an assumption of risk or comparative fault rationale. If the accountant, for example, explained what would be involved in establishing and monitoring an effective system of internal control, and the business declined to incur whatever loss was involved, the accountant's position will improve remarkably. Even the accountant cannot ensure that his advice will actually be followed. Similarly, if the business is experiencing a cash flow hemorrhage, all financial records are maintained "in house," and the accountant merely prepares a yearly tax return, the accountant should be able to escape liability. The ambiguous situations, of course, are those where the evidence is equivocal, or where nothing is said.

The main way that the accountant can protect himself is through the use of an *engagement letter*. An engagement letter is a written agreement between the accountant and the client as to the nature and limitations of the services to be rendered. As such, it constitutes tangible evidence of the contractual understanding between the parties and estab-

⁴¹ Most accounting texts also deal with the subject of internal control, albeit at varying levels and degrees of sophistication. See, e.g., Arthur Andersen & Co., *A Guide for Studying and Evaluating Internal Accounting Controls* (1978); A.A. Arens & J.K. Loebbecke, *Auditing, An Integrated Approach* (3d ed. 1984), especially ch. 9, "The Study, Evaluation and Testing of Internal Control"; L.P. Bailey, *Contemporary Auditing* (1979), especially ch. 6, "Internal Control: Systems Evaluations"; V.Z. Brink & H. Witt, *Modern Internal Auditing* (4th ed. 1982), especially ch. 26, "Fraud and Investigations"; J.C. Burton, R.E. Palmer & R.S. Kay, *Handbook of Accounting and Auditing* (1981), especially ch. 13, "Internal Control"; J.W. Cook & G.M. Winkle, *Auditing: Philosophy and Technique* (2d ed. 1980), especially ch. 7, "Internal Controls—Design and Review"; C.T. Horngren, *Cost Accounting: A Managerial Emphasis* (5th ed. 1982), especially ch. 27, "Accounting Systems and Internal Control"; K.P. Johnson & H.R. Jaenicke, *Evaluating Internal Control* (1980); W.B. Meigs & R.F. Meigs, *Accounting, The Basis for Business and Technique* (6th ed. 1984), especially ch. 6, "Internal Control"; A.N. Mosich & E.J. Larsen, *Intermediate Accounting* (5th ed. 1984), especially ch. 6, "Cash and Short Term Investments"; B.E. Needles, Jr., H.R. Anderson & J.C. Caldwell, *Principles of Accounting* (2d ed. 1984), especially ch. 8, "Internal Control and Merchandising Transactions"; R.F. Salmonson, R.H. Hermanson & J.D. Edwards, *A Survey of Basic Accounting* (3d ed. 1981), especially ch. 5, "Internal Control and the Control of Cash"; P.H. Walgenbach, N.E. Dittrich & E.I. Hanson, *Principles of Accounting* (3d ed. 1984), especially ch. 7, "Internal Control, Cash and Short-Term Investments."

lishes a "meeting of the minds." A recent study⁴² of 176 CPA firms concluded that "engagement letters are commonly used for audits, compilations and reviews and, to a lesser extent, for management advisory services." A provision contained in many of the letters that were studied limited the accountant's responsibility for disclosure of material errors, irregularities or illegal acts, including fraud or defalcations. The authors of the study conceded that "professional standards in the U.S. do not require or even recommend an engagement letter for an audit engagement." However, they also observed that engagement letters not only facilitated communication between the accountant and his client, but also served as an important liability-limiting device. As expressed by another commentator,⁴³ "adequate documentation of work performed in an engagement may be the single most important defense against successful malpractice suits." While it might not be negligent for an accountant not to have an engagement letter with his client, it is surely the accountant's responsibility to clarify his relationship with his client, if there is any difference of opinion as to who is to do what.

A closely related issue is what happens when the accountant actually detects or encounters suspicious circumstances suggestive of an internal controls deficiency, even though it might not have been his responsibility to ferret out such a weakness under the terms of his engagement. In such an instance, it seems clear that the accountant is under an obligation to apprise his client that a problem exists. He cannot simply sweep the offending data under the rug and proceed as though it was business as usual. In August 1977, in fact, the Auditing Standards Executive Committee of the AICPA issued Statement on Auditing Standards (SAS) 20, "Required Communication of Material Weakness in Internal Accounting Control," establishing a requirement that the accountant communicate to management any material weaknesses in internal accounting control that come to his attention during an examination of financial statements.

⁴² Van Son, Guy & Betts, "Engagement Letters: What Practice Shows," *J. Accountancy* 72 (June 1982).

⁴³ Winters, "Avoiding Malpractice Liability Suits," *J. Accountancy*, 69 (Aug. 1981).

Taking the Offensive

As the alignment of interests discussed so far suggests, many businesses retain independent accountants, yet still sustain losses as a result of the forging of various signatures on negotiable instruments. A powerful defense to the business' suit against the bank either dealing with or paying those instruments, is that the business failed to devise, implement, and maintain a system of internal controls that would either have prevented the theft, or facilitated its earlier discovery.

One way for the bank to highlight the relationship between the business and its independent accountants, and the duties and mutual knowledge conditions existing between them, is for the bank to actually file a third-party complaint, cross-claim or cross-complaint (depending upon local procedure) against the accountants for *implied equitable indemnity*. Under such a theory, sanctioned in many jurisdictions,⁴⁴ the independent accountants would share responsibility with the bank for any losses sustained by the business, based upon a trier of fact's perception of their comparative fault.

The bank's cause of action against the accountants under such circumstances has a great deal of intuitive appeal, especially when many signatures are forged over a period of time. The longer that funds are stolen from the business without the business detecting any loss, the more the risk of loss detectable by the bank is lessened. Whatever story the dishonest employee tells to the bank becomes self-validating, and the bank should be able to appeal to the precedent and history of its relationship with the thief, as a way of justifying itself. In

⁴⁴ In California, at least, see *American Motorcycles Ass'n v. Superior Court*, 20 Cal. 3d 578, 578 P.2d 899, 146 Cal. Rptr. 182 (1978), wherein the California Supreme Court held that a tortfeasor whose negligence is a proximate cause of an indivisible injury remains individually liable for all compensable damages attributable to that injury. Earlier, in *Li v. Yellow Cab Co.* 13 Cal. 3d 804, 532 P.2d 1226, 119 Cal. Rptr. 858 (1975), the court adopted the comparative negligence doctrine, under which an injured individual's recovery is simply proportionately diminished, rather than completely eliminated, when he is partially responsible for the injury. The petitioner in *American Motorcycle Ass'n* argued that this logically compelled elimination of the rule of joint and several liability. The court disagreed. However, it did permit joint or multiple tortfeasors to apportion liability among themselves, on a comparative negligence basis—the theory of “implied equitable indemnity.” Since *American Motorcycle Ass'n*, concepts of implied equitable indemnity in California have undergone an extraordinary evolution, a discussion of which would require a separate presentation.

short, the pattern of conduct and the elapsed time alone constitute the “objective indicia from which the bank could reasonably conclude that the party presenting the check [was] authorized to transact in the manner proposed.”⁴⁵

The bank’s conduct may therefore be viewed as non-risk-creating, so as to preclude the finding of a duty owed by the bank to protect the business. This is even more true, in light of other loss-allocation principles set forth in the UCC, which place the onus of detecting an employee’s fraudulent conduct on the business, rather than on the bank with which the dishonest employee transacts.⁴⁶

The accountants, on the other hand, are the ones to whom the business looks for financial security, not the bank. To state the proposition in its simplest form, it is the accountants’ job to safeguard the business’ fiscal health and well-being. The business does not retain the bank to perform this task. (Indeed, in a typical action for conversion, the business has no relationship whatsoever with the thief’s bank, further negating any inference that such a bank would owe any duty, however remote, to the business.)

Should the bank sue the accountants for indemnity (or even if the business sues both the bank and the business’ accountants, right from the start), complicated questions will arise as to who caused what. It is not within the scope of this article to analyze complicated causation issues that have puzzled scholars for years. As expressed by two prominent commentators:

There is perhaps nothing in the entire field of law which has called forth more disagreement, or upon which the opinions are in such a welter of confusion. Nor, despite the manifold attempts which have been made to clarify the subject, is there yet any general agreement as to the best approach. Much of this confusion is due to the fact that no one problem is involved, but a number of different problems, which are not distinguished clearly, and that language appropriate to a discussion of one is carried over to cast a shadow upon the other.⁴⁷

⁴⁵ Sun ’N Sand, Inc., 21 Cal. 3d at 696, 582 P.2d at 937, 148 Cal. Rptr. at 346.

⁴⁶ See, e.g., U.C.C. § 3-405.

⁴⁷ Prosser & Keaton, note 19 *supra*, § 41.

This being so, there can be no question but that the bank's dealing with the thief, however innocent and in whatever capacity, is part of the causal chain that results in the business' being deprived of funds. To quote the *Restatement (Second) of Torts*:

The words "legal cause" are used . . . to denote the fact that the causal sequence by which the actor's tortious conduct has resulted in an invasion of some legally protected interest of another is such that the law holds the actor responsible for such harm unless there is some defense to liability.⁴⁸

However, it is also true that anything that the bank did or did not do, by itself, would not have been sufficient to cause the result. Also required would be the negligence of the accountants (in failing to devise, implement, and maintain a system of internal controls), to whom the business looks for comfort and solace in connection with such matters. This suggests far more complicated causal relationships, essentially metaphysical in nature, in which the doctrines of "independent" as opposed to "joint" tortfeasorship and "intervening cause" and "superseding cause" play a prominent part.⁴⁹

The bank should not permit itself to get bogged down with these problems. In any suit where both the bank and the accountants are present, the business will be interested in creating an artificial dichotomy between itself and its accountants. To some extent, this is due to the exigencies of the situation in which the business finds itself. The primary thrust of the business' claim against the accountants is negligence, and in order to advance that claim, it is to the business' interest to stretch as far as possible the scope of the duty that the accountants owe to it. With every expansion of the accountants' duty, however, the scope of any duty owed to the business by the bank ought logically tend to decrease, as the accountants, for and on behalf of the business, should exercise an incrementally greater degree of diligence on the business' behalf.

⁴⁸ *Restatement (Second) of Torts* § 9 (1965); see also §§ 430 et seq.

⁴⁹ See Prosser & Keaton, note 19 *supra*, § 44; *Restatement (Second) of Torts* §§ 440 et seq. (1965).

This is simply another illustration of *Basch v. Bank of America*, and the principle that, in the final analysis, every business ought to be held responsible for its own financial affairs and internal control mechanisms. Any fault of the accountants, therefore, is directly attributable or allocable to the business itself. The case of business versus bank versus accountants is not a true three-party case, then, but rather a two-party case in which the business must answer not only for its own conduct, but for that of its accountants, as well.

Conclusion

The internal controls defense is a powerful weapon that a defendant bank can use to defeat or diminish a plaintiff's claim. If properly deployed, with good evidence and strong expert testimony, it significantly enhances the bank's chances for success in an increasingly hostile litigation environment.