

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)	
)	
WESTERN IOWA FARMS CO.,)	CASE NO. BK91-82008
)	
DEBTOR)	A93-8025
)	
WESTERN IOWA FARMS CO.)	
)	CH. 11
Plaintiff)	
vs.)	
)	
FIRST SAVINGS BANK AND NORWEST)	
BANK, ANACONDA-BUTTE, N.A.,)	
)	
Defendant)	

MEMORANDUM

Hearing was held on July 28, 1994, on a Motion for Summary Judgment filed by Norwest Bank Anaconda-Butte, N.A., and on a Motion for Summary Judgment filed by First Savings Bank F.S.B., Manhattan, Kansas, and resistances by plaintiff. Appearing on behalf of debtor/plaintiff was Victor Lich of Lich, Herold & Mackiewicz, Omaha, Nebraska. Appearing on behalf of First Savings Bank was Frederick Stehlik of Schmid, Mooney & Frederick, P.C., Omaha, Nebraska. Also appearing on behalf of First Savings Bank was Richard Seaton of Everett, Seaton, Miller & Bell, Manhattan, Kansas. Appearing on behalf of Norwest Bank was Thomas Flaherty of Fraser, Stryker, Vaughn, Meusey, Olson, Boyer and Bloch, P.C., Omaha, Nebraska. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is not a core proceeding as defined by 28 U.S.C. § 157, but is a proceeding related to a case under title 11. All parties have consented in writing to the bankruptcy judge entering judgment, subject to review under 28 U.S.C. § 158, as permitted by 28 U.S.C. § 157(c)(2).

Background

The plaintiff, Western Iowa Farms (Western Iowa), operated a business that financed cattle purchased by others. During 1989 and part of 1990, the plaintiff maintained a business account at the defendant, Norwest Bank Anaconda-Butte, N.A. (Norwest). The plaintiff authorized Leonard Russell and his son Mike Russell, who were independent livestock dealers, to issue checks on Western Iowa's account at Norwest. Mike and Leonard Russell were given

blank checks by Western Iowa to buy cattle drawn on Western Iowa's account at Norwest.

Between November 9, 1989 and January 2, 1990, Leonard Russell signed eight checks and Mike Russell signed two checks that were drawn on the Norwest account and were payable to either Walter L. Johns, David Wullschleger, or Steven J. Blumer. The checks were made out and signed as follows:

<u>Exhibit</u>	<u>Check no. & date</u>	<u>Signer</u>	<u>Payee</u>	<u>Amount</u>
1	56849 11/09/89	Leonard	Wullschleger	\$47,642.37
2	56855 11/16/89	Leonard	Johns	\$27,409.67
3	57015 11/28/89	Leonard	Wullschleger	\$10,551.04
4	57016 11/30/89	Leonard	Johns	\$36,295.40
5	57021 12/01/89	Leonard	Johns	\$39,488.40
6	57020 12/04/89	Leonard	Johns	\$ 7,840.12
7	57031 12/19/89	Leonard	Wullschleger	\$40,548.05
8	56896 12/23/89	Mike	Johns	\$34,065.12
9	56897 12/23/89	Mike	Johns	\$12,442.11
10	57034 01/01/90	Leonard	Blumer	<u>\$18,709.60</u>
			TOTAL	\$274,991.88

None of the payees received or deposited these checks. Instead, all of the checks were deposited by Brad Russell, son of Leonard and brother of Mike, into two bank accounts at that were controlled by the Russells and in which Western Iowa had no interest. Both accounts were located at First Savings National Bank of Manhattan, Kansas (First Savings). When First Savings accepted the checks from Brad for deposit, the payee's indorsement had been forged by Brad. Brad also wrote the words "For deposit only," and the Russell account number on the back of each check.

First Savings presented all ten checks to Norwest for collection. Norwest charged Western Iowa's account and paid First Savings.

In the ordinary course of business between the Russells and Western Iowa, the Russells purchased cattle with Western Iowa checks, resold the cattle to a third party, received payment for the sale, and repaid Western Iowa the amount of the original checks plus a fee. However, these ten checks do not represent actual

cattle purchases. The Russells issued the checks to the payees, forged the payee's indorsements, and deposited the proceeds into their own accounts. Since no cattle were purchased, no cattle could be sold to generate funds to repay Western Iowa. Apparently, Western Iowa has not been able to recover sufficient funds from the Russells to cover its losses.

Western Iowa filed this adversary complaint against Norwest and First Savings to recover \$277,991.88, the total amount of the forged checks. First Savings and Western Iowa agree that any liability on the part of First Savings will be determined under the law that was in effect in Kansas during the period of time that the checks were paid, which in this case occurred before the 1992 revisions to Articles 3 and 4 to the Uniform Commercial Code were adopted by the Kansas Legislature. See KAN. STAT. ANN. § 84-4-102(2) (1983) ("The liability of a bank for action or nonaction with respect to any item handled by it for purposes of presentment, payment, or collection is governed by the law of the place where the bank is located.").

Western Iowa alleged in its complaint that First Savings converted the proceeds of the checks by accepting the forged checks from Brad Russell pursuant to pre-revision Section 3-419 of the Kansas Uniform Commercial Code. KAN. STAT. ANN. § 84-3-419(1)(c) (1983) ("An instrument is converted when it is paid on a forged indorsement."). Western Iowa's second allegation is that First Savings failed to exercise ordinary care, act in good faith, and adhere to reasonable commercial standards in the banking industry by paying Brad the amount of the checks. First Savings alleges that the deposits are excepted from Section 3-419 of the Kansas Uniform Commercial Code because the indorsements are effective and are, therefore, deemed not to be forgeries under Section 3-405(1)(b) and (c) of the Uniform Commercial Code. KAN. STAT. ANN. § 30-3-405(1)(b) & (c) (1983).¹ First Savings next alleges that if the indorsements are effective, the issue of whether First Savings adhered to reasonable commercial standards is moot as a matter of law because First Savings accepted the checks as a holder in due course.

Discussion and Decision

A. Standard for Summary Judgment

Motions for summary judgment are filed pursuant to Fed. Bankr. R. 7056, which incorporates Fed. R. Civ. P. 56. A summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact

¹ See infra p. 7 for the text of Section 3-405(1)(b) and (c).

and that the moving party is entitled to a judgment as a matter of law." Fed. Bankr. R. 7056(c); Fed. R. Civ. P. 56(c); Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986).

While state law governs the substantive issues in this case, the law applicable to the summary judgment motion is federal law because procedural issues in federal courts are governed by federal law. Erie Railroad Co. v. Tompkins, 304 U.S. 64, 58 S. Ct. 817, 82 L. Ed. 2d 1188 (1938). The burden is on First Savings to establish both that there is no genuine issue as to any material fact and that it is entitled to judgment as a matter of law. United States Gypsum Co. v. Greif Bros. Cooperage Corp., 389 F.2d 252 (8th Cir. 1968). The materials submitted on a motion for summary judgment are viewed in a light most favorable to the party opposing the motion, and that party should be given the benefit of all inferences reasonably deducible from the evidence. Adickes v. S.H. Kress & Co., 398 U.S. 144, 90 S. Ct. 1598, 26 L. Ed. 2d 142 (1970).

"[T]he burden on the moving party may be discharged by "showing" ... that there is an absence of evidence to support the nonmoving party's case." Celotex Corp. v. Catrett, 477 U.S. 317, 325, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986). In addition, a failure by the nonmoving party to submit evidence to support its claims will result in summary judgment being entered against him. Metro North State Bank v. Gaskin, No. 93-2850, 1994 U.S. App. LEXIS 22174 (8th Cir. August 19, 1994) (refusing to overturn the entry of summary judgments by a district court in situation where nonmoving party failed to submit evidence in support of its claim).

Any deposition testimony that would be admissible at trial may be considered when determining a summary judgment motion. 6 JAMES W. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 56.11[1.--3], at 56-100 (2d ed. 1994). Even though deposition testimony is better than affidavit testimony because the deponent is subject to cross-examination, it still suffers from one weakness, which is that the demeanor of the deponent is not observable by the Court. Id.

B. Undisputed Facts

1. Leonard Russell and Mike Russell were authorized by Western Iowa to issue checks on Western Iowa's account at Norwest, and Western Iowa gave Leonard and Mike blank checks to carry out this authorization. Filing no. 1, Adversary Complaint ¶ 7.

2. Leonard Russell issued three checks payable to David Wullschleger, four checks payable to Walter Johns, and one check payable to Steven Blumer. In addition, Leonard Russell directed Mike Russell to issue two checks payable to Walter Johns. See generally Exhibits 2-5 and attached exhibits.

3. Leonard Russell gave all of the checks to Brad Russell and instructed Brad Russell to deposit the checks into accounts controlled by the Russells. Exhibit 6.

4. Brad Russell forged all of the names of the payees on all ten checks and deposited the check proceeds into bank accounts controlled exclusively by the Russells. The checks were not delivered at any time to the payees. Exhibit 6.

5. At the time the checks were issued, David Wullschleger was not owed any money by Western Iowa or the Russells. Mr. Wullschleger's only livestock transactions with Leonard Russell occurred in 1988, long prior to the issuance of the forged checks. Mr. Wullschleger's only other business transaction with the Russells during the period of time that the checks were issued concerned a bond that Mr. Wullschleger held on one of the Russell's sale barns. The Russells paid any resulting obligation from the bond in full, separate from the checks issued in November and December 1989. Mr. Wullschleger has not had a business relationship with Western Iowa at any time.

No transaction took place prior to or after the issuance of the checks which would cause any money owed by Western Iowa or the Russells to be paid to Mr. Wullschleger. The checks issued by Leonard Russell and payable to Mr. Wullschleger were not issued for the purpose of paying Mr. Wullschleger for any business transaction. See Exhibit 3, attached exhibits 1, 3, & 7.

6. Brad Russell was not authorized to sign David Wullschleger's name on the back of any of the three checks which were payable to Mr. Wullschleger. See Exhibit 3, attached exhibits 1, 3, & 7. Brad Russell was not authorized by Mr. Wullschleger to deposit the checks into the Russell's account at First Savings.

7. At the time the checks were issued, Steven Blumer did not owe money to and was not owed any money by Western Iowa or the Russells. Mr. Blumer never engaged in any transaction concerning livestock or otherwise with the Russell's or Western Iowa which would cause Leonard Russell to issue a check to Mr. Blumer. Therefore, the check issued by Leonard and payable to Mr. Blumer was not issued for the purpose of paying Mr. Blumer for any obligation, outstanding or otherwise. See Exhibit 4, attached exhibit 10.

8. Steven Blumer did not sign the back of the check which was issued as payable to him. Brad Russell forged Mr. Blumer's name without his knowledge or authorization and deposited it into an account controlled by the Russells without Mr. Blumer's knowledge or authorization. See Exhibit 4.

9. Walter Johns did engage in numerous livestock transactions with the Russells during the period of time that the forged checks

were issued. Walter Johns routinely purchased cattle for the Russells, and the Russells used Western Iowa checks to pay for the cattle. However, Mr. Johns did not have any knowledge of the four checks issued by Leonard and the two checks issued by Mike on the Western Iowa account. See Exhibit 2, attached exhibits 2, 4, 5, 6, 8 & 9. All livestock transactions between Mr. Johns and the Russells were paid in full with checks other than the ones at issue in this case. As far as Mr. Johns recalls, Leonard Russell always paid Mr. Johns within the next business day after each transaction took place.

10. Walter Johns did not authorize Brad Russell to indorse the six checks which are payable to Mr. Johns. Mr. Johns did not authorize Brad Russell or any of the Russells to deposit the checks into an account controlled by the Russells.

11. Each check in this case bore the forged indorsement, the words "For deposit only," and a deposit number that corresponded to an account at First Savings directly controlled by the Russells. James Wild Affidavit, attached exhibits 1-10 and 19.

12. Neither David Wullschleger, Steve Blumer nor Walter Johns maintained an account at First Savings.

13. The checks that Brad deposited were deposited in the following order:

<u>Ex.</u>	<u>Payee</u>	<u>Date of Deposit</u>	<u>Account No.</u>	<u>Total number of checks deposited on this date</u>
1	Wullschleger	11/09/89	1651513280	1
2	Johns	11/16/89	1651513280	1
3	Wullschleger	11/28/89	1651513280	6
4	Johns	11/30/89	1651513280	1
6	Johns	12/04/89	1606544780	3
5	Johns	12/8/89	1606544780	3
7	Wullschleger	12/19/89	1651513280	5
8	Johns	12/27/89	1606544780	4
9	Johns	12/27/89	1606544780	*
10	Blumer	01/03/89	1606544780	1

(James Wild Affidavit, attached exhibits 1-10, 11, 18).

14. First Savings accepted the checks for deposit even though: the payees on the checks did not have accounts at First Savings; Brad Russell did not have any authority from the payees to deposit the checks into the Russell accounts; First Savings did not have any acknowledgment by the payees that Brad Russell could deposit their checks into Russell accounts; the deposit numbers on the checks corresponded to accounts controlled by the Russells, not the payees; all of the indorsements were signed in Brad Russell's handwriting; and the deposit number and the "For deposit only" were written in the same handwriting as the indorsement.

C. SECTION 3-405 EXCEPTION

1. Applicable Law

The general rule in Kansas under the pre-revision Uniform Commercial Code was: "An instrument is converted when it is paid on a forged indorsement." KAN. STAT. ANN. § 3-419(1)(c) (1983). This Court has already held in a previous order that Western Iowa has a cause of action against First Savings for conversion because First Savings paid the Russells on a forged instrument. Western Iowa Farms Co. v. First Savings Bank (In re Western Iowa Farms Co.), Neb. Bkr. 93:424 (Bankr. D. Neb. Aug. 24, 1993).

First Savings takes the position that it is exempted from this general rule because the indorsements in this case are effective pursuant to Section 3-405(1)(b) and (c) of the Kansas Uniform Commercial Code, and therefore, the checks were properly payable. Section 3-405(1)(b) and (c) states:

(1) An indorsement by any person in the name of a named payee is effective if: (b) a person signing as or on behalf of a maker or drawer intends the payee to have no interest in the instrument; or (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.

KAN. CODE ANN. § 84-3-405(1)(b) & (c) (1983).

Comment 4 to Section 3-405 states:

The principle followed is that the loss should fall upon the employer as a risk of his business enterprise rather than upon the subsequent holder or drawee. The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or if he is not, is at least in a better position to cover the

loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.

KAN. STAT. ANN. § 84-3-405(1)(c), comment 4 (1983). The comment illustrates that the purpose of Section 3-405 is to shield a holder, like First Savings, from the liability of Section 3-419, which adopts the theory that the last party to deal with the forger should bear the loss because the payment on a forged instrument is not an "acceptance" but is an exercise of dominion and control over the instrument inconsistent with the rights of the owner." See KAN. STAT. ANN. § 84-3-419(1)(c), comment 3 (1983).

This exception, which is often referred to as the "fictitious payee rule" in subsection (b) cases or the "padded payroll case" under subsection (c) cases, applies to this case. The exception "is not whether the named payee is "fictitious," but whether the signer intends that he shall have no interest in the instrument." KAN. STAT. ANN. § 84-3-405, comment 3 (1983). Once intent is proven, Section 3-405(1) "treats anyone's indorsement in the name of the payee as effective to pass title to the instrument, leaving the drawer liable on the instrument despite the forged indorsement." Western Casualty & Surety Co. v. Citizens Bank, 676 F.2d 1344, 1345 (10th Cir. 1982).

The question raised in this summary judgment motion is whether Brad Russell's forged indorsements are effective because Leonard Russell intended that the named payees on the eight checks that Leonard issued would not have any interest in the checks and because Leonard Russell caused Mike Russell to issue two checks payable to Walter Johns with the intent that Mr. Johns would not have any interest in the checks. Leonard Russell died in 1990, and therefore, there is no direct testimony from Leonard as to what his intent was.

2. Conclusions and Discussion

The only reasonable inference from the undisputed facts recited above is that Leonard Russell did not intend for the payees to have an interest in the checks. Leonard Russell is dead. His intent must be inferred from the circumstances.

The circumstances in this case show the following. Leonard issued checks payable to Mr. Johns, Mr. Blumer and Mr. Wullschleger, and he instructed Mike Russell to issue checks payable to Mr. Johns. None of the payees had any knowledge about the checks, nor did the payees have any reason to believe that the Russells would issue such a check. Mr. Wullschleger did not engage in any business transactions with the Russells or Western Iowa at the time the checks were issued to cause Leonard to issue a check to him. Mr. Blumer had never engaged in any business transaction

with the Russells or with Western Iowa. Mr. Johns engaged in several livestock transactions with Mike and Leonard during the period of time that the checks were issued, but he accounted for all such transactions and was paid in full by the Russells with checks different from those at issue in this case.

The logical inference from the facts is that only an intent to deny the payees any interest in the checks could cause Leonard Russell to direct Brad Russell to forge the payee's signatures and to deposit the proceeds into the Russell accounts.

Western Iowa has not submitted any evidence to counter the evidence of First Savings that shows that Leonard intended to deny Mr. Wullschleger any interest in the checks. Western Iowa's defense is that certain statements by Brad and Mike, which concern their impression of their Dad's intent, are hearsay, and since that evidence is arguably not admissible, there is no factual basis for determining Leonard's intent. However, the finding above that Leonard Russell intended that the payees would not have any interest in the check was made without considering the statements made by Brad and Mike concerning their father's intent. The objectionable testimony is not necessary to reach a conclusion in this motion for summary judgment.

Once the moving party, First Savings, has shown that no genuine issue of material fact exists, the burden is on Western Iowa to present evidence on the issue of Leonard's intent concerning denying the payees any interest in the checks. Western Iowa has not come forward with any such evidence, and in this situation, the Court finds that there are no reasonable inferences from the testimony that would support Western Iowa's position.

The payees, Mr. Wullschleger, Mr. Johns, and Mr. Blumer, are all disinterested parties to this lawsuit. There is no reason to question the veracity of their testimony. Brad and Mike Russell are interested parties, but their testimony is also credible because the testimony is to a certain extent an admission against their own interests. For example, Brad's testimony concerning the forged indorsements subjects him to civil, and perhaps criminal, liability. Therefore, there are no genuine issues of material fact in this case.

Under Section 3-405 of the Kansas Uniform Commercial Code, Brad's indorsements in the names of the payees are effective as to the checks signed by Leonard because Leonard did not intend for the payees to have any interest in the checks. KAN. STAT. ANN. § 84-3-405(1)(b) (1983). Brad's forged indorsements on the two checks signed by Mike are also effective because Leonard provided Mike, an authorized agent of Western Iowa, with the names of the payees, but Leonard did not intend for the payees to receive any interest in the checks. KAN. STAT. ANN. § 84-3-405(1)(b) (1983).

D. Negligence Standard

Even though this action appears to fall under Section 3-405(b) and (c), Western Iowa alleges that First Savings is not entitled to summary judgment under Section 3-405 because it failed to use ordinary care when it accepted the forged instruments. This allegation raises the legal issue of whether Section 3-405 of the Kansas Uniform Commercial Code requires a depository bank, like First Savings, to adhere to reasonable commercial standards before being entitled to the protection of Section 3-405.

The language of pre-revision Section 3-405 of the Kansas Uniform Commercial Code does not explicitly require that First Savings use ordinary care before asserting the protection of the statute. See KAN. STAT. ANN. § 84-3-405 (1983). However, the Kansas Uniform Commercial Code imposes a general obligation of good faith on parties to contracts governed by the terms of the Code. KAN. STAT. ANN. § 84-1-203 (1983). This obligation extends to pre-revision Articles 3 and 4 and negotiable instruments. Western Casualty & Surety Co. v. Citizens Bank, 676 F.2d 1344, 1347 (10th Cir. 1982). Under Section 1-203 of the Uniform Commercial Code, the definition of "good faith" that was applicable to pre-revision Articles 3 and 4 was defined subjectively as "honesty in fact," and did not include the objective "ordinary care" or "reasonable commercial standard" definitions. See KAN. STAT. ANN. § 84-1-201(19) (1983) ("Good faith" means honesty in fact in the conduct or transaction concerned.)).

While "honesty in fact" is the general rule, there are provisions in pre-revision Articles 3 and 4 which expressly impose an objective standard of care for banks. See, e.g., KAN. STAT. ANN. § 84-3-306 (1983) (stating that a party contributing to the material alteration of an instrument is precluded from asserting the alteration against the drawee or payor who acted within the reasonable commercial standards of the business); KAN. STAT. ANN. § 84-4-406 (1983) (stating that a bank customer who fails to timely examine a bank statement for unauthorized usage of the customer's account may still recover against the payor bank if the customer shows that the bank failed to use ordinary care in handling the item).

The duty of a depository bank to adhere to reasonable commercial standards extends as well to actions in conversion. Section 3-419(3) states:

Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depository or collecting bank, 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 its

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.

KAN. STAT. ANN. § 84-3-419(3) (1983).

There is a split of authority as to whether Section 3-405, which does not expressly require that a depository bank follow reasonable commercial standards, is nevertheless subject to an objective standard of due care. The Tenth Circuit discussed this issue when it considered New Mexico's version of Section 3-405 of the Uniform Commercial Code, which was identical to the Kansas provision, in Western Casualty. The court noted:

Section 3-405 has been referred to as a "first cousin" to § 3-406 and § 4-406, "under which, if both parties are negligent, the bank bears the loss." J. White & R. Summers, *Handbook of the Law under the Uniform Commercial Code* § 16-8, at 638 (2d ed. 1980). In light of similarities among these sections, White & Summers argue that under § 3-405, "even the negligent customer should be permitted to prove the payor-bank's negligence and, having so proven it, should be able to assert the forged indorsement." *Id.* at 638-39. However, as one court noted, the "conspicuous ... absence" in § 3-405 of a requirement that the bank exercise ordinary care just as easily leads to the conclusion that the drafters of the Code purposely intended that under the circumstances outlined in § 3-405 the drawer would be liable without regard to the bank's negligence. *Prudential Insurance Co. v. Marine National Exchange Bank*, 371 F. Supp. 1002, 1003 (E.D. Wis. 1974).

Western Casualty, 676 F.2d at 1347.

The Kansas Supreme Court has not directly ruled on this issue. However, it did discuss the issue of ordinary care in a forged indorsement case in Cairo Coop. Exchange v. First Nat'l Bank of Cunningham, 620 P.2d 805 (1980), modified on other grounds, 624 P.2d 420 (Kan. 1981). In Cairo, an employee of a farm cooperative, who was authorized to sign checks on behalf of the cooperative, caused checks to be issued to various customers, but instead of delivering the checks, the employee forged the payees' indorsements and stamped the cooperative's restrictive indorsement on the back of the checks. 620 P.2d at 806. The restrictive indorsement stated, "Pay to the order of First National Bank, Cunningham, Kansas. For Deposit Only, Cairo Co-op Equity Exchange, Farmer's

Co-op." Id. at 806-07. The checks were presented to First National Bank by the employee for cash, and the bank paid cash to the employee, who subsequently disappeared. Id. at 807.

The cooperative sued the bank for conversion pursuant to Section 3-419, and negligence and failure to exercise good faith and ordinary care pursuant to Section 4-103 of the Kansas Uniform Commercial Code. Cairo, 620 P.2d at 807. The Kansas Supreme Court ultimately held the bank liable to the cooperative for conversion and for breach of contract for honoring a check in violation of a restrictive indorsement. Id. at 805.

In reaching this decision the Court favorably cited to a case that is identical to the facts before this Court. The Court discussed the case as follows:

In *Underpinning v. Chase*, 46 N.Y.2d 459, 414 N.Y.S.2d 298, 386 N.E.2d 1319 (1979), employee Walker embezzled money from the company by writing checks to payees, obtaining the company signatures, and forging a restrictive indorsement thereon. Several depository banks accepted the checks and deposited the proceeds to Walker's account in violation of the restrictive indorsement. Underpinning sued the depository banks. The court held where the forgery is effective, the drawer could have several causes of action against the drawee including conversion of proceeds of the check; liability for money had and received; or conversion of the instrument itself. The court stated:

"In summary, we hold today that a drawer may directly sue a depository bank which has honored a check in violation of a forged restrictive indorsement in situations in which the forgery is effective. This result is not only theoretically viable, but is in accord with principles of equity and sound public policy. It is basic to the law of commercial paper that as between innocent parties any loss should ultimately be placed on the party which could most easily have prevented that loss. Hence, in most forged indorsement cases, the party who first took the check from the forger will ultimately be liable, assuming of course that there is no

solvent forger available. This is so because it is the party who takes from the forger who is in the best position to verify the indorsement....

...The presence of a restriction imposes upon the depository bank an obligation not to accept that item other than in accord with the restriction. By disregarding the restriction, it not only subjects itself to liability for any losses resulting from its actions, but it also passes up what may well be the best opportunity to prevent the fraud. The presentation of a check in violation of a restrictive indorsement for deposit in the account of someone other than the restrictive indorser is an obvious warning sign, and the depository bank is required to investigate the situation rather than blindly accept the check. Based on such a failure to follow the mandates of due care and commercially reasonable behavior, it is appropriate to shift ultimate liability from the drawer to the depository bank."

Underpinning at 468-469.

Cairo, 620 P.2d at 808-09. Based upon the favorable citation to Underpinning, it appears that the Kansas Supreme Court takes the position that even though the indorsement may be effective under Section 3-405, a bank is not entitled to the protection of Section 3-405, at least in a restrictive indorsement situation, if the bank did not act in a commercially reasonable manner. Accord Travelers Indemnity Co. v. Center Bank, 202 Neb. 294, 275 N.W.2d 73 (Neb. 1979); Wymore State Bank v. Johnson Intern Co., 873 F.2d 1082 (8th Cir. 1989); but see Western Casualty & Surety Co. v. Citizens Bank, 676 F.2d 1344 (10th Cir. 1982).

In this case, all ten checks deposited by Brad Russell contained the words "For Deposit Only." Under Kansas law, a restrictive indorsement includes an indorsement which "(c) includes the words ... 'for deposit,' ... or like terms signifying a purpose of deposit or collection." KAN. STAT. ANN. § 84-3-205(c) (1983). Even though all ten checks were deposited, the checks violated the restrictive indorsement because the deposit numbers on the checks matched accounts controlled by the Russells, while the indorsements were in the names of the payees. Therefore, this case

is a restrictive indorsement case and is subject to the Kansas Supreme Court's analysis of Underpinning.

Section 84-3-206(3) of the Kansas Uniform Commercial Code requires that a bank must pay or apply the value of the item consistent with the restrictive indorsement to become a holder for value or a holder in due course under the Code. KAN. STAT. ANN. § 84-3-206(3) (1983). These two sections on restrictive indorsements and Section 3-419(3) require that First Savings must be found to have followed reasonable commercial standards before finding that the effectiveness of the signatures exempts First Savings from an action for conversion of the instrument.

The depositions of James Wild, Vice-President of First Savings, and Margieanne Bosse, the branch manager of First Savings' branch where the checks were deposited, support the conclusion that a material fact question exists as to whether First Savings acted in a commercially reasonable manner. Margieanne Bosse stated that the indorsements were not in proper form as to be acceptable by First Savings because the bank policies, according to a manual, in effect at First Savings during 1989-90 required that checks be indorsed by account holders or stamped. Deposition of Margieanne Bosse, p. 9. The checks deposited by Brad Russell were neither indorsed by the account holders (the Russells) nor stamped.

James Wild stated that with commercial accounts, First Savings does not check all deposits because the volume of items received is too large. Deposition of James Wild, p. 14. However, he noted that in this instance, First Savings relies on the customer to guarantee that the check was presented in good faith and that all signatures are genuine. Id. at 14-15. Mr. Wild also stated that it was the practice of First Savings not to require a customer's indorsement on an item that the customer seeks to deposit into his own account, even if the check is payable to another payee. Id. at 16-17. It appears that his testimony conflicts with the testimony of Ms. Bosse concerning whether the account holder has to indorse checks which are payable to one other than the customer depositor.

In Underpinning, the bank was found to be acting unreasonably when it accepted checks for deposit into an account that was other than the account of the named payee.

There is a material issue of fact as to whether First Savings acted in a commercially reasonable manner when it accepted the ten checks for deposit. Under Kansas law, an effective indorsement does not protect a bank from liability when the bank does not follow reasonable commercial standards by accepting a check for deposit that violates a restrictive indorsement. First Savings' Motion for Summary Judgment is denied.

A separate journal entry shall be filed.

DATED: October 4, 1994

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

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Richard Seaton, Attorney
United States Trustee

Movant (*) is responsible for giving notice of this journal entry to all other parties (that are not listed above) if required by rule or statute.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)
)
WESTERN IOWA FARMS CO.,) CASE NO. BK91-82008
) A93-8025

DEBTOR(S))
)
WESTERN IOWA FARMS CO.,) CH. 11
) Filing No. 64, 67; 74, 78
Plaintiff(s))
vs.) JOURNAL ENTRY
)
FIRST SAVINGS BANK, MANHATTAN)
KANSAS and NORWEST BANK)
ANACONDA-BUTTE, N.A.,)

Defendant(s)) DATE: October 4, 1994
HEARING DATE: July 28,
1994

Before a United States Bankruptcy Judge for the District of Nebraska regarding Motion for Summary Judgment filed by Norwest Bank Anaconda-Butte, N.A., and Motion for Summary Judgment filed by First Savings Bank F.S.B., Manhattan, Kansas, and resistances by plaintiff.

APPEARANCES

Victor Lich, Attorney for plaintiff
Frederick Stehlik, Attorney for First Savings Bank
Richard Seaton, Attorney for First Savings Bank
Thomas Flaherty, Attorney for Norwest Bank

IT IS ORDERED:

Motion for summary judgment filed by First Savings is denied.
See memorandum of this date.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Copies faxed by the Court to:

LICH JR, VICTOR 397-1254
STEHLIK, FREDERICK 493-7005
FLAHERTY, THOMAS 341-8290

Copies mailed by the Court to:

Richard Seaton, Attorney
United States Trustee

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