

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, MANHATTAN,)	
KANSAS,)	
)	
Defendant)	

MEMORANDUM

Hearing was held on the adversary complaint. Appearances: Victor Lich, Jr., for plaintiff; Frederick Stehlik, Christopher Curzon and Richard Seaton for defendant. 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(b)(2), but is otherwise related to a case under title 11. Pursuant to 28 U.S.C. § 157(c)(2), the parties have consented to this bankruptcy judge hearing, determining and entering appropriate orders and judgment, subject to review under 28 U.S.C. § 158.

Facts

The plaintiff, Western Iowa Farms Co. (Western Iowa), a Nebraska corporation, operated a business that financed cattle purchases by others. During 1989 and part of 1990, the plaintiff maintained a business account at Norwest Bank Anaconda-Butte, N.A. (Norwest). Western Iowa 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 with the checks drawn on Western Iowa's account at Norwest.

Although the Russells signed many checks for the purchase of cattle, ten checks are the focus of the problem in this case. 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 named payees received, indorsed, 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 Brothers account number or the Onaga Livestock account number on the back of each check. Both Russell Brothers and Onaga Livestock were businesses operated by Brad and Mike Russell.

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 and used the proceeds for their own business.

First Savings previously filed a motion for summary judgment and, by memorandum and journal entry filed on or about October 4, 1994, this court denied the motion and made the following finding:

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.

Western Iowa Farms Co. v. First Sav. Bank (In re Western Iowa Farms Co.), Neb. Bkr. 94:576, 589 (Bankr. D. Neb. Oct. 4, 1994) [hereinafter this case shall be referred to as First Sav. Bank Summary Judgment].

In that memorandum and journal entry, this court found that the form of the indorsement on each check in question, which included the forged signature of the named payee, the words "for deposit only" and the account number for the First Savings customer, one of the Russell entities, was, by definition, a "restrictive indorsement." The factual issues left for trial were whether the bank, by accepting the checks for deposit into the Russell controlled account, violated the restrictive indorsement and/or whether the actions of First Savings when accepting such checks for deposit into the Russell controlled account were commercially reasonable.

First Savings, at the time of the deposit of the checks in question, did not have a specific written "in-house" policy with regard to depositing checks into a commercial account. Instead, it trained its employees, particularly its tellers, to follow Federal Reserve Bank policies and Uniform Commercial Code standards. Generally, those policies and standards required the teller, when accepting a commercial deposit, to make certain that there was some type of an indorsement on the check, and that

there was a reference, by name or account number, to a customer depository account. The purpose for making certain that there was some type of reference to the customer account was so that if the deposited checks were returned, for forgery or otherwise, they could be traced back to that particular customer account and that customer could be charged for the amount of the returned check. The policy of First Savings was to know its customer and depend upon its customer for making good any returned checks.

Brad Russell was the person in the Russell organization that made all of the deposits. A bank officer testified that she was in charge of the tellers at the branch where all of these deposits were made and that she knew Brad Russell by sight and that he appeared in the bank to make deposits and transact other business several times each week. She was also aware that several hundred thousand dollars per week or month passed into and out of the Russell controlled accounts. She had no knowledge of the type of business that Brad Russell was in, and did not express any opinion as to whether the account status of the Russell controlled accounts was such that if a check was returned the customer would be able to cover the returned check by a chargeback.

The checks were handled by First Savings according to the general policy and were deposited into the account number listed on the restrictive indorsement.

Expert testimony was presented by both parties on the issue of the commercial reasonableness of the actions taken by First Savings concerning the checks in question.

On the ultimate issue, the court finds as a fact that First Savings, by following the restrictive indorsement and depositing the checks into the account number listed on the restrictive indorsement, did not violate the restrictive indorsement and did act in a commercially reasonable manner. First Savings is not liable to Western Iowa for the face amount of the checks or any other amount.

Law

In this adversary proceeding, there were originally two defendants. Western Iowa sued its bank, Norwest, as well as First Savings. Norwest filed a motion for summary judgment which was granted. Western Iowa Farms Co. v. First Sav. Bank (In re Western Iowa Farms Co.), Neb. Bkr. 94:568 (Bankr. D. Neb. Oct. 4, 1994) [hereinafter this case shall be referred to as Norwest Summary Judgment]. This court found that Norwest as the drawee bank properly paid to First Savings the face amount of the checks

from the account of Western Iowa. Under the Montana version of the Uniform Commercial Code, Section 3-405(1)(b) and (c), Norwest is excused from liability to Western Iowa for paying on forged indorsements because the indorsements were "effective" as that term is used in the Uniform Commercial Code. That section provides:

(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.

MONT. CODE ANN. § 30-3-405(1)(b) and (c) (1990).

This exception to liability on the part of the drawee bank, "[i]n certain factual situations, [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).

For purposes of the summary judgment motion filed by Norwest, this court found that Brad Russell's forged indorsements were 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. Norwest Summary Judgment, Neb. Bkr. 94:568, at 574.

The Montana version of the Uniform Commercial Code was the applicable law for determining the rights of Norwest and of Western Iowa because Norwest was situated in Montana. With regard to the rights of First Savings vis-a-vis Western Iowa, the parties have agreed 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. Section 84-4-102(2) (1983) ("The liability of a bank for action or non-action 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.") The indorsements were effective under the Kansas

version of the Uniform Commercial Code, as well as under the Montana version. First Sav. Bank Summary Judgment, Neb. Bkr. 94:576, at 584.

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 depositing the amount of checks into accounts controlled by the Russells. 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).

This court has already held in a previous order, which denied First Savings' motion to dismiss this adversary proceeding, that Western Iowa has a cause of action against First Savings for conversion because First Savings paid the Russells on a forged indorsement. Western Iowa Farms Co. v. First Savings Bank (In re Western Iowa Farms Co.), Neb. Bkr. 93:424 (Bankr. D. Neb. Aug. 2, 1993). Thereafter, this trial was scheduled to permit the parties to present evidence concerning the exception to liability relied upon by First Savings.

First Savings takes the position that it is exempted from the general rule that it, as a depository bank, is liable for conversion if it pays on a forged instrument, because the indorsements in this particular case have been found by this court to be effective pursuant to Section 3-405(1)(b) and (c), both under the Montana and Kansas Uniform Commercial Code. The Uniform Commercial Code generally excepts a depository bank from liability for conversion if it has acted in good faith and in accordance with reasonable commercial standards when dealing with restrictive indorsements. The specific language of the Uniform Commercial Code, at Section 3-419(3) is:

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).

In denying the motion for summary judgment filed by First Savings, this court found that the Kansas Supreme Court impliedly had applied the duty of ordinary care and conformance with commercially reasonable standards in a forged instrument case brought under Section 3-405. 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, the court relied upon a New York Court of Appeals decision, Underpinning v. Chase, 46 N.Y.2d 459, 414 N.Y.S.2d 298, 386 N.E.2d 1319 (N.Y. 1979). In Underpinning, an employee embezzled money from the company by writing checks to payees and forging a restrictive indorsement. 46 N.Y.2d at 462-63. The restriction required deposit into a third-party account. Id. Several depository banks accepted the checks and deposited the proceeds to the employee's account in violation of the restrictive indorsement. Id. Underpinning sued the depository banks. Id.

The New York court held, among other things:

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 fraud.

Id. at 469. The court further stated: "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." Id. Because the court found that such action on the part of the depository bank was actually a failure to follow the mandates of due care and commercially reasonable behavior, it shifted the ultimate liability from the drawer to the depository bank. Id.

The Underpinning decision was fact specific. The New York court found that depositing checks to the employee's account was contrary to the instructions given to the bank by the restrictive indorsement language. Such actions on behalf of a depository

bank were found, as a matter of fact, to be commercially unreasonable and done with a lack of due care.

Based upon the Kansas Supreme Court's reliance upon Underpinning, the motion for summary judgment filed by First Savings was denied and trial was scheduled on the issue of whether or not the actions by First Savings in accepting for deposit checks with restrictive indorsements which included forged payee signatures, the terminology "for deposit only" and the handwritten account number for one of the Russell's accounts, was actually a failure to follow the mandates of due care and commercially reasonable behavior. First Savings Summary Judgment, Neb. Bkr. 94:576, at 589. Since the Cairo decision of 1980, the same New York court that decided Underpinning has decided Spielman v. Manufacturers Hanover Trust Co., 60 N.Y.2d 221, 469 N.Y.S.2d 69, 456 N.E.2d 1192 (N.Y. 1983), which, factually, is exactly the same as the case now before this court.

In Spielman, the New York Court of Appeals held that the depository bank, in accepting a check bearing the same form of indorsement as found in this case, had followed the directions in the indorsement and properly deposited the check to the account of its own customer, as shown by the account number which was part of the restrictive indorsement. 60 N.Y.2d at 227. The indorsement in Spielman was exactly the same as the indorsement on each of the checks in this case. That is, the payee's signature was forged; underneath that forged signature were the words "for deposit only"; and below those words was the account number of the depository bank's customer. 60 N.Y.2d at 225. The court acknowledged its decision in Underpinning, but distinguished it by stating:

As to the depository, we held in Underpinning that notwithstanding the general rule, the drawer may recover from it in those "comparatively rare instances" when the depository has acted wrongfully and yet the drawee has acted properly in honoring the check because the forgery is effective.

Spielman, 60 N.Y.2d at 225. The court went on to say: "The wrong in Underpinning was the payment by the depository in disregard of the restrictive indorsement." Id.

In Underpinning, the restrictive indorsement contained the account number of the payee, but the depository banks either gave cash to the depositing employee or deposited the proceeds of the checks into the employee's account at the bank. Spielman, 60 N.Y. 2d at 225-26. In contrast, in Spielman, the check in question was deposited to the credit of the depository's

customer, the owner of the account which was specifically stated in the indorsement. Id. at 226. The New York court found that a restrictive indorsement requires the taker to apply the proceeds of the instrument in a manner consistent with the indorser's directions, which means that the depository bank was to credit the proceeds by depositing them into the account identified on the back of the check. Id. at 227. The New York Court of Appeals concluded that the depository bank was not liable for conversion:

It is the direction to deposit to the account of the customer and the bank's action in honoring that direction which distinguishes the case from the facts in Underpinning and establishes that the bank's action accorded with reasonable business practice for there are many instances in which ... a business may indorse for deposit funds to the credit of another and a depository is not on notice of chicanery because of it nor is it liable if it faithfully follows such a direction.

Id. at 228.

The Kansas Supreme Court followed the decision of the New York Court of Appeals in Underpinning and determined that if a depository bank did not act in a commercially reasonable manner, it could be liable in conversion to the drawer for paying on an effective forged indorsement. The facts in the Kansas case and the facts in the New York Underpinning case quite easily led those courts to find that the depository banks had acted in a commercially unreasonable manner and without due care. The facts in this case, however, are quite different from Cairo and Underpinning and are exactly the same as the facts in Spielman. In Spielman, the same New York Court of Appeals that decided Underpinning determined that a depository bank which paid pursuant to a restrictive indorsement could not be held liable in conversion.

First Savings deposited the checks in conformance with the restrictive indorsement. Western Iowa has shown no reason why the Kansas Supreme Court would interpret the Kansas Uniform Commercial Code in a manner different from that which the New York Court of Appeals used in Spielman. Therefore, as explained in the facts section of this memorandum, First Savings, a depository bank, which handled the checks in question in conformance with the restrictive indorsements thereon, has not acted in a commercially unreasonable manner and cannot be held liable to Western Iowa for its actions.

Separate judgment entry shall be filed.

DATED: February 16, 1996

BY THE COURT:

Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Copies faxed by the Court to:

LICH JR, VICTOR

397-1254

CURZON, CHRISTOPHER\STEHLIK, FREDERICK

493-7005

Copies mailed by the Court to:

Richard Seaton, P.O. Box 816, Manhattan, KS 66502

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

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WESTERN IOWA FARMS CO.,)	
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FIRST SAVINGS BANK, MANHATTAN,)	
KANSAS,)	
Defendant)	

JUDGMENT

Defendant, First Savings Bank, Manhattan, Kansas, is not liable to plaintiff, Western Iowa Farms Co., and judgment is entered in favor of defendant and against plaintiff. See memorandum entered this date.

DATED: February 16, 1996

BY THE COURT:

Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

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