*The risk of the forgery of signatures and the problem of the conflicting entitlements in the law of negotiable instruments: a comparative study*

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# THE RISK OF THE FORGERY OF SIGNATURES AND THE PROBLEM OF CONFLICTING ENTITLEMENTS IN THE LAW OF NEGOTIABLE INSTRUMENTS - A COMPARATIVE STUDY

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# CHAPTER FIVE

## RISK ALLOCATION IN THE FORGERY OF NEGOTIABLE INSTRUMENTS.

### INTRODUCTION

(i) It will be recalled from the previous chapter,[1] that the parties involved in litigation over forgery of negotiable instruments may vary according to the particular setting. In instances of dishonour, the competing parties are two in number, namely, the purported maker or drawer, the party whose signature was forged; and the bona fide acquirer, the party into whose possession the forged instrument may bona fide come. In instances of payment, the competing parties are, by comparison, three in number, namely, the purported maker or drawer, the bona fide acquirer and the drawee acceptor/payor. The fraudulent person may, however, be a party to the negotiable instrument transaction. Nevertheless, the enforcement of the instrument against him might not be possible either due to his insolvency or non-availability.

(ii) Since the forgery of negotiable instruments involves the theft of a blank instrument, such as a cheque slip, the fraudulent use of someone's name as maker or drawer, the fraudulent cashing of the instrument with a bona fide third party and the possibility that it shall be erroneously paid by the drawee, its occurrence gives rise to a competing interest situation.[2] The interest of the purported maker or drawer to have himself unaccountable

for the contractual promise fraudulently attributed to him, the interest of the acquirer to establish a property right to the instrument in his favour and, ultimately, his interest to enforce the contractual promises incorporated in it or his interest to retain the proceeds of payments made to him and finally, the interest of the drawee to charge erroneous payments to the purported maker or drawer or, alternatively, his interest to recover erroneous payments from the acquirer/recipient, cannot be reconciled.[3]

Since the interests arising from the forgery of instruments are irreconcilable, the law should determine the party to whom the risk evolving from the forgery of instruments should be allocated. Since, as has been established above,[4] the utilisation of economic analysis in determining the party to whom risk should be allocated could achieve a rational solution, the risk evolving from the forgery of negotiable instruments should be allocated to the party best able to provide against it. Finally, as has been mentioned above,[5] the theory of value maximisation with reference to the cost and benefit analysis is presumed to be the most convenient approach in determining the party in the best position to provide against the occurrence of negotiable instrument fraud. The party who is in the best position to provide against the occurrence of negotiable instrument fraud, as has been suggested,[6] is the party who is in the position to derive an enforceable value from the cost and time involved in

the provision against the said risk or the party who is in the position to absorb the said time and cost.

The Status of the Competing Parties in Providing Against the Risk of Forged Instruments.

(i) Each of the above competing parties is in the position to avoid the occurrence of fraud arising from the forgery of negotiable instruments. The purported maker or drawer can avoid the occurrence of the fraud of the forgery of negotiable instruments by exercising every care as to the safe custody of his blank instruments such as cheque books. To this effect he should, firstly, employ every measure, the purpose of which is to prevent the loss of his cheque book or any of its cheque slips. An example of such measures is the installation of a coded safe box together with a burglar alarm. Secondly, the purported maker drawer should employ a periodic checking system as to the existence of the cheque book and the regularity of its contents. Finally, he should employ regular contact with his bank as to the status of his account and report any unauthorised advices or mandates purporting to be made in his name, or on his behalf.

(ii) The bona fide acquirer can avoid the risk arising from the forgery of negotiable instruments by exercising every care as to the identity of the party from whom he establishes his title to the negotiable instrument. He should, firstly, restrict his acquisition of negotiable instruments with third parties, the reliability of whom

he is not familiar with. He should not engage in the acquisition of negotiable instruments from strangers. Secondly, should the engagement with strangers be indispensable the bona fide acquirer should safeguard his interest. He should either defer the performance of his obligation towards the party from whom he intends to acquire the instrument until its final payment, or he should shop for information concerning the genuineness of the offered instrument, the identity of the party in question and the genuineness of his title. To this effect he may have, either directly or through an agent, to contact the drawee in order to verify the instrument in question and its regularity, or he may have, for the same purpose, to contact the purported drawer, i.e. the party whose name was fraudulently used to facilitate the fraud.

(iii) Finally, the drawee payor can avoid the occurrence of the fraud arising from the forgery of negotiable instruments by the exercise of every care in providing against its occurrence, and by the exercise of every care in providing for its detection, should it occur. The drawee can provide against the occurrence of the fraudulent practice of forging negotiable instruments by employing an identification scheme the introduction of which could render the forgery impossible or more onerous.

Examples of such a scheme are the printing of the customer's picture on every cheque slip or, alternatively, the drawee may stipulate that he shall not honour the presented instrument unless the acquirer compares the

identity of the purported maker or drawer with the identification card issued by the drawee to the latter. By printing the customer's picture on the identification card or cheque slips, the fraudulent person would not be able to forge the intercepted instrument. Due to the dissimilarity between the forger and the customer, third parties would not normally accept to exchange the offered instrument. However, the device of printing the picture of the customer on the negotiable instrument or on identification cards does not always prevent the fraudulent practice from materialising. In instances where the fraudulent person is identical to the customer, the forgery may escape detection either by the drawee or the third party acquirer.[7]

A more effective identification scheme, the introduction of which could provide against the occurrence of the forgery of instruments, is the utilisation of finger prints. Every individual has his own distinct finger print. Thus, if the drawee stipulates that for a negotiable instrument to be duly made, it must incorporate in addition to the customer's signature, his finger print, fraudulent persons might be deterred from practising their fraud.[8] The fixing of his finger print as that of the maker or drawer would firstly, be detectable by the drawee, accordingly he would not reap the fruits of his fraudulent practice and secondly, it would identify him accurately. Accordingly, the bringing about of his punishment would be facilitated.

The drawee can, by comparison, provide for the

detection of the forgery of instruments by employing a measure the purpose of which is to compare between identifications kept on file and those appearing on the negotiable instrument. He should, firstly, keep on file a facsimile of his customer's identification. Secondly, he should employ persons possessing the qualifications to compare between genuine and forged identifications. Finally, he should update his technology so as to detect the sophisticated forgery. An example of such measure would be the installation of a finger print reading machine.

## The Compatibility of the Competing Parties' Duty to Exercise a High Standard of Care with Economic Efficiency

### The Exercise of Care as to the Safe Custody of Blank Instruments

(i) The exercise of a high standard of care as to the custody of cheque books is firstly, costly; and secondly, time consuming. The involvement of cost in the custody of cheque books is illustrated by the installation of sophisticated measures such as coded safe boxes, together with a burglar alarm. The involvement of time in the custody of cheque books is, however, illustrated by the provision of periodic checking as to the existence of the cheque book and the regularity of its contents, as well as the establishment of a regular contact with the drawee, so as to inform the latter of any irregularity in respect of

advices and mandates purporting to be made in the name of the customer.

(ii) For the involvement of cost and time to be economically efficient it should be value-maximising. Cost and time are value-maximising if their involvement generates utility. For a utility to be of an enforceable value, the cost and time from which it evolves should be allocated to safeguard someone's interest to a given entitlement i.e. property.

(iii). Blank instruments such as cheque slips and cheque books do not possess enforceable value. The value of negotiable instruments is incorporated in their currency. Negotiable instruments gain currency when and only when they are signed. In the absence of a valid signature, the blank instrument would operate as a piece of paper, qua piece of paper. It operates as a worthless piece of paper in the hands of its acquirer. The instrument in its status as such does not incorporate a valid contractual promise or undertaking to pay on its day of maturity the sum of money for which it is drawn. Accordingly it does not establish in favour of the party into whose possession it may bona fide come, a contractual liability on the basis of which he can enforce its incorporated credit.

(iv) Since blank instruments such as cheque slips and cheque books are worthless pieces of paper, their possessor should not be under a duty to exercise excessive

care as to their safe custody. The involvement of cost and time arising from the exercise of the said care is economically inefficient. Since they are not directed to establish an interest to a particular entitlement, their involvement would result in a misallocation of resources. By comparison, value would be maximised and ultimately economic efficiency would be satisfied if the possessor of blank cheque slips and cheque books was exonerated from the duty of exercising excessive care. The cost and time which would have been involved in the course of exercising the excessive care would be utilised in a manner compatible with his commercial needs, had the standard of care been lessened.

The Exercise of Care as to the Acquisition of Negotiable Instruments

(i) The exercise of care in the acquisition of negotiable instruments is, in many cases, costly and almost always time consuming. The involvement of cost is illustrated by the incurring of expenses in the course of shopping for information concerning the genuineness of the instrument, the subject matter of the acquisition and the validity of the transferor's title, i.e. the party from whom the acquirer purports to establish his title to the instrument in question.

In order for the acquirer to gather information concerning the status of the negotiable instrument or the status of its possessor, he might need to employ an

independent agent, or if he wishes to involve himself in the gathering of information directly, he would have to establish a reliable means of communication with the parties concerned such as the signatories on the instrument and the drawee.

The employment of an independent agent, as well as the establishment of a reliable means of communication, is costly. The cost involved in the employment of an independent agent is illustrated by the fees payable to him as consideration for the service of gathering information. The cost involved in the establishment of a reliable means of communication is illustrated by the expenses involved in the course of facilitating the said communication. Examples of expenses evolving from the employed means of communication are paper expenses, post and telephone charges, or charges payable to the associated agent, such as the collecting bank.

The consumption of time evolving from the exercise of care as to the acquisition of negotiable instruments is, however, illustrated by its involvement in the shopping for information. The information relating to the status of the offered instrument and that relating to the status of its possessor is not always readily avilable. Its gathering through an independent agent or through the establishment of a reliable means of communication, involves time.

Time in commerce signifies value. Merchants utilise time to engage in commercial transactions, so as to promote their businesses. Each of the transactions in

which they involve is not, in a sense, separate from the other transactions. The value enforceable from the said transaction is utilised to finance other transactions. If the performance of a particular transaction was disturbed, the related transactions would likewise be disturbed. Ultimately, the merchant might have to forego the opportunity to engage in the related transactions. The disturbance of the particular transaction as could be inferred, may damage the financial interest of the commercial community.

(ii) For the involvement of cost and time to be economically efficient, it must be value maximising. Cost and time would be value maximising when their involvement generates an enforceable value. The involvement of cost and time arising from the exercise of care as to the acquisition, i.e. that arising from the information shopping, is not, however, value maximising. The utility derivable from the involvement of cost and time is that it reveals to the third party the true status of the instrument in question and its possessor. In instances where the revealed information indicates that the instrument is genuine and its possessor's title is valid, the third party would be protected in his acquisition. If, by comparison, the revealed information indicates that the instrument is a forgery and the title of its possessor is void, the third party would refrain from its acquisition.

The positive or negative information does not add

much to the third party. If, in instances of positive information, the third party decides to acquire the instrument in question, the cost incurred in the course of shopping for information would be deemed as a misallocation of value. The possessor of a negotiable instrument exchanges his instrument for a value equal to its face value. The third party with whom the possessor intends to exchange the instrument would not be able to charge to the latter the cost incurred in the course of information shopping.[9] And since the third party is in many instances a consumer, he might not be in a position to absorb the said cost. There might not be other parties to whom he may re-allocate it.

In instances of negative information, i.e. where the revealed information indicates that the instrument in question is a forgery and the title of its possessor is void, the cost arising from the shopping for information would be borne by the third party to whom the instrument was offered for a valuable exchange. If in the light of the revealed information, the third party determines not to acquire the instrument in question, he would not be able to charge to the possessor, the party from whom he intended to acquire the instrument, the cost incurred in the course of information shopping. The possessor would either be the forger, his accomplice or a bona fide acquirer. The right of recourse against the forger or his accomplice is normally unavailing, either due to the said party's insolvency or non-availability.

The bona fide acquirer would not normally accept to

bear the cost of information shopping. If the said cost was to be incurred by him, he, due to the non-availability of other genuine parties to whom he may charge the cost of information shopping or due to his consumer capacity, might not be in the position to absorb it or to derive an enforceable value from it. In such an instance, the assumption of cost would result in a misallocation of wealth to him.

The fact that the bona fide acquirer/possessor would not accept to bear the cost of information shopping becomes more apparent where the revealed information deters the third party from acquiring the instrument. In such an instance, the bona fide acquirer would be appropriating value without receiving an enforceable value in consideration had the cost of information shopping been allocated to him. The assumption of cost arising from the information shopping would in the last analysis result in a misallocation of wealth to such a party.

On the other hand, since the third party is in many instances a consumer, he might not be in the position to absorb the cost of information shopping. In his capacity as such, he might not be able to distribute the incurrable cost. There might not be other parties to whom he could re-allocate the said cost. Ultimately, the allocation of the duty to shop for information to the bona fide third party might not achieve an optimum distribution of wealth. Its application could result in a misallocation of wealth to him.

(iii) The involvement of time in the information shopping as to the status of the instrument, the subject matter of acquisition and the status of its possessor, also illustrates a misallocation of wealth. In instances of positive or negative information, the third party would not be able to utilise the involved time in an efficient manner. Due to the uncertainty as to the status of the instrument, the subject matter of acquisition and the status of its possessor, the third party may, during the time consumed in the shopping for information, have to forego the opportunity to engage in other transactions, the finance of which is dependent on the value allocated as consideration for the offered instrument, or the value enforceable from the acquisition of the said instrument.

To illustrate, assume that Billy Barnes runs a small construction firm. He contracts with Willy Williams to renovate the latter's dwelling house. The contract stipulates that the cost of the renovation shall be payable on an instalment basis. Every instalment shall be due after the completion of part of the work.

Assume further, that due to the limited financial resources of the construction firm, Billy Barnes utilises the due payments to purchase construction necessaries. Assume finally, that Willy Williams offers Billy Barnes as discharge for the due instalments, cheques purporting to be drawn by John Alex in favour of Willy Williams. The face value of the offered cheques purports to be the payable wages plus accumulated profits due to Willy Williams as manager and co-partner of a joint enterprise

engaged in the car retail business.

If Billy Barnes was under a duty to shop for information concerning the status of the offered cheques and the status of their possessor, i.e. Willy Williams, he would either have to suspend the construction work or defer the cashing of the cheques until the relevant information is gathered. If Billy Barnes was to suspend his work whilst the relevant information is gathered, he would be foregoing the opportunity of being involved in other construction contracts where he would be able to utilise his business in making profit. If Billy Barnes was to defer the cashing of the cheques until the relevant information is gathered, he might have to forego the opportunity to utilise the proceeds of the cheques in purchasing construction necessaries.

To state the obvious, and as it could be inferred from the foregoing, the uncertainty arising from the involvement of time in the information shopping, could damage the financial interest of the third party to whom the instrument is offered for a valuable exchange. This is illustrated by the probability that the evolving uncertainty would cause the third party to forgo the opportunity to utilise the allocated or the due enforceable value in other transactions.

(iv) It could be argued that the bona fide third party to whom the instrument was offered for a valuable exchange, may avoid the inconvenience arising from the involvement of cost and time by refraining from acquiring

negotiable instruments from strangers or by deferring the performance of his obligation until the collection of the instruments' proceeds is completed. In reply, it could be stated that the application of either option is incompatible with the nature of negotiable instruments, as well as the objective of promoting the said institution. Negotiable instruments are intended to serve as a substitute for money. In order to facilitate their function as such, they should be capable of being liquidated into money immediately. And in order to promote their utility, they must firstly, be freely marketable and secondly, the public must be protected in its acquisition. To state the obvious and as it will be shown later,[10] the above mentioned options would restrict the acquisition of negotiable instruments and secondly, they would prevent the said institution from fulfilling its economic function, i.e. as a substitute for money.

## The Exercise of Care in the Provision Against the Occurrence of the Forgery of Negotiable Instruments and the Exercise of Care in the Provision for its Detection

(i) The exercise of care in the provision against the occurrence of the forgery of negotiable instruments and the exercise of care in the provision for its detection involve cost. The cost arising from the provision against the occurrence of the forgery is illustrated by the printing of the customer's picture on every blank instrument such as cheque slips or alternatively, by the

issuance of identification cards bearing the picture of the customer. The cost involved in the provision of measures capable of detecting forgery is, by comparison, illustrated in the recruitment of experts or the installation of updated technology the purpose of which is to compare accurately the signature appearing on the instrument and that kept on file.

(ii) Unlike the cost arising from the exercise of a high standard of care as to the safe custody of blank instruments and as to the acquisition of negotiable instruments, the involvement of cost arising from the exercise of a high standard of care in the course of providing against the occurrence of fraudulent practice, and that involved in the course of providing for its detection, is economically efficient. On the one hand, the instrument the examination of which is required, possesses an enforceable value. By virtue of the signature incorporated in it, the instrument purports to gain currency. By virtue of its prima facie currency, the instrument purports to confer rights in favour of its possessor/acquirer and it purports to establish an order directing the drawee to pay its face value.

The carrying out of a careful examination would necessarily inform the drawee of the true status of the presented instrument. He, accordingly, would be able to determine the appropriate behaviour. In instances where the revealed information indicates that the instrument is a forgery and the title of its possessor/acquirer is void,

the drawee would be able to dishonour the instrument. He would be able to challenge the possessor's entitlement to the proceeds of the instrument. In instances where the revealed information indicates that the presented instrument is genuine and the title of its possessor is valid, the drawee would be able to pay the former the face value of the instrument. He would be able to charge to the purported maker or drawer any payments bona fide made. He may debit the purported maker's or drawer's account with the face value of the presented instrument. And finally, he would be able to challenge any claims or defences, the purpose of which is to defeat the drawee's act of payment.

On the other hand, the cost involved in the course of exercising a high standard of care in the provision against the forgery of negotiable instruments is compatible with the notion of value maximisation. The employment of measures capable of providing against the occurrence of the forgery and that capable of providing for its detection is, firstly, a routine application of the practice of parties engaged in the business of banking. Secondly, it enhances the business of the party so engaging. The employment of the said measures would increase his reliability. The public would then be encouraged to deposit their credits with him. The employment of the said measures would assure them that their credits shall not be tampered with. Ultimately, they would not be involved in disputes with the drawee concerning their credits. Finally, in his capacity as a

party engaged in the business of banking, the drawee is in the position to distribute the cost involved in the exercise of a high standard of care, on his customers. By way of periodic and service charges he may re-allocate the said cost to the beneficiaries of his business. The allocation of the duty to exercise a high standard of care would, as could be noted, achieve an optimum distribution of wealth.

(iii) It has been argued that drawees in the electronic age are not in a position to provide against the occurrence of the forgery of negotiable instruments, nor are they in the position to provide for its detection.[11] Negotiable instruments in the electronic age, due to their large involvement in banking channels and in order to expedite their payment and collection, are either paid without verifying the genuineness of the purported maker/drawer's signature or they are not physically presented for payment. Accordingly, the drawee would not have the chance to verify the genuineness of the said signature.

For the purpose of expediting the payment and collection of negotiable instruments, the drawee, with the aid of computerised technology specifies on the lower part of the instrument, four fields of magnetic ink character recognitions, MICR's. The extreme lower left hand corner of the instrument is designated for the MICR that indicates the routeing destination of the instrument, the payment of which is purported to be made by other than the

depositary agent. Next to it is the field which is designated for the MICR relating to "on us" items i.e. instruments payable by the agent with whom it is deposited for collection. Next to it is the field which is designated for the MICR relating to the customer's account, and finally the extreme lower right hand corner of the instrument is designated for the MICR which indicates the amount payable. The drawee encodes the MICR pertaining to the sorting destination and the customer's account, whilst the depositary agent encodes the MICR that pertains to the amount payable. Each of the MICR's appears in the form of encoded symbols and numbers. The said symbols and numbers signify the particular information incorporated in the particular MICR.[12]

The collection of the magnetic ink encoded negotiable instruments is initiated soon after the payee or the subsequent holder deposits it with his agent for collection. The depositary agent then sorts out electronically the deposited instruments. He finally remits the instrument in question either directly or through an intermediary to its designated destination. The drawee receives the remitted instrument. Before making payment, he electronically verifies the routeing of the instrument and the status of the customer's account.[13]

Since, due to the large volume of instruments processed daily, the drawee, it has been argued, finds it impracticable to examine the genuineness of the purported maker or drawer's signature,[14] the banking channels

devised the practice of negotiable instrument truncation. In light of a special arrangement between the drawee and the depositary or collecting agent, the latter need not present the instrument as such in order to demand its payment from the drawee. After sorting out the destination of the deposited instrument, the collecting or depositary agent may demand the payment of the instrument by remitting electronically a message to the drawee. To this end he incorporates in the message the MICR's pertaining to the routeing destination, the customer's account and the amount payable. The drawee electronically verifies the said MICR's. Upon the relevant findings he determines whether to pay or dishonour the instrument.

Since, in the light of the negotiable instrument truncation practice, the deposited instrument is physically retained by the collecting or depositary agent, the drawee would not have the chance to verify its genuineness. Due to the non-physical remittance of the deposited instrument, the signature of the purported maker or drawer would not be available to the drawee. Accordingly, he would not be in a position to compare it with its facsimile which he has on file. The employment of measures, the purpose of which is to verify the genuineness of the purported maker's/drawer's signature would be superfluous. Ultimately, the failure to provide such measures would not constitute a breach of care.

(iv) From the foregoing, it could be inferred that the above argument releases the drawee from the duty of

exercising care in providing against the occurrence of the forgery of negotiable instruments, and it releases the said party from the duty of providing for the detection of such a fraudulent practice. Accordingly, the said argument suggests the risk arising from the forgery of negotiable instruments should be allocated to either of the remaining competing parties, namely, the purported maker/drawer[15] or the bona fide third party acquirer.[16] The allocation of the risk in question to either party would necessarily suggest that the party to whom risk is to be allocated bears the blame for not exercising a high standard of care, the observance of which could have avoided the occurrence of the fraudulent practice. In other words, the above argument allocates to the purported maker/drawer or the bona fide third party acquirer the duty to exercise care as to the safe custody of blank instruments or the duty to exercise care as to the acquisition of negotiable instruments.

As has been mentioned above,[17] the allocation of the said duty to either party is economically inefficient. Its application could result in a misallocation of wealth, i.e. value. On the other hand, the allocation of the risk of forged instruments to either the purported maker/drawer or the bona fide third party acquirer would not facilitate the economic function of negotiable instruments. The utilisation of negotiable instruments as a finance device would, on the one hand, be restricted and on the other hand, third parties would be deterred from the acquisition of such instruments. To state the

obvious, the allocation of the risk of forged negotiable instruments to either the purported maker/drawer or the bona fide third party acquirer would restrict the promotion of the institution of negotiable instruments.

Finally, a further illustration of the inefficiency in allocating the risk of forged instruments to either the purported maker/drawer or the bona fide third party acquirer, is that it allocates the said risk to the party least able to provide for insurance.[18] The purported maker/drawer and the bona fide third party are presumed to be the least able to provide for insurance efficiently because of their consumer capacity or non-involvement in the said risk. Because of the said status the necessary information in light of which the decision to purchase insurance could be made, might not be available. Because of the said status, the purported maker/drawer and the bona fide third party acquirer might not be able to determine the rate of the risk of forged instruments and the gravity of the said risk. Finally, because of the said status, the parties in question might not be in a position to distribute the cost of insurance. There might not be other parties against whom they may re-allocate the said cost. The cost of insurance might then have to be borne by them exclusively. The cost involved in the provision of insurance would ultimately take the form of misallocation of wealth.

(v) The allocation of the risk of forged instruments to either the purported maker/drawer or the bona fide third

party acquirer, results in a windfall in favour of the party best able to provide against the said risk. The drawee is deemed to be the party best able to provide against the risk of forged instruments because, due to his status as such he, firstly, possesses the last clear chance to prevent the forgery from escaping detection and secondly, he is presumed to be in the best position to provide efficiently for insurance.

The drawee is deemed to possess the last clear chance of detecting the forgery because:

1) he is the ultimate party in the chain of payment with whom the instrument rests,
2) he keeps on file a facsimile of the purported maker's or drawer's signature, and
3) he makes the final decision whether to pay or dishonour the instrument.

In his capacity as the ultimate party in the chain of payment, the drawee is deemed to stand as the principal debtor. Due to his status as such, he would be under a duty to ensure that the debt shall be paid in favour of his creditor or in compliance with the latter's instruction. In his capacity as a party possessing a facsimile of the purported maker's or drawer's signature, he is deemed to be the best able to compare the purported signature with that on file. Due to his status as such, he would be under a duty to utilise the available measures to detect any irregularity. Finally, in his capacity as the ultimate decision maker, he is deemed to be in the best position to make the appropriate decision. Due to

his status as such, he would be under a duty, before making the necessary decision, to satisfy his conviction as to the correctness of the said decision.

The drawee is presumed to be in the best position to provide for insurance because of his engagement in the business of collecting, accepting and paying negotiable instruments i.e. the banking business. Because of the said status, he would be in the position to gather the information necessary, in light of which the decision to provide for insurance could be made. Because of the said status, the drawee is in the position to appreciate the rate of the risk of forged instruments and the gravity of the said risk. And finally, because of the said status, the drawee is in the position to distribute the cost of insurance among his customers. By way of periodic or service charges, he may re-allocate the cost of insurance without causing the other competing parties to be worse off.[19]

(vi) As far as the above argument is concerned, namely that due to the modern banking tendency and the large volume of negotiable instruments processed daily, drawees are not presumed to be in the position to provide against the risk of forged instruments, it could be replied that the drawee's non-examination of the purported maker's or drawer's signature with its facsimile i.e. the ratio which underlies the above argument, is attributable to the drawee's own conduct. Such fact could be inferred from the instances where the instrument, after its physical

remittance to the drawee, is paid without examining the genuineness of its purported maker's or drawer's signature. The drawee's abstention from examining the genuineness of the purported maker's or drawer's signature suggests that the carrying out of such examination due to the incompatibility of the face value of the instrument, i.e. the utility derivable from it, with the trouble, time and cost involved in the carrying out of such examination, is economically inefficient. The abstention from carrying out the necessary examination, illustrates the drawee's willingness to bear the risk inherent in honouring a forged instrument, rather than assuming the burden of examining the said instrument. Such interpretation is reinforced by the fact that drawees, even in the modern banking tendency, subject negotiable instruments, the face value of which are high, to examination.[20] The ratio underlying the decision to examine the instrument in question is submitted to be based on economic grounds. The drawee considers the risk arising from the payment of such instruments, due to their large face value, more burdensome than the trouble, time and cost involved in the examination, had it been observed.

The attribute of the non-examination of the purported maker's or drawer's signature to the drawee's own conduct, becomes more apparent in instances of negotiable instrument truncation. The negotiable instrument truncation is a practice where, by virtue of a special arrangement between the drawee and the collecting or the

depositary agent, the former waives his right of receiving the actual instrument. He accepts to make his decision to pay or dishonour the instrument by mere reference to the electronic message which the collecting or depositary agent remits to him.[21]

To state the obvious, the drawee's willingness to waive his right of demanding the physical remittance of the instrument stems from an economic basis. The gist of the said basis is that the drawee considers the examination of the instrument, had it been remitted, more costly than the risk arising from its payment. His waiver of the right of physical remittance illustrates his willingness to assume the risk arising from the payment of a forged instrument, rather than the burden arising from the carrying out of the necessary examination. The above interpretation is reinforced by the fact that, even in the modern banking tendency, drawees limit the truncation arrangement to instruments, the face value of which do not exceed a fixed sum. If, however, the face value of the instrument in question exceeds the fixed sum, drawees demand the physical remittance of the instrument.[22] This tendency illustrates that the drawee insists on the physical remittance of instruments when the risk arising from honouring them is more burdensome than the trouble, time and cost involved in the examination had it been observed. It illustrates the drawee's willingness to assume the burden of carrying out the necessary examination, rather than assuming the risk of honouring the instrument.[23]

## The Compatibility of the Competing Parties' Duty to Exercise a High Standard of Care with the Interests Relating to Negotiable Instruments.

(i) As may be recalled from an earlier discussion,[24] the interest most material to negotiable instruments is the promotion of the said institution. The institution of negotiable instruments will be promoted when its economic function as a substitute for money is facilitated. A negotiable instrument will function as a substitute for money when it is used as a finance device.

For negotiable instruments to operate as a finance device and ultimately as a substitute for money, they should possess some of the attributes of money. In particular, they should firstly be freely transferable and, secondly, they should operate as a reliable means of payment.

The free transferability of negotiable instruments would be approached when their negotiation and acquisition are facilitated. To facilitate the negotiation and acquisition of negotiable instruments, the community engaging in the said activities should be protected in its dealings. It should not be frustrated as to its reasonable expectation. It should not be made accountable for risks the occurrence of which could not reasonably be attributed to it. It should not be burdened with the duty to exercise a high standard of care, the observance of which could result in an economic windfall against it.

The negotiable instrument's function as a reliable means of payment would be approached when:

1) its capability of being liquidated into money immediately is facilitated, and
2) when its enforcement clothes the transaction arising from it with finality.

In order to facilitate the negotiable instrument's capability of an immediate liquidation into money, it should be self sufficient. That is to say that the instrument, the acquisition of which is under examination, should be able to circulate freely without requiring consultation of extrinsic elements. The person to whom the instrument is offered should not be under a duty to enquire with regard to the genuineness and regularity of the instrument beyond its four corners. He should not be, in particular, under a duty to shop for information concerning the status of the instrument and the status of its possessor, i.e. the party from whom the third party acquirer intends to purchase the instrument.

In order to clothe the negotiable instrument transaction with finality, the involved parties should not be allowed to re-open the dispute as to its validity, in instances where the competing parties are innocent. The party against whom the performance of the transaction in question operates should not be allowed to challenge the entitlement of the other innocent competing party. In particular if the drawee of a negotiable instrument erroneously pays a forged instrument in favour of a bona fide third party acquirer, he should not be allowed to

challenge the recipient's entitlement to the proceeds. The latter should not be compelled to revert the erroneously paid proceeds to the former.

The establishment of the finality rule would on the one hand conform with the reasonable expectation of the party in whose favour it operates and, on the other hand, it enhances the certainty arising from the enforcement of the particular transaction. As far as the payment upon a forged instrument is concerned, the establishment of the bona fide acquirer/recipient's entitlement to the paid proceeds conforms with his reasonable expectation that the instrument to which he establishes his property right is what it purports to be. Its acquisition confers exclusively in his favour a property right to the incorporated purported credit, whilst its payment confers exclusively upon him a property right to the paid proceeds.

The establishment of the entitlement to the erroneously paid proceeds in favour of the bona fide acquirer/recipient, enhances the certainty arising from the act of payment in the sense that it reasonably assures the acquirer/recipient, i.e. the party in whose favour it operates, that the act of payment is final and the payor shall not be entitled to challenge the validity of his payment. The certainty arising from the application of the finality rule affords the acquirer/recipient a reasonable security. He need not concern himself with the validity of former transactions; and he may carry on his

commercial engagement without the fear of being involved in disputes relating to foreclosed transactions.

(ii) If, by comparison, proprietors of blank instruments and acquirers of negotiable instruments were under a duty to exercise a high standard of care as to their safe custody or acquisition, or alternatively they were to bear the risk arising from the forgery of negotiable instruments, they would be deterred from the engagement in dealing with negotiable instruments. Proprietors of blank instruments would be deterred from the activity of negotiating, i.e. issuing negotiable instruments, whilst the public would be deterred from the acquisition of negotiable instruments. Ultimately, the involvement of negotiable instruments as a finance device would be restricted or even eliminated. The objective of promoting the said institution would then fail.

If, however, third parties were under a duty to shop for information concerning the status of the instrument they intend to acquire and the status of its possessor, three inter-related consequences detrimental to the institution of negotiable instruments would result. In the first place, the allocation of the duty to shop for information to the third party would, due to the cost and time involved, discourage the third party from acquiring negotiable instruments from strangers. The activity of acquisition would be severely restricted. Ultimately, the objective of promoting the institution of negotiable instruments would fail.

In the second place, if the acquisition of negotiable instruments was to be severely restricted, genuine acquirers of genuine instruments would not be able to cash their instruments on their day of maturity. Accordingly, they would not be able to utilise the credit incorporated in their instruments efficiently. This could occur in instances where the genuine acquirer of a genuine instrument intends to cash his instrument in a foreign jurisdiction. If the said jurisdiction adopted a risk allocation rule, the application of which would deter the acquisition of negotiable instruments from strangers, the genuine acquirer of a genuine negotiable instrument might not be able to utilise the incorporated credit immediately. Because of his foreign status he might not be able to cash his instrument. He might not be able to liquidate his instrument into money immediately. Ultimately, he might not be able to utilise the said credit to satisfy his urgent needs.[25]

In the third place, the time involved in the shopping for information might overlap with the maturity of the negotiable instrument. Accordingly, the genuine acquirer of a genuine instrument might forego the advantages inherent in the negotiable instrument. He might forego the right to exercise his right of recourse on the instrument against prior parties. He might forego an enforceable security on the instrument or he might forego the advantages inherent in the holder status.

To illustrate, assume that John Alex attends a three year course at the Sorbonne University. Shortly before

the course ends, Alex advertises to sell his Renault car. Pierre Legrand, a classmate of Alex, offers to purchase the car for 7,000 francs. By way of payment Legrand offers Alex a cheque. In order to secure its payment, Alex requires the certification[26] of the drawee bank on the cheque. On the next day Alex returns home to England. Two days after his arrival, he opens an account with a bank. Alex then deposits the French inland cheque with his bank and requests the latter to expedite its collection.

If the bank with whom the cheque is deposited was under a duty to shop for information as to the status of the cheque and the status of its acquirer, i.e. John Alex, before presenting it for payment, the time that would have been involved had the shopping for information taken place might overlap with the maturity of the cheque. The cheque might elapse before the necessary information is collected.[27] By the time the necessary information is collected, the credit against which the cheque was drawn might not be available in the hands of the drawee. The drawer, i.e. Pierre Legrand might utilise the said credit in another transaction, once he realises that it has not been paid within the maturity of the cheque. Accordingly, Alex might forego the security manifested by the drawee's certification.[28] He might forego the advantages inherent in the negotiable instrument and those inherent in the holder status. He, in order to exercise his right of recourse against the drawer, may have to establish his claim and answer any counter claims or

defences that might be interposed by the drawer, i.e. Pierre Legrand.

If however the bona fide acquirer recipient was made accountable for the proceeds of the erroneous payment, two detrimental consequences would result. In the first place, the drawee payor's entitlement to reclaim the erroneously paid proceeds would damage the reasonable expectation of the acquirer recipient. The instrument to which he establishes a property right would not confer upon him a property right to the incorporated credit. The acquirer/recipient would not establish a property right to the paid proceeds.

In the second place, the drawee's entitlement to reclaim the erroneously paid proceeds would re-open the dispute as to the validity of former transactions. Such establishment would result in an uncertainty. The party against whom the rule operates would be uncertain as to his status in the former transactions. He might have to either forego the opportunity to engage in other transactions, the finance of which is dependent on the negotiable instrument transaction, or he might have to disturb his commercial arrangement. As could be noted, the uncertainty created by the drawee's entitlement to re-open former transactions would damage the financial interest of the bona fide third party acquirer recipient.

Finally, as a result of the uncertainty created by the drawee's entitlement to the erroneously paid proceeds and due to the inconsistency of such rule with the reasonable expectation of the other competing party,

namely the bona fide acquirer recipient, third parties would be deterred from the acquisition of negotiable instruments. Their acquisition of such instruments would be severely curtailed. Ultimately, the institution of negotiable instruments would not be promoted and its function as a reliable means of payment would fail.

(iii) The allocation of the duty to exercise a high standard of care to the drawee, or the allocation of the risk of forged instruments to him would, by comparison, approach a risk allocation rule compatible with the objective of promoting the institution of negotiable instruments. In the first place, the commercial community would be encouraged to engage in the activity of negotiating and acquiring negotiable instruments. In the second place, negotiable instruments would be freely transferable. In the third place, negotiable instruments would be capable of being liquidated into money immediately and, finally, their employment as a finance device would be facilitated.

The allocation of the duty to exercise a high standard of care, or the allocation of the risk of forged instruments to the drawee, would neither damage the reasonable expectation of the said party nor would it create an undue hardship to him. Due to his status as a party engaged in the banking business, he ought to appreciate the rate and the gravity of the evolving risk. Accordingly, he ought to foresee the necessity to provide against it, either by the exercise of a high standard of

care or by the provision for insurance. Due to his status as a party engaged in the business of banking, he is presumed to be in the position to distribute the cost involved in the exercise of care or in the provision for insurance, among his customers.

The Compatibility of the Competing Parties' Duty to Exercise a High Standard of Care with Other Interests.

(i) There are other interests which the law making institution takes into account in formulating a risk allocation rule. In the context of negotiable instruments, the material interests in formulating the risk allocation rule in instances of negotiable instrument fraud are, it will be recalled,[29] the interest of the public at large and the notion of fairness and justice.

As far as the interest of the public is concerned, each of the purported maker, drawer, the bona fide third party acquirer and the drawee payor is in the position to avoid the occurrence of the forgery of negotiable instruments. Each can avoid the occurrence of the said risk by the exercise of a high standard of care. Nevertheless, the allocation to each of the above competing parties of the duty to exercise a high standard of care might not be reconcilable with the notion of fairness and justice.

(ii) The exercise of a high standard of care, as has been illustrated above,[30] involves cost. For the assumption of cost to be reasonably justifiable, it should

be value maximising. That is to say that the duty to incur cost should be allocated to the party who derives an enforceable utility from it or to the party who is in the position to absorb it. If the duty to incur cost was allocated otherwise, the party to whom it would be allocated would suffer a hardship.[31]

(iii) In order to approach a fair and just rule, the duty to exercise a high standard of care and ultimately incur cost should, in instances of multiple competing parties, be allocated to the party who would suffer least hardship had the duty to exercise a high standard of care been allocated to him.[32] As it has been shown above,[33] the drawee payor, due to his status as a party engaged in the business of banking, is presumed to be the least prejudiced, had the duty to exercise a high standard of care been allocated to him. He is presumed to be in the best position to utilise the cost involved in the course of exercising a high standard of care and he is presumed to be in the best position to absorb it.

If, as a result of the failure to exercise a high standard of care forged negotiable instruments were paid, it would be fair and reasonable to hold him liable for the evolving risk, rather than allocating the said risk to either the purported maker, drawer or the bona fide third party acquirer. If the risk of forgery of negotiable instruments was to be allocated to either of the said parties, they would suffer the most hardship. Due to their status as such, they would not be in a position to

derive an enforceable utility from the assumption of cost, nor would they be in the position to absorb it, had the duty to exercise a high standard of care been allocated to them.

The Party to Whom the Risk of Forgery of Negotiable Instruments Should Be Allocated.

(i) The determination of the party to whom the risk of the forgery of negotiable instruments should be allocated, may differ in accordance with the particular setting in which the said risk may arise. In instances of payment, the risk of the forgery of negotiable instruments should be allocated to the drawee payor. Due to his status as a party engaged in the business of banking, he is presumed to be in the best position to provide against the said risk. The allocation of the risk of the forgery of negotiable instruments to him satisfies the interests most relevant to the problem of allocating risk in instances of negotiable instrument fraud.[34]

(ii) In instances where the drawee detects the forgery and ultimately dishonours the presented instrument, the party to whom the risk of forgery of negotiable instruments should be allocated, is either the purported maker/drawer or the bona fide third party acquirer. The drawee in this instance would not be involved as a competing party. His detection of the forgery and the subsequent dishonour exonerates him from the evolving risk. By such steps, he is presumed to have discharged

his duty to avoid the occurrence of risk inherent in the forgery of negotiable instruments.

(iii) In instances where the involved competing parties are similarly situated, there can be no sound reason justifying the reallocation of the risk from one party to another. The risk in this instance should be allocated where it lies. Any attempt to reallocate the risk to the other competing party would result in a hardship against the said party.

In instances of forged instruments, the competing parties, namely, the purported maker drawer and the bona fide third party acquirer are not, however, similarly situated in the strict sense. Although they are presumed to be innocent, their equities are not equal. The bona fide third party acquirer is submitted to be better situated to provide against the occurrence of loss. The said party can provide against the loss in question by the exercise of reasonable care in his acquisition.

Reasonable care in the acquisition of negotiable instruments would be satisfied once the third party to whom a negotiable instrument is offered for a valuable exchange identifies the possessor of the instrument i.e. the party from whom he intends to acquire it and makes a reasonable enquiry as to the genuineness of the latter's title. The exercise of such care is not unduly onerous to the bona fide third party. Every person ought to exercise reasonable care to safeguard his interest. The bona fide third party to whom the instrument is offered

for a valuable exchange is not bound after all to accept a negotiable instrument as a satisfaction of his underlying rights. In instances where the third party is not familiar with the character of the party with whom he intends to engage, he may demand from the latter a more reliable instrument of payment as a discharge for the underlying monetary obligation.

The purported maker drawer of a forged instrument, by comparison, is not in a position to provide against the resulting loss by the exercise of reasonable care in the safe custody of his blank instruments. Such a care would be satisfied once the proprietor of blank instruments avoids placing his instruments in situations where a dishonest person may obtain free access to them and misuse them. The supposed innocence of the purported maker drawer presumes his compliance with the reasonable care requirement.

If, however, the purported maker drawer was made to exercise more than reasonable care in the safe custody of his blank instruments, he would have to incur cost and consume time without deriving an enforceable value from them. The value derivable from the investment of cost and time in the safe custody of blank instruments is not enforceable because the entitlement in which the said cost and time are invested is a worthless piece of paper. The exercise of more than reasonable care in the safe custody of blank instruments, as could be noted, results in a misallocation of wealth. Accordingly, its imposition is submitted to be invalid under an efficient risk allocation

rule.[35]

From the foregoing it could be concluded that in instances where the loss in question results from the acquisition of a forged instrument it should be allocated to the bona fide third party acquirer. As between himself and the purported maker drawer, he is presumed to be better situated to prevent the occurrence of loss. Ultimately the bona fide acquirer should not be allowed to reallocate the resulting loss to the other competing party, namely the purported maker drawer.

The allocation of the risk of the forgery of negotiable instruments to the bona fide third party acquirer is not, however, incompatible with the interests relevant to the institution of negotiable instruments. An instrument would possess the negotiability attribute if it is clothed with currency. An instrument gains currency when it is validly signed. In the absence of a valid signature, the instrument would be dispossessed of any practical value as between the third party acquirer and the purported maker, drawer. The party into whose hands the instrument comes would not be able to enforce the credit incorporated in it. There would not be a potential liable party against whom the instrument could be enforced. The acquired instrument operates in the hands of the bona fide third party acquirer as a piece of paper qua piece of paper.

The Party to Whose Favour the Proposed Risk Allocation Rule Should Operate

(i) The allocation of the risk of the forgery of negotiable instruments to either the drawee payor or the bona fide third party acquirer, should not be applied rigidly. In order to avoid moral hazard,[36] the party to whom the above mentioned risk is initially allocated should be allowed to reallocate a proportion of the resulting loss to the other competing party whose negligent behaviour contributed to the occurrence of the loss.

The standard of care of the other competing party, i.e. the party to whose favour the risk allocation rule is initially established, however, should be measured in a manner compatible with his status. The required standard of care should be measured by reference to the party's capability to comply with it in an economically efficient manner. The compliance with the required standard of care should not result in allocating to the party in question the duty to take precautionary measures, the provision of which might create an unjustifiable economic detriment against him. That is to say, the required standard of care should not impose upon the party to whom the risk is intended to be reallocated, the duty to incur cost in instances where he is not in the position to derive an enforceable utility from it or to absorb it.

(ii) In instances of dishonour, the standard of care of the purported maker/drawer, i.e. the party to whose favour

the risk allocation rule is established, should be measured with that of the "reasonable man". He should observe reasonable care in the custody of his blank instruments, such as cheque slips. He should not put his cheque slips or cheque books, for an example, in a place where their vulnerability to theft becomes increasingly foreseeable, such as the placement of a cheque slip on a desk in an unlocked office without attendance. Thus if the said cheque was stolen and the thief forged the customer's signature and negotiated the cheque to a bona fide third party for value, the customer, i.e. the purported maker drawer should bear the entire loss arising from the forgery. He should compensate the bona fide third party acquirer to the amount of the face value of the acquired instrument. His failure to exercise reasonable care is presumed to have caused the occurrence of the loss.

In this instance the equities of the purported maker drawer are not equal to the equities of the bona fide third party acquirer. The latter remains unable to provide against the risk of forgery whilst the purported maker drawer is in the position due to his capacity to exercise reasonable care, to provide against the said risk. The exercise of reasonable care as to the safe custody of blank instruments does not, as will be shown later,[37] create an undue hardship to the purported maker drawer. The compliance with it is compatible with the reasonable expectation of the said party, the special nature of negotiable instruments, as well as economic

efficiency.

The loss arising from the forgery of negotiable instruments may however be proportioned between the competing parties in instances where the negligence of the bona fide acquirer contributes to the occurrence of loss. Such instances arise when the bona fide third party accepts to cash a forged instrument in suspicious circumstances. The equities of the bona fide third party acquirer in this instance are submitted to be equal to the equities of the negligent purported maker drawer. His failure to shop for information concerning the status of the offered instrument and the status of its possessor is presumed to have facilitated the occurrence of the loss. The imposition of the duty to shop for information in this instance is not by comparison detrimental to the third party acquirer.[38] It is compatible with the behaviour of the reasonable man.

(iii) In instances of payment, the required standard of care of the purported maker drawer and the bona fide third party should, likewise be measured with that of the reasonable man. The purported maker drawer should exercise reasonable care as to the safe custody of his blank instruments such as cheque slips, as well as to the examination of bank statements. The purported maker drawer should firstly avoid putting his blank instruments in public places where their vulnerability to misuse becomes increasingly foreseeable and secondly he should examine the items of credit and debit in his bank

statements and report within a reasonable time any irregularity to the drawee.

The equities of the purported maker drawer in this instance are submitted to be equal to the equities of the drawee payor. The former's failure to exercise reasonable care and the drawee payor's failure to exercise a high standard of care, are presumed to have contributed to the occurrence of loss. The allocation of the duty to exercise reasonable care to the purported maker drawer and the allocation of the duty to exercise a high standard of care are compatible with the reasonable expectations of the party in question, the special nature of negotiable instruments, and economic efficiency. The drawee payor due to his status as a party engaged in the business of banking, ought to foresee the rate and the gravity of the risk. Accordingly he ought to exercise a high standard of care to provide against its occurrence. Due to his status as such he is presumed to be in the position to derive an enforceable utility from the cost involved in the exercise of a high standard of care and he is presumed to be in the best position to distribute it, at the optimum level.[39]

Thus if a dishonest employee stole a cheque slip from his employer's unlocked office, forged the latter's signature, cashed it with the drawee, and managed to repeat the fraudulent practice several times, the employer, i.e. the purported maker/drawer should bear a proportion of the evolving loss. He should be denied the right to a full recredit of his account with the drawee.

His failure to exercise reasonable care as to the safe custody of his cheque slips and his failure to examine and report any irregularity in his bank statement, are presumed to have contributed to the occurrence of loss.

The drawee should not, however, be allowed as a matter of right to charge to his customer i.e. the purported maker drawer, a proportion of the loss arising from the erroneous payment of a forged instrument. Should such right be established to the drawee payor, the loss arising from the said risk would be proportioned at the whim and caprice of the drawee. Accordingly, the right to challenge the equity of the apportionment rule would be shifted to the other competing party, i.e. the purported maker/drawer. He would ultimately have to seek a court settlement. Due to the transaction costs involved in the litigation and the burden of establishing his right, the purported maker/drawer might refrain from suing the drawee/payor, in instances where the disputed right is trivial. To state the obvious, the drawee's right to charge to his customer a proportion of the evolving loss might, on the one hand, result in a windfall in favour of the drawee and it, on the other hand, would shift the risk of the payment of a forged instrument to the party least able to reallocate it efficiently.

In order to avoid the above application the drawee payor should not be allowed as a matter of right to charge to his customer a proportion of the evolving loss. He should approach such right by a court order in instances where his customer disputes the existence of his

negligence or its gravity. Due to his status as the party engaged in the business of banking, he is presumed to be in the best position to re-allocate the transaction cost involved in the litigation, to his customer. Where the disputed right is trivial and the drawee does not consider litigation practicable, he is presumed to be in the best position to distribute the evolving loss among the beneficiaries of his business, i.e. his customers. Such application approaches, on the one hand, an economically efficient rule, while on the other hand, it preserves the general risk allocation rule.

(iv) As far as the bona fide third party acquirer is concerned, the concept of "reasonable care", according to which the care of the third party acquirer is measured, should be interpreted in a loose manner. Its application should not involve the duty to shop for information, in instances of regular transactions, concerning the status of the offered instrument or the status of its possessor. Should the concept of reasonable care involve the shopping for information, its application would result in unjustifiable economic detriment against the third party acquirer. He might have to incur cost in instances where he might not be in the position to derive an enforceable utility from it or absorb it. Moreover, the allocation of the duty to shop for information to the third party acquirer would, as has been illustrated above,[40] restrict the acquisition of negotiable instruments. Ultimately,

the objective of promoting the said institution would fail.

Reasonable care, in this context, should be applied so as to denote the duty to shop for information in suspicious circumstances only, i.e. in instances where a reasonable man, had he been involved, in the light of the surrounding circumstances, would have shopped for information. An example of such an instance is the offering of a company's large cheque for a valuable exchange made by a company messenger boy to a car dealer. Such an instance excites suspicion as to the genuineness of the cheque and the validity of its possessor's title because, on the one hand messenger boys are not expected to earn a substantial amount of money and on the other hand, they are not expected to possess an enforceable interest in their employer's cheques.

If the car dealer, as far as the above example is concerned, accepted to cash the offered cheque for the messenger boy, without making the necessary enquiry, he would be presumed to be negligent. Should the drawee erroneously pay the bona fide third party acquirer, the latter may not claim a property right to the erroneously paid proceeds. He should revert to the payor the erroneously paid proceeds. His failure to carry out the necessary enquiry is presumed to have caused the occurrence of loss.

(v) There is nothing unfair or unreasonable in allocating to the purported maker drawer or the bona fide

third party acquirer, the duty to exercise reasonable care. The compliance with the standard of care of that of the reasonable man does not involve the cost and time evidenced in the exercise of a higher standard of care. Accordingly, the exercise of reasonable care does not result in an unjustifiable detriment against him.

In the second place, the allocation of the duty to exercise reasonable care conforms with the nature of the institution of negotiable instruments. Although blank instruments are not valuable property, the negligence in their safe custody may facilitate their clothing with a prima facie currency. The blank instrument would then purport to circulate as a regular negotiable instrument. The public, due to the instrument's prima facie regularity, might be misled. Third parties may engage to purchase the instrument or the drawee may erroneously pay it.

Finally, the allocation of the risk arising from the forgery of negotiable instruments to either the purported maker/drawer or the bona fide third party acquirer is not incompatible with the reasonable expectation of the said party. Due to the special nature of negotiable instruments as documents freely transferable as a finance device, the proprietor of blank instruments should reasonably expect that the failure to exercise reasonable care as to their safe custody might lead to their misuse and third parties might be misled in their acquisition and payment. In instances where the proprietor of blank instruments fails to exercise care in the examination of

bank statements and report any irregularity, he should reasonably expect that the immediately affected party, i.e. the drawee, would consider the items i.e. instruments which he paid as genuine mandates and he would consider the customer's silence as ratification of his act of payment. The drawee may then be misled as to subsequent forged instruments. His customer's silence may induce him to make erroneous payments or it may cause the drawee to forgo the opportunity to recover erroneous payments from the recipient.

In instances where the bona fide third party to whom the instrument is offered for a valuable exchange fails to shop for information in suspicious circumstances, he should reasonably expect that the instrument to which he intends to establish his property right might be a forgery, or the title of its possessor might be defective. Accordingly, he should reasonably expect that his property right to the instrument or to its proceeds might, by the interposition of claims of other competing parties, be defeated, if he determines, despite the suspicious surrounding circumstances, to acquire the offered instrument.

The Holder Concept

(i) The problem of risk allocation in instances of paying forged instruments is submitted to be the most delicate issue in the context of the forgery of negotiable instruments. Its determination takes into account the

equities of all competing parties. The allocation of the risk to either of the competing parties necessarily suggests that the equities of the other competing parties are superior to that of the party to whom risk is allocated.

As may be recalled, it has been considered that the risk arising from the payment of a forged instrument should be allocated to the drawee payor. The equities of the purported maker, drawer and those of the bona fide third party acquirer are submitted to be superior to the equities of the drawee payor. In order to put the proposed risk allocation rule in the negotiable instrument perspective, the right of the parties in whose favour the risk allocation rule operates, should be interpreted in a manner compatible with the nature of negotiable instruments.

(ii) As far as the purported maker/drawer is concerned, his right to have his account recredited as if payment had not been made, could be explained on the basis that any payment purporting to be made in reliance on a forged instrument, is deemed to be made without a proper mandate. For a mandate to be validly made, it must be signed by or on behalf of its maker. In the absence of such signature, the prima facie signed mandate may not bind its purported maker drawer. Such signature may not attribute to the said party a contractual obligation. Accordingly, no liability may be established against him.

(iii) As far as the bona fide third party is concerned, and in order to indorse his right of retaining the erroneously paid proceeds, he should have the holder status established in his favour. The establishment of the holder status in his favour necessarily affords him an exclusive property right to the credit incorporated in the instrument. And should the credit be erroneously paid the establishment of the holder status affords the bona fide acquirer recipient an exclusive property right to the paid proceeds. That is to say, that the establishment of the holder status in favour of the bona fide third party acquirer confers upon him a legal title to the paid proceeds. Due to his status as such, he may not be compelled to revert to the drawee payor the proceeds of the erroneous payment.

In order to establish the holder status in favour of the bona fide acquirer of a forged instrument, the concept of holder should be defined in a wide sense. Its application should embrace every bona fide acquirer who establishes his title to the instrument in question through a regular chain of signatures and without being guilty of gross negligence.

The requirement of regularity of signatures satisfies the rule of economic efficiency as well as the nature of the institution of negotiable instruments. On the one hand, it frees the public from the duty to make enquiry beyond the four corners of the instrument. The third party would not have to allocate cost and time for the purpose of collecting information. The regularity

requirement, on the other hand, facilitates the free transferability of negotiable instruments. It isolates the validity of the instrument from elements extraneous to it. The public would then be encouraged in its acquisition. The objective of promoting the institution of negotiable instruments as a finance device would ultimately be facilitated.

The "without gross negligence" proviso, by comparison, provides against the problem of moral hazard. It creates an adequate incentive to use reasonable care. It deters the third party to whom the instrument is offered for a valuable exchange from acquiring it in suspicious circumstances. It compels him to safeguard his interest either by shopping for information or by refraining from acquiring the instrument.

Summary

(i) From the foregoing, the proposed risk allocation rule could be summarised as follows:-

In instances where the risk arises from the payment of a forged instrument, the evolving loss should be allocated to the drawee payor. Due to his status as a party engaged in the business of banking, he is presumed to be in the best position to provide against it. He is, firstly, in the best position to prevent the risk from ever materialising and he is in the best position to prevent its escape from detection should it occur. Secondly, due to his status as such, he is in the best

position to provide for insurance efficiently. And finally, due to his status as such, he is in the best position to derive an enforceable utility from the cost involved in the exercise of a high standard of care or that involved in the provision for insurance and he is in the best position to absorb such cost.

(ii) In instances of dishonour, the risk arising from the forgery of negotiable instruments should be allocated to the bona fide acquirer. As between himself and the other competing party, namely the purported maker/drawer, the bona fide third party acquirer is presumed to be better situated to prevent the occurrence of loss. Where no negligence as such could be attributed to the similarly innocent party, namely, the purported maker/drawer, no sound reason could justify reallocating the loss to him. The equities of the purported maker/drawer are, in this instance, superior to the equities of the bona fide third party acquirer.

(iii) However, in order to avoid moral hazard, the party to whose favour the risk allocation rule operates, should exercise reasonable care. The purported maker/drawer should exercise reasonable care as to the safe custody of his blank instruments, as well as the examination of bank statements. He should, accordingly, report to the drawee any existing irregularities. The bona fide third party acquirer should, by comparison, exercise reasonable care as to his acquisition in suspicious circumstances. He should either shop for information concerning the status

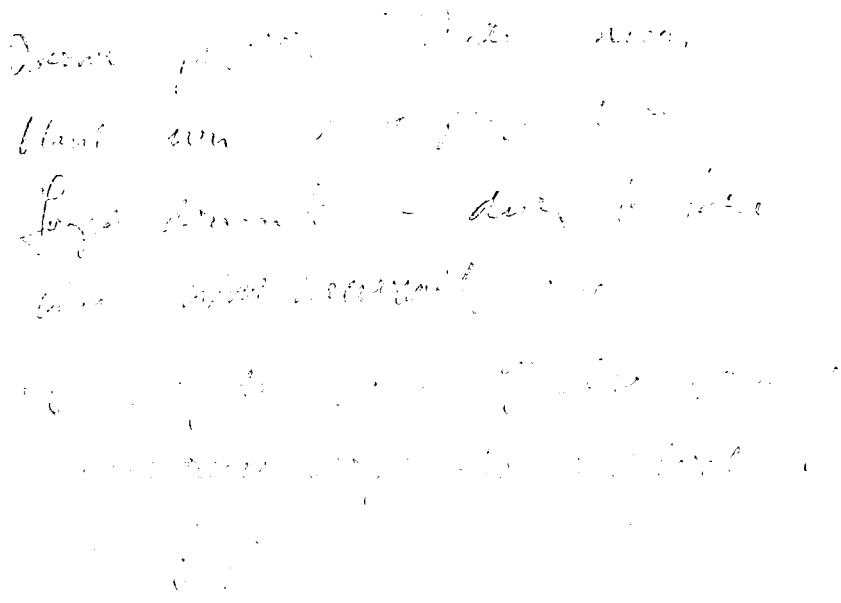
of the instrument and the status of its possessor, or he should refrain from its acquisition.

Should the above mentioned parties fail to comply with the required standard of care, they should bear a proportion of the resulting loss. The loss allocated to them should, however, be in harmony with the gravity of their negligence. The parties in question, whose negligence was a contributing factor to the loss occurring, should bear the loss.

The allocation of the duty to exercise reasonable care, to either the purported maker/drawer or the bona fide third party acquirer is neither unfair nor is it unreasonable. The compliance with the required standard of care does not result in an economic windfall to the detriment of the party in question. It does not import the duty to incur cost in an inefficient manner. The allocation of the duty to exercise reasonable care is consistent with the reasonable expectation of the party in question, as well as the special nature of negotiable instruments. Due to the special nature of negotiable instruments as documents freely marketable, the purported maker/drawer and the bona fide third party acquirer ought to foresee the risk that innocent third parties might be injured as to their financial interest had the party in question failed to exercise reasonable care.

(iv) Finally, and in order to put the general risk allocation rule in the negotiable instrument perspective, the concept of holder should be broadly defined. It

should apply to every bona fide acquirer who establishes his title to the instrument in question through a regular chain of signatures and without being guilty of gross negligence. Such definition satisfies the relevant interests. It satisfies the interest of the institution of negotiable instruments, the interest of the commercial community, the rule of economic efficiency and the notion of fairness and justice.



## CHAPTER FIVE

BACK NOTES - (1.-40.)

1. See pp.214-223 supra.

2. For an illustration of such an instance see p.206 supra.

3. For details concerning the various interests of the competing parties see pp.220-222 supra.

4. See pp.112-113 supra.

5. See pp.113-171 supra.

6. Ibid.

7. The practice of printing the customer's picture on every cheque slip, or the issuing of an identification card bearing the customer's picture does not operate either as a measure capable of preventing the forgery of negotiable instruments from materialising in the first place, in instances where the forger fraudulently issues the instrument in question to his favour or to his accomplice. In this instance the forger or his accomplice does not represent himself to the third party to whom he purports to negotiate the instrument for a valuable exchange as the maker or drawer. Rather he purports to behave as the ostensible payee. Accordingly the third party in question would not be in the position to detect the forgery by mere reference to the physical appearance of the instrument. He would not be able to establish the true identity of the actual maker or drawer until he shops for information to this effect.

8. The practice of requiring the affixing of fingerprints may also be utilised as a preventive measure in instances where the drawee's customer is a corporation. This could be approached by stipulating that for a negotiable instrument to be duly issued by the corporation, it should incorporate in addition to the corporate seal, the fingerprint of one or more of the corporation's directors or other persons authorised to issue negotiable instruments in the name of the corporation. Nothing is peculiar in such a stipulation because corporate bodies operate through their directors and share holders, i.e. individuals.

9. It could be argued however that third parties could charge the cost of information shopping to the parties from whom they acquire the instrument, through the imposition of a discount system. By fixing a discount rate compatible with the cost of information shopping, the third party may shift the incurrable expenses to the possessor of the instrument,

cf. Weinberg, Commercial Paper in Economic Theory & Legal History, (1981-82), Ky. L. J. 567.

To state the obvious, the discount system is employed in instances where the offered instrument matures at a future date and where its acquirer intends to cash it before the day of maturity. The difference between the actual face value of the instrument and its value after the discount represents the interest due from the day of discount until the day of maturity. Since the acquirer elects to cash the instrument before its day of maturity he is deemed to have assigned to the third party with whom he discounts the instrument the right to the enforceable interest.

Demand instruments by comparison are payable immediately after issuance. They are capable of being liquidated into money immediately after acquisition. The face value of a demand instrument such as a cheque represents its actual enforceable value. It does not incorporate in its face value, interest the maturity of which is due at a future date. Thus demand instruments are not the subject of discount. Acquirers of such instruments do not normally accept to cash them at a discount rate. They consider such behaviour as a misallocation of wealth. They would be allocating for the instrument a value higher than that which they would obtain had they accepted the discount rate.

Finally even in instances of future instruments such as a bill of exchange the maturity of which falls on a future date, acquirers of such instruments would not normally accept to discount their instruments at a rate higher than the deductible due interest. They would be deemed to have allocated for the instrument, a value higher than the value they would obtain had they accepted the discount rate. They would consider such behaviour as irrational and a form of misallocation of wealth.

10. See pp.351-359 infra.

11. Hudak and MacPherson, Forged Altered or Fraudulently Obtained Cheques, (1977), 23 Prac. Law. 73.

Murray, Price v Neal in the Electronic Age, (1970) 87 Bank. L. J. 686.

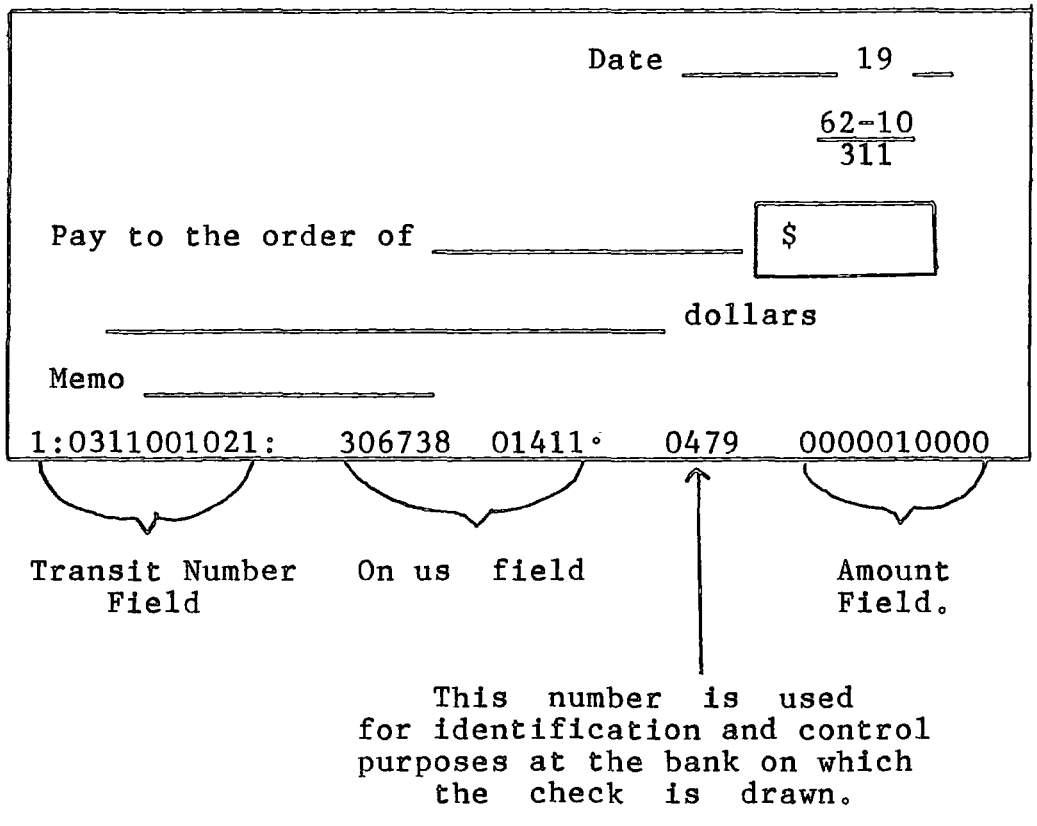
Harwood, Note, Commercial Transactions, Commercial Paper, Allocation of Liability, (1978), 24 Wayne L. Rev. 1077.

The draftsmen of the United States New Payment Code (N.P.C.) also subscribed to the above mentioned argument. They were of the opinion that drawees in modern banking practice are not in a position to provide against forgery of negotiable instruments. To this end they proposed the rule that drawees may recover from the recipient, e.g. the

intermediary, the depositary agent, or the ultimate possessor depositor, the proceeds of the erroneous payment, once it is made in reliance upon a forged instrument. Section 204 of the proposed N.P.C. provides that any party, including a collecting bank, who transfers an unauthorised item, is liable to all parties to whom the item is transferred and who pay or give value for the item in good faith. Thus the drawee who pays a forged instrument may according to the foregoing section, claim from the collecting agent or any prior transferor, the proceeds of the erroneous payment, provided that such demand is made within a reasonable time. The recipient however may not defeat the drawee's cause of action unless the latter fails to set up against his customers defences and claims which the recipient would have had against the customer. The drawee's negligence in not detecting the forgery is not, however, a defence in favour of the recipient.

For a general outline of the N.P.C.'s proposed treatment of the risk allocation rule,
cf. Dow and Ellis, The Proposed Uniform New Payments Code, (1985), 22 Harv. J. Legisl. 399.

12. The following is an example of the magnetic encoded cheque. It is borrowed from,
Hill, MICR Fraud, (1984) 9 Delaware J. Corp. L., 351.



13. For a brief outline of the collection process of magnetic ink encoded negotiable instruments, cf. Hill, MICR Fraud, Ibid. 347.

Dow and Ellis, The Proposed Uniform New Payments Code, (1985) 22 Harv. J. Legisl., 402 et seq.

14. Murray, Price v Neal in the Electronic Age, (1970) 87 Bank. L. J., 686.

Hudak and MacPherson, Forged Altered or Fraudulently Obtained Cheques, (1977), 23 Prac. Law. 73.

15. cf. Remarks of Van Zeeland, the Belgian delegate, to the Geneva Conference on the Unification of the Laws Relating to Bills of Exchange, Promissory Notes and Cheques, 2nd Session, L. N. Doc. No. C.194. M77 1931 II B P.308.

16. cf. Murray, Price v Neal in the Electronic Age, (1970) 87 Bank. L. J. 686.
and Section 204 United States New Payment Code, cited n.11 above.

17. See pp.330-339 supra.

18. In order for the insurance theory to operate as a valid risk allocation mechanism, it should not base its risk allocation rule on the party's capability to provide for insurance only. It should take into account, among other things, the degree of blame for causing the occurrence of loss that could be attributed to the party in question. If the risk in question was to be allocated to a particular party, regardless of the said party's or other party's degree of fault in not providing against the occurrence of loss, the theory would allocate the evolving risk inefficiently. Its application could give rise to moral hazard. That is to say that the party to whose favour the application of insurance theory would run, might be encouraged to behave carelessly. Accordingly, the rate of accident occurrence would increase. The loss resulting from such accidents would have initially to be borne by the party to whom the insurance theory allocates loss who might well be an innocent party. And in instances where the resulting loss is trivial, the innocent party to whom it is initially allocated might have to absorb it. The careless party would then escape liability. cf. pp.162-164 supra.

In instances where the loss in question results from the erroneous payment of a forged instrument it should not be allocated to either the innocent purported maker/drawer or the bona fide third party acquirer. Neither of the said parties, due to their status as such could reasonably be blamed for the occurrence of loss. The party who is in the best position to provide against the occurrence of the said loss is the drawee payor. His failure to

exercise care in providing against the occurrence of the forgery and his failure to exercise care in providing for its detection, is submitted to attribute to him the blame for contributing to the occurrence of loss.

Should the drawee payor decide for his own profit and administration to avail himself of the advantages of negotiable instrument truncation, his decision as such should not cloud the issue of care. Should, however, the drawee payor decide to pay the presented instrument without insisting on its physical remittance, he should pay through insurance for his administrative gain.

His abstention from examining the genuineness of the presented instrument and his waiver of demanding its physical remittance for examination, arises from an economic consideration. He considers the non-examination of the instrument in question is less detrimental from his point of view than the exercise of a high standard of care. cf. pp.348-350 infra.

19. For a critique of the argument which determines the purported maker drawer or the bona fide third party acquirer, as the party to whom the risk of the forgery of negotiable instruments should be allocated,
cf. Dow and Ellis, The Proposed Uniform New Payments Code (1985) 22 Harv. J. Legisl., 426-430.

The American Law Institute (A.L.I.) and the National Conference of Commissioners of Uniform State Laws (N.C.C.U.S.L.) were also critical of the above mentioned argument. They rejected Section 204 of the proposed New Payment Code (N.P.C.) which incorporated the said argument. They, in their recent revision of Article 3 U.C.C., reinstated the doctrine of Price v Neal. They were in favour of the rule which allocates the risk of the forgery of negotiable instruments to the drawee payor.
cf. New Article 3-419 U.C.C. and the A.L.I. Progress Report on Articles 3, 4 and 4a U.C.C., P.18.

20. cf. Dow and Ellis, The Proposed Uniform New Payments Code, (1985) 22 Harv. J. Legisl., 426.

Hudak and MacPherson, Forged Altered or Fraudulently Obtained Checks, (1977), 23 Prac. Law.

21. cf. A.L.I. Progress Report on Articles 3, 4 and 4a U.C.C., p.27.

22. Dow and Ellis, The Proposed Uniform New Payments Code, (1985), 22 Harv. J. Legisl.

Hudak and MacPherson, Forged Altered or Fraudulently Obtained Checks, (1977), 23 Prac. Law.

23. However the drawee may by way of fixing a high rate of periodic and service charges on consumer cheques and on businesses' small cheques, recover in the long run, the loss arising from the erroneous payment of forged instruments, the examination of which is not considered practicable in banking channels. Such application is more sound than the rule of distinguishing between the erroneous payment of small instruments and that of large instruments. Whereby in the former instance, the drawee is allowed to shift the loss to the collecting agent or to any prior transferor, whilst in the second instance, he is denied such right.
cf. Dow and Ellis, The Proposed Uniform New Payments Code, (1985), 22 Harv. J. Legisl., 419.

To state the obvious, the competing parties in instances of paying small instruments and large instruments, namely the drawee payor, and the collecting agent or any prior transferor, are similarly situated. The latter party in instances of small instruments is in no better position to detect the forgery than had the involved instrument been drawn for a large amount. In both instances he cannot provide against the forgery, other than by shopping for information or by refraining from the collection or the acquisition of instruments from strangers. The shopping for information or the abstention from the collection or acquisition from strangers may result in the misallocation of wealth.
cf. pp.15-32 and accompanying n.
Or it may restrict the free transferability of negotiable instruments. Accordingly the objective of promoting the institution of negotiable instruments would fail, cf. p.57 et seq.

Likewise the drawee in instances of paying small instruments is in a no worse position than had the involved instrument been drawn for a large amount. His abstention from carrying out the necessary examination is attributed to his own wilful conduct. He considers the non-examination of small instruments more economic than the utility derivable from them had the examination been carried out.

24. See pp.100-107 supra.

25. Assume that Volandro Leoni is an Italian businessman. In addition to the large shoe store which he runs, he owns shares in the international Stock Exchange markets. Through his office linked computer he monitors the share fluctuations in the Stock Exchange markets.

On one of his holidays, Sẽnor Leoni stops in London. During his stay, the shares in the City boom. Leoni telexes to his secretary and instructs him to remit to him, i.e. Leoni, the registration certificates of the shares which he holds in B.P. Through a stockbroker,

Leoni sells the said shares and takes in consideration an inland cheque.

Assume further that Sẽnor Leoni decides to purchase English made shoes for his business. If banks and department stores were discouraged from cashing personal cheques in favour of a stranger, Volandro Leoni would not be able to liquidate his cheque into money. He would not be able to utilise the said cheque to finance other transactions. Ultimately he would not be able to utilise the said cheque to satisfy his commercial needs. The credit incorporated in it would be of little practical value. It would not be utilised until Sẽnor Leoni returns home and cashes it or deposits it for collection with his bank.

26. The Geneva Conference on the Unification of the Laws Relating to Bills of Exchange Promissory Notes and Cheques, 2nd session 1931, admitted the practice of certification. Nevertheless, the concept of certification in the Geneva legal systems has a different connotation to that found in the U.C.C. By virtue of Article 6 of Annex II on the Reservations to the Convention on the Uniform Law, the practice of certification does not operate as an acceptance. It does not impose upon the drawee bank a contractual liability in favour of the holder of the cheque. Article 6 reads,

> "Each of the High Contracting Parties may provide that a drawee may write on the cheque a statement of certification, confirmation, visa, or other equivalent declaration, provided that such declaration shall not operate as an acceptance and may also determine the legal effects thereof."

In the U.C.C., certification operates as an acceptance. It accordingly imposes upon the bank i.e. the party who fixes his certification, a contractual liability in favour of the holder. The bank promises to honour the certified instrument on its day of maturity. Should it fail to pay the instrument the holder may enforce its face value against the bank in reliance on the contractual promise. Article 3-411 reads in part,

> "(1) Certification of a cheque is acceptance. Where a holder procures certification the drawer and all prior indorsers are discharged ..."

And Article 3-413 reads in part,

> "(1) The maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement or as completed pursuant to Section 3-115 on incomplete instruments ..."

In February 1941, France promulgated a law regulating the rules as to certification. Certification in this context is given a definition in conformity with that

established in Article 6 of Annex II on the Reservations to the Convention on the Uniform Law Relating to Cheques. Accordingly the practice of certification does not resemble the act of acceptance. Its only legal effect is to certify the existence of the credit against which the cheque is drawn with the bank, during the maturity of the cheque in question.

cf. Farnsworth, The Cheque in France and the United States - A Comparative Study, (1961-62), 36 Tulane L. Rev. 260.

27. In the Continental Geneva legal systems, cheques are given a short period of circulation. By virtue of Article 29 G.U.L.(Cheques) inland cheques may not be in circulation for more than 8 days. Cheques drawn in one country and payable in another may not be in circulation for more than 20 or 70 days, depending on whether the countries in question are situated in the same continent or in different continents. Nevertheless, by virtue of Article 14 of Annex II on the Reservations to the Convention on Uniform Law Relating to Cheques, each of the countries ratifying the G.U.L.(Cheques) may reserve its right to derogate from the provision of Article 29. It may prolong the time limit within which cheques may circulate. The said power is conferred upon the contracting country for inland as well as foreign cheques. If however cheques were in circulation beyond the fixed time limit, they forfeit their significance as negotiable instruments. The holder of such a cheque would need to establish his claim against the prior party, against whom he intends to enforce the cheque, and he may need to answer defences and claims which the said party might interpose against him. The cheque which has been in circulation beyond the fixed time limit operates in the hands of its holder as an assignment of right. Prior parties may then defeat the holder's claim by interposing their personal defences against him.

cf. Article 24 G.U.L.(Cheques).

The ratio underlying the shortening of the time limit within which cheques, as such, may be in circulation, is said to be to prevent the usage of cheques from overlapping with the function of money.

cf. Farnsworth, The Cheque in France and the United States - A Comparative Study, (1961-62), 36 Tulane L. Rev., 260.

In France, cheques drawn and payable in French territory may not be in circulation for more than eight days.

cf. Article 29 of Decret Loi 30th October 1935, and Amos and Walton's Introduction to French Law, (1967), 3rd Edtn., 368.

Thus, and as far as the above illustration is concerned, if the bank with whom John Alex deposited the inland French cheque for collection was under a duty to shop for information concerning the status of the deposited cheque and the status of its depositor, i.e.

John Alex, the time involved in the shopping for information might overlap with the maturity of the cheque. The bank may need more than five days to collect the relevant information and ultimately render the relevant decision. The said time, as could be noted may overlap with the maturity of the cheque i.e. 8 days. Accordingly, John Alex may forfeit the advantages inherent in the cheque as a negotiable instrument. He may need to establish his claim against the drawer Pierre Legrand and he may need to answer personal defences and claims interposed against him by the latter.

28. Since the practice of certification in France operates only as a confirmation of the existence of the credit against which the cheque is drawn cf. n.26 above, its legal effect is confined to the time limit within which cheques may be in circulation. The statement of circulation forfeits its practical value soon after the expiration of the fixed time limit e.g. eight days. Accordingly, the drawee would be discharged from the liability arising from his certification. The holder may not enforce the credit incorporated in the cheque if the said enforcement was sought to be made after the expiration of the fixed time limit.
cf. Farnsworth - The Cheque in France and the United States - A Comparative Study (1961-62) 36 Tulane L. Rev., p.260.

29. See pp.107-111 supra.

30. See pp.330-342 supra.

31. It has been established earlier cf. page 65, that the notion of fairness and justice would be achieved once the loss in question is allocated to the party who suffers the least hardship from it. The party who suffers the least hardship in the context of negotiable instrument fraud is the party who is better situated to derive an enforceable value from the cost and time evolving from the exercise of a high standard of care, or the party who is in the best position to absorb such cost and time. As could be noted, the notion of fairness and justice with reference to the concept of hardship is compatible with the idea of economic efficiency. Its application allocates the resulting loss to the party who is in the best position, in the economic sense, to provide against its occurrence.

32. cf. p.111 supra.

33. See pp.340-342 supra.

34. See pp.351-361 supra.

35. See pp.331-332 supra.

36. Moral hazard is a term of art in the law of economics. It denotes what is commonly known as careless behaviour,
cf. Veljanovski, The Economic Approach to Law, (1981) 142, 143.

37. See 372 infra.

38. Ibid.

39. See pp. 340-342.
As to the compatibility of the allocation of the duty to exercise a reasonable standard of care to the purported maker/drawer with his reasonable expectation, the special nature of negotiable instruments and economic efficiency, see p.372.

40. See pp.332-339 supra.

# CHAPTER SIX

## THE COMPATIBILITY OF THE ATTITUDE OF THE ANGLO-AMERICAN AND THE CONTINENTAL GENEVA LEGAL SYSTEMS IN ALLOCATING THE RISK OF THE FORGERY OF INSTRUMENTS WITH THE PROPOSED RISK ALLOCATION RULE.

### INTRODUCTION

The central issue of this chapter is to examine the compatibility of the attitude of the Anglo-American and the Continental Geneva legal systems respectively in allocating the risk arising from the forgery of negotiable instruments with the rational risk allocation rule as proposed in the previous chapter. Throughout this discussion, a brief account of the above proposed risk allocation rule will be made in the appropriate place, whereas cross references to the previous chapter will be made for a detailed account of the said rule.

(i) The Anglo-American and the majority of the Continental Geneva legal systems adhere to a common risk allocation rule, as far as the forgery of negotiable instruments is concerned. They, in principle, allocate the risk arising from the forgery of negotiable instruments in a manner compatible with the proposed rational risk allocation rule.

In instances of dishonour, they allocate the said risk to the bona fide third party acquirer. They approach such application by denying the binding attribute to the forged signature. Accordingly, no liability could

be established against the purported signatory e.g. the purported maker/drawer. The bona fide third party acquirer, in the last analysis, cannot enforce the forged instrument against the purported signatory.

The Anglo-American legal systems import the non-binding attribute to the forged signature by denying its operativeness (Section 24 B.E.A. and Article 3-404 U.C.C.[1]). The Continental Geneva legal systems import the non-binding attribute of forged signatures by an express provision to this effect (Article 7 G.U.L.(Bills) and Article 10 G.U.L.(Cheques)[2]).

In instances of payment, the legal systems under consideration allocate the risk arising from the forgery of negotiable instruments to the drawee/payor. They deny to the forged signature its binding attribute. They deny to the drawee the right to establish any liability against the purported signatory i.e. the purported maker/drawer. Ultimately, they deny him the right to enforce the erroneous payment against the said party.

The Anglo-American legal systems approach the above application by denying to the forged signature, its operativeness. Accordingly, no valid discharge could be established through it.[3] The majority of the Continental Geneva legal systems approach the said rule by cross referring to the generally accepted rule in the civil law. Debtors, under the said rule, may not pay the due obligation in favour of someone other than the creditor or the party to whose favour the payment order is directed.[4]

The Anglo-American and the Continental Geneva legal

systems, on the other hand, deny to the drawee payor the right to recover from the bona fide third party acquirer/recipient, the proceeds of the erroneous payment. They establish in favour of the acquirer/recipient a legal title to the paid proceeds. The bona fide acquirer/recipient is, accordingly, entitled to retain the erroneously paid proceeds.

The Anglo-American legal systems approach the above rule by way of derogating from the general rule, namely, parties making payment in the mistake of fact as to its validity, are entitled to reclaim it back in restitution from the recipient.[5]

The Continental Geneva legal systems approach the above rule by drawing an analogy between the erroneous payment of a forged instrument and the erroneous payment of an instrument drawn against insufficient funds. In both instances, they establish a holder status in favour of the acquirer recipient. Ultimately, they establish a legal title to the paid proceeds in favour of the said party.[6]

(ii) The competing parties' relative ability to provide against the risk of the forgery of negotiable instruments was one of the main considerations underlying the formulation of the above rule. Lord Mansfield in the celebrated case of Price v Neale[7] expressed the view that the drawee/payor is presumed to be in the superior position to provide against the risk of the forgery of negotiable instruments. Due to his status as a party

with whom creditors keep a facsimile of their signatures, he is presumed to be in the best position to unveil the forgery. Lord Mansfield observed ...

> "Here was no fraud: no wrong; it was incumbent upon the plaintiff to be satisfied that the bill drawn upon him was the drawer's hand before he accepted or paid it; but it was not incumbent upon the defendant to enquire into it. Here was notice given by the defendant to the plaintiff of a bill drawn upon him: and he sends his servant to pay it and take it up. The other bill he actually accepts; after which acceptance the defendant innocently and bona fide discounts it. The plaintiff lies by for a considerable time, after he has paid these bills, and then found out that they were forged; and the forger comes to be hanged. He made no objection to them at the time of paying them. Whatever neglect there was, was on his side. The defendant had actual encouragement from the plaintiff himself for negotiating the second bill from the plaintiff's having without any scruple or hesitation paid the first: and he paid the whole value bona fide. It is a misfortune which has happened without the defendant's fault or neglect. If there was no neglect in the plaintiff yet there is no reason to throw off the loss from one innocent man upon another innocent man: but in this case if there was any fault or negligence in anyone it certainly was in the plaintiff and not in the defendant."[8]

The above proposition led some observers to believe that the ratio underlying the rule in the case at bar was the "negligence" of the drawee payor. Upon such finding they attempted to set limits to the said rule. They were of the opinion that the risk arising from the erroneous payment of a forged instrument should be allocated to the bona fide acquirer recipient in instances where no negligence could be attributed to the drawee/payor.[9]

To state the obvious, the above quoted proposition

does not suggest that Lord Mansfield regarded the plaintiff Price, i.e. the drawee/payor in that case, as negligent, nor did he suggest that had the drawee/payor been free from negligence, he would have been entitled to recover the proceeds of the erroneous payment from the bona fide acquirer/recipient i.e. the defendant Neale. Mathew J. in London & River Plate Bank v Bank of Liverpool[10] expressed a similar view. He discarded the idea of negligence as a ratio underlying the decision in Price v Neale, holding that ...

> "... it was not said in that case that there had been negligence. Nor was it said that if there had been no negligence the action will lie."[11]

Apparently the term "negligence" in Lord Mansfield's above quoted proposition was not meant in the sense in which it is generally used, based upon the notion of duty of care and the standard of conduct of "the reasonable man" as the test for establishing the liability of the party in question. Such interpretation is reinforced by the fact that, in instances where the forgery of a signature was cleverly executed and the drawee would not have had the chance to unveil the forgery had he exercised the care of a reasonable man, the risk allocation rule would not be allocated to the other competing party. The risk arising from the erroneous payment would remain allocable to the drawee payor. The term negligence in the above quoted proposition, accordingly, must have been meant to be applied in a broader sense, denoting the breach of a higher standard of care.[12]

## The Party to Whose Favour the Anglo-American and the Continental Geneva Legal Systems Establish the Risk arising from the Forgery of Negotiable Instruments in Instances of Dishonour.

The Anglo-American and the majority of the Continental Geneva legal systems establish the risk arising from the forgery of negotiable instruments in instances of dishonour in favour of the purported maker drawer. They do not establish against him a liability rule. They deny to the bona fide third party acquirer the right to enforce the forged instrument against the purported maker/drawer.[13]

The legal systems under consideration however do not adhere to an absolute application of the above rule. They impose particular limitations, the impact of which could result in shifting the general risk allocation rule.

## The Continental Geneva Legal Systems.

(i) The majority of the Continental Geneva legal systems limit the application of the above mentioned rule to the instances where the purported maker/drawer i.e. the party to whose favour the risk allocation rule is applicable, was free from negligence.[14] If the said party was guilty of negligence, the bona fide third party acquirer, i.e. the party to whom the risk is initially allocated, may reallocate the entire loss arising from the forgery of the negotiable instrument in question, to the former.[15]

The rule that the loss arising from the forgery of

negotiable instruments may be reallocated to the purported maker/drawer in instances of the latter's negligence, could be traced to the general application of the rules of negligence. As a general rule, it is submitted that as far as the Continental Civil legal systems are concerned, a man cannot take advantage of his own wrong. Whoever causes another to be misled, may not draw back from the position which his misconduct has caused. In implementing the said rule, the Continental Civil legal systems do not require the presence of a specific duty of care. By comparison, they impose upon every member of the community a general duty of care not to injure another. The failure to comply with the said duty may accordingly establish against the negligent party a liability in favour of the plaintiff victim.[16]

Negligence in the safe custody of blank instruments is an illustration of the operation of this rule. Whoever leaves his blank instruments without guard in a place where their vulnerability to theft becomes increasingly foreseeable, is presumed to be negligent. If a dishonest person in such an instance steals the negligently placed blank instrument, forges the proprietor's signature, issues it to his favour, and indorses it to a bona fide third party for value, the negligence in the safe custody of the blank instrument is presumed to have misled the bona fide third party acquirer as to the true status of the offered instrument and the status of its possessor. It is presumed to have led the bona fide third party acquirer to believe that the

instrument was genuine and the title of its possessor was valid. Finally, it is presumed to have caused the bona fide third party acquirer to cash the offered instrument for the thief forger.

(ii) At the Geneva conference on the Unification of the Laws relating to Bills of Exchange, Promissory notes and Cheques, 2nd session, the representatives of the Continental Civil legal systems admitted the applicability of the immediately above rule.[17] The representative of the Italian government articulated the above rule in an express provision. The proposed article 26 bis provided in part that the loss arising from the payment of a forged instrument shall be allocated to the drawee payor, unless the said party could show that the negligence of the purported maker/drawer has caused the loss to occur. The proposed article reads:

> "The drawee who pays a cheque that has been altered or forged cannot apply to the drawer for repayment unless the latter has committed a fault or unless the forgery, alteration or falsification is attributable to one of his employees.
> Any stipulation to the contrary is null and void."[18]

The significant part of the above proposed article is that it reallocates the risk arising from the payment of a forged instrument to the negligent purported maker/drawer. By analogy, the bona fide third party acquirer should be able to reallocate the risk arising from the dishonoured forged instrument to the purported maker/drawer. The bona fide third party acquirer of a dishonoured forged instrument is similarly situated with the drawee payor

of a forged instrument. They are presumed to be, as between themselves and the purported maker/drawer, the risk bearers in instances of dishonour and payment respectively. Their status as such does not necessarily arise from their negligent behaviour, rather it arises from their being better situated to provide against the occurrence of the risk in question. In instances where the status of the competing parties changes, as when the purported maker/drawer behaves negligently, the equities of the party to whom the risk is initially allocated, becomes superior to the equities of the other competing party. Since, by virtue of the proposed article 26 bis mentioned above, the drawee payor is entitled to reallocate the risk to the negligent purported maker drawer, the bona fide third party acquirer of a dishonoured forged instrument, should be entitled to reallocate the risk to the negligent purported maker drawer. Like the drawee in instances of payment, the equities of the innocent bona fide third party acquirer in instances of dishonour become superior to the equities of the negligent purported maker/drawer.[19]

The English Legal System

The law in the English legal system requires, among other things, the presence of a specific duty of care in order to raise the concept of negligence as a cause of action.[20] For a specific duty of care to be present, the injurer and the victim must be "in privity" so far as the

damage sought to be recovered takes the form of economic loss.[21] That is to say that the victim must be closely connected with the injurer, so that the latter will take him into consideration whilst he is carrying out his act.

## The Concept of Negligence as a Cause of Action in the English Context of Negotiable Instruments

(i) Unlike the law on the Continent, there is no general duty to exercise reasonable care owed to the public. Ashurst J. once attempted to lay down a general proposition to this effect. In Lickbarrow v Mason[22] he observed that ...

> "We may lay it down as a broad general principle that whatever one of two innocent persons must suffer by the acts of a third, he who has enabled such third person to occasion the loss must sustain it."[23]

Nevertheless, courts in subsequent cases denied the applicability of such a broad proposition to English law. In Swan v North British Australasian Co.[24] Blackburn J. expressed the necessity of the presence of a specific duty of care requirement in order to raise the concept of negligence as a cause of action. He held that:

> "He who omits to qualify the rule he has stated by saying the neglect must be in the transaction itself and be the proximate cause of the leading the party into that mistake and also as I think that it must be the neglect of some duty that is owing to the person led into that belief or what comes to the same thing to the general public of whom that person is one and not merely neglect of what would be prudent in respect to the party himself or even of some duty owing to third persons with whom those seeking to set up the estoppel are not privy."

In London Joint Stock Bank v Macmillan & Arthur,[25] the House of Lords put the rule in clear words, that the broad proposition laid down by Ashurst J. has no application to English Law. The rule as laid down by Blackburn J. expresses the correct interpretation of the English law. Parmoor L.J. observed:

> "My Lords, in the hearing of the appeal a very large number of cases were referred to in the exhaustive arguments of counsel. I desire to refer further to only two of these cases. It must be taken that the rule expressed by Ashhurst J. in Lickbarrow v Mason is too wide when he says, 'We may lay it down as a broad general principle that whatever one of two innocent persons must suffer by the acts of a third, he who has enabled such third person to occasion the loss must sustain it.', and that the accurate rule is stated by Blackburn J. in Swan v North British Australasian Co."[26]

(ii) The requirement that the plaintiff must be privy i.e. closely connected with the defendant in order to establish the presence of a specific duty of care owed to him is submitted to be narrowly defined in the context of negotiable instruments. A party is deemed to be privy with another if he is engaged in a contractual relationship with him or his involvement in the other party's conduct is almost certain to occur. Thus, the parties privy with the maker or drawer of a negotiable instrument are the drawee and the collecting bank. The former's close connectedness arises from the contract of deposit according to which the drawee engages with his customer. The collecting bank's close connectedness with the maker or drawer arises, by comparison, from the fact that the collecting bank's involvement in the dealing with negotiable instruments is almost certain to occur. The large majority of negotiable instruments are not paid at the counter, rather their payment is arranged through

an independent agent. The possessor of a negotiable instrument deposits his instrument with a collecting bank. The latter either directly or through an intermediary presents the deposited instrument to the drawee for payment.

The remote acquirer of a negotiable instrument is not, by comparison, either in a contractual relationship with the maker or drawer, nor is his involvement in the negotiable instrument transaction almost certain to occur. The maker or drawer of a negotiable instrument engages in a direct contractual relationship with the immediate acquirer only i.e. the payee. In the second place, the maker or drawer of a negotiable instrument might not intend at the time of issuing it that the instrument in question shall be circulated in the stream of commerce. He might arrange with his immediate transferee i.e. the payee, that the instrument shall not be transferred to a third party.

In light of the foregoing, courts in the legal system under consideration are of the opinion that the maker or drawer of a negotiable instrument is not under a duty to exercise reasonable care towards the remote acquirer i.e. holder. Accordingly, the former would not be liable in negligence to the acquirer should the latter sustain an injury as a result of the maker's or drawer's lack of care. In **Scholfield v The Earl of Londesborough,**[27] the House of Lords observed that the defaulting drawer of a negotiable instrument is not liable for any damage caused by his negligence to the remote acquirer. Lord Halsbury

questioned the applicability of Pothier's proposition, upon which the ratio of the drawer's fault rule is believed to be based, to English Law.[28] His Lordship observed:

> "My Lords, I do not myself think that either the original by Scacchia or the commentary by Pothier are relevant to the matter in hand. We are not dealing here with either mandant or mandatory and I do not think it is part of the commercial law of England howsoever applied and before accepting the modified doctrine of Pothier it is well to see what that doctrine is."[29]

His Lordship went on to say:

> "It seems to me it would be a very serious proposition to lay down that such questions should be permitted to arise when dealing with such an instrument as a bill of exchange and other questions would then arise as I think was pointed out in the course of the argument. A minute examination of every bill tendered for acceptance and a consideration of how far its form might give an opportunity to a forger to forge and escape detection. My Lords this very case has in almost precisely similar circumstances already been decided in the Adelphi Bank v Edwards and I regret very much that that case has not been reported. I entirely concur with what Lindley L. J. said in that case and it was wrong to contend that it is negligence to sign a negotiable instrument so that somebody else can tamper with it and the wider proposition of Bovill C. J. in a former case, Societe Generale v Metropolitan Bank that people are not supposed to commit forgery and that the protection against forgery is not the vigilance of parties excluding the possibility of committing forgery but the law of the land.
>
> It appears to me that even if the modified rule laid down by Pothier considering the principles on which that learned author himself relies for its acceptance is not and never has been the law of England, I think this appeal ought to be dismissed with costs."[30]

Lord Watson observed in the same case,

> "If, on the other hand, the decision in Young v Grote was based upon the ratio that the customer in filling up the cheque through his wife, whom he had constituted his agent for that purpose, had failed in the duty which he owed to his banker by giving facilities for fraudulent alteration, I am not prepared to affirm that it cannot be supported by authority. But it does not in my opinion necessarily follow that the same rule must be applied between the acceptor of a bill of exchange and a holder acquiring right to it after acceptance. The duty of the customer arises directly out of the contractual relation existing at the time between him and the banker who is his mandatory. There is no such connection between the drawer or acceptor and possible future indorsees of a bill of exchange."[31]

In London Joint Stock Bank v Macmillan and Arthur,[32] the House of Lords re-affirmed the decision in Young v Grote. It dismissed Lord Halsbury's contention that Pothier's proposition has no application whatsoever in English law. It expressed the view that a duty to exercise reasonable care exists as between the customer and his banker. However, and so far as the question turns on the existence of a duty to exercise care to the remote indorsee, i.e. acquirer, the House of Lords in the London Joint Stock Bank case approved its decision in the Scholfield case. It answered the said question in the negative, that is to say that no duty of care is owed either by the drawer of a negotiable instrument or its acceptor, to the remote acquirer. This could be inferred from the passages which Lord Finlay L.C. quoted with approval from the judgement of the five out of six peers who decided the case in question.[33]

Thus, if John Alex recruited in his business a

dishonest secretary, who, to Alex's knowledge was guilty of fraud on previous occasions, and entrusted him with the seal and cheque books of the business, and the dishonest secretary steals several of the business cheques, misuses the seal, issues cheques in his favour and indorses them to Billy Barnes, a bona fide third party, in discharge of due monthly rents of a house let by Billy Barnes to the dishonest secretary, the bona fide third party acquirer i.e. Billy Barnes, may not be heard to set up John Alex's lack of care in recruiting a dishonest person and in the failure to supervise his job as a defense for enforcing the credit incorporated in the fraudulently issued cheques against John Alex. In such an instance, Billy Barnes is not in privity with John Alex; accordingly, the latter does not owe him a specific duty of care. In the last analysis, no negligence could be attributed to John Alex and finally, no liability in negligence could be established against him.

The Evolution of the Concept of Negligence

(i) In so far as the resulting damage falls within the category of "physical damages" i.e. damage to life, limb or property, courts managed to break away from the rigidity of the narrow conception of close connectedness. They interpreted the doctrine of "proximity" i.e. close connectedness so as to denote "foresight".[34] They laid down the rule that physical damage would be recoverable if its occasioning by another was forseeable to the

wrongdoer, had he directed his mind as a reasonable man would at the time of the act or omission, which is called into question.

The above rule was firmly established for the first time in the celebrated product liability case i.e. Donoghue v Stevenson,[35] in which a friend of Mrs. Donoghue bought from a cafe a contaminated bottle of ginger beer for Mrs. Donoghue. The latter brought the action against the manufacturer of the ginger beer for the recovery of the damage caused to her health.

Lord Atkin's famous passage read before the House of Lords is submitted to be an interesting one.[36] He laid down what then became known as the neighbour test. His Lordship observed that every member of the public is under a duty not to injure his neighbour. A person is deemed to be my neighbour if he is so closely and directly affected by my act that I ought reasonably to have him in contemplation as being so affected when I am directing my mind to the acts or omissions which are called into question.

(ii) As an application of the above test, Lord Atkin extended the liability of a manufacturer of defective products in favour of the remote consumer. Since he, i.e. the negligent manufacturer elects to set his defective product free in the stream of commerce, he ought to forsee that a third party might come into contact with the said product and sustain an injury. In light of such finding,

the court in Donoghue v Stevenson gave judgement in favour of the plaintiff Mrs. Donoghue.

(iii) Courts in later cases, on the basis of the wide application of the "proximity" concept as laid down in Lord Atkin's neighbour test, attempted to extract a general principle of law and extend the application of the above rule to other areas of the law. The risk arising from the defective construction work was in particular an area of the law in which courts attempted to extend the application of the rule in Donoghue v Stevenson. The judgement of Lord Wilberforce in Anns v Merton London Borough Council[37] was of significance in this connection. He suggested two stages, the satisfaction of which could establish the presence of the duty to exercise reasonable care. He observed that in the absence of any compelling policy consideration, the duty to exercise reasonable care should be established in instances where the ensuing damage is reasonably forseeable. The passage reads:

> "The position has now been reached that in order to establish that a duty of care arises on a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather the question has to be approached in two stages. First, one has to ask whether as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity or neighbourhood such that in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative or to reduce or limit the scope of the duty of the class of person to whom it is owed or the damages to which a breach of it may give rise."[38]

(iv) Lord Roskill in Junior Books Ltd. v Veitchi[39] applied the two stage test of Lord Wilberforce to situations where the ensuing damage took the form of "economic loss". Junior Books Ltd. v Veitchi involved the supervision of the construction of a defective floor of a factory by a sub-employed architect. The floor after a while developed cracks. Nevertheless, it was not alleged at the time of the trial that the defective floor represented a risk to life, limb or property. The proprietor of the factory had to remedy the defect and in the course of doing so he incurred loss.

Since the sub-employed architect and the proprietor were not in privity in the strict sense and on the other hand the involved damage did not fall within the category of recoverable damages i.e. physical damages no liability could be established in the traditional sense against the former. Nevertheless, Lord Roskill in giving his judgement observed that the question whether a duty to exercise reasonable care exists should be established by reference to sound legal principles and not by capricious judicial determination such as those based on contract, delict and quasi delict or by applying artificial distinctions such as that applied by the various categorisation of damages. He was of the view that the two stage test laid down by Lord Wilberforce in the Anns case represented the sound legal principle. His Lordship held:

> "I think today the proper control lies in not asking whether the proper remedy should lie in contract or instead in delict or tort not in somewhat capricious judicial determination whether a particular case falls on one side of the line or the other not in somewhat artificial distinctions between physical and economic or financial loss when the two sometimes go together and sometimes do not (it is sometimes overlooked that virtually all damage including physical damage is in one sense financial or economic for it is compensated by an award of damages) but in the first instance in establishing the relevant principles and then deciding whether the particular case falls within or without those principles. To state this is to do no more than to restate what Lord Reid said in Dorset Yacht and Lord Wilberforce in Anns. Lord Wilberforce in the passage I have already quoted enunciated two tests which have to be satisfied. The first is sufficient relationship of proximity the second any considerations negativing reducing or limiting the scope of the duty or the class of the person to whom it is owed or the damages to which a breach of the duty may give rise. My Lords, it is I think in the application of those two principles that the ability to control the extent of the liability in delict or in negligence lies."[40]

Recent Restrictions on the Modern Concept of Negligence

(i) In the more recent cases, English courts are reluctant to accept the fact that Lord Wilberforce's two stage test lays down a rule of law of a universal application. They expressed their doubts that the above quoted broad proposition was meant to formulate the test for establishing the presence of the duty to exercise care for every area of cases[41]. Lord Brandon of Oakbrook in **Leigh & Sillivan v Aliakmon Ltd.**[42] commented on Lord Wilberforce's two stage test and said:

> "The second observation which I would make is that Lord Wilberforce was dealing, as is clear from what he said with the approach to the questions of the existence and scope of a duty of care in a novel type of factual situation which was not analogous to any factual situation in which the existence of such a

> duty had already been held to exist. He was not, as I understand the passage, suggesting that the same approach should be adopted to the existence of a duty of care in a factual situation in which the existence of such a duty had repeatedly been held not to exist."[43]

(ii) As an application of the recent limitation imposed upon Lord Wilberforce's two stage test, English courts reinstated the rule that the wide application of the proximity concept is confined to the instances where the resulting damage is related to life limb or property of the plaintiff. And in order for the plaintiff to be entitled to recover from the negligent party the damage caused to his property, he must establish a legal or possessory title to the damaged property.[44]

(iii) In instances where the resulting damage takes the form of economic loss, courts interpret the concept of proximity in the traditional narrow sense. They infer the existence of proximity situations where the negligent party and the plaintiff are in privity or closely connected. In such situations only, they infer the presence of a duty to exercise reasonable care. If, by comparison, the plaintiff was not in privity or closely connected with the negligent party, the latter would not owe a duty to exercise reasonable care to the former. If the plaintiff sustained damage to his economic interest as a result of another's lack of care, the latter would not be liable to the former in "negligence". Ultimately, the plaintiff would not be able to recover from the careless party the damage caused to him by the latter's misconduct.

The Concept of Negligence in the Law of Negotiable Instruments Revisited.

(i) From the foregoing, it appears that since English courts have long established the rule that makers drawers and acceptors of negotiable instruments do not owe a duty to exercise reasonable care to the future indorsee i.e. remote acquirer, Lord Wilberforce's two stage test does not have an application to establish the presence of such a duty. In Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd.[45], the Privy Council refused to extend Lord Wilberforce's two stage test to negotiable instrument cases. It reinstated the rule as laid down in Scholfield v the Earl of Londesborough[46] and affirmed by the House of Lords in London Joint Stock Bank v Macmillan and Arthur.[47]

The Tai Hing case involved the payment of cheques fraudulently made in the name of a medium sized company by its accounts clerk Mr. Luing. Tai Hing Cotton Mill Ltd. was a company doing business in Hong Kong. It was engaged in the textile business. The company operated through its divisions. Each of the divisions opened its own current account in the name of the company. The company had in its employ a dishonest accounts clerk, namely Mr. Luing. Luing managed to defraud the company by filing forged invoices to its managing director who was authorised to sign cheques in the company's name. He misrepresented to the director that the company was indebted to a real supplier. In reliance on the filed invoices the managing director issued cheques to the named

supplier and delivered them to Luing for remittance. The latter did not however intend that the named supplier should have an interest in the cheques. He accordingly cashed the cheques and misappropriated their proceeds.

After the fraud was discovered, the company did not dismiss Luing from his job. On the contrary and after the death of his superior Luing took over the job of the latter. From 1972 until 1978 Luing managed to misappropriate the funds of three of the company's divisions. He forged the signature of the managing director and cashed the cheques with the defendants. During the said period he managed to forge some three hundred cheques.

The counsel for the defendants i.e. the payor banks, argued that the company, Tai Hing, owed "a wider duty of care" and "a narrower duty of care" to the payor banks. Under the wider duty of care, the counsel for the defendants argued that the company is under a duty to exercise such precautions as a reasonable customer in its position would take to prevent forged cheques being presented to the banks. Under the narrower duty of care it is argued, by comparison, that the company is under a duty to examine its monthly statements so as to be able to notify the banks of any items which were not or may not have been authorised by it.

The counsel argued that the above mentioned duty of care arises in contract as well as in tort. As an authority for his argument, he cited the two stage test of Lord Wilberforce as laid down in Anns v Merton London

Borough Council. He contended that the rule in Anns has transferred the law of negligence in English law from the traditional sense to the modern sense. The presence of a duty to exercise reasonable care should, by virtue of the Anns case, be determined by reference to Lord Wilberforce's two stage test.[48]

The relevant part of the argument is that related, as far as this section is concerned, to the determination of the presence of the wider duty of care. The failure to comply with the wider duty is submitted to facilitate the occurrence of loss to the bona fide third party acquirer. Thus the determination of the presence of the said duty vindicates the right of the third party acquirer to recover from the purported maker/drawer the face value of the acquired forged instrument.

The failure to examine bank statements and the failure to report any irregularity does not normally, by comparison, contribute to the occurrence of loss to the third party acquirer. The latter's relationship with the purported maker/drawer is incidental. Its basis could be limited to a single transaction only. The examination of periodic statements would not remedy the damage caused by the forgery. There might not be another fraudulent instance to which the examination of the bank statement could alert the mind of the third party acquirer.

The Privy Council, in dealing with the presence of a wider duty of care reinstated the traditional rule as laid down in the **Bank of Ireland v Evans' Charities Trustees**[49] and affirmed by the House of Lords in **London Joint Stock**

Bank v Macmillan and Arthur.[50] It held that for a party to plead negligence as a basis for full recovery, it must be negligence in the transaction. That is to say that the failure to exercise reasonable care must be the proximate cause of the resulting damage. Lord Scarman in the case under consideration quoted with approval Lord Finlay in London Joint Stock Bank v Macmillan and Arthur, saying that,

> "Of course the negligence must be in the transaction itself that is in the manner in which the cheque is drawn. It would be no defence to the banker if the forgery had been that of a clerk of a customer that the latter had taken the clerk into his service without sufficient enquiry as to his character."[51]

In instances where the resulting damage was the direct cause of an act perpetrated by an independent party, such as that normally illustrated by the damage resulting from the forgery of negotiable instruments, the negligence of the other competing party such as the negligence of the purported maker/drawer in the safe custody of his blank instruments, is not deemed to be the proximate cause of the damage in question. Accordingly, no liability could be established against the said party. Lord Scarman, in commenting upon the decision in the House of Lords in London Joint Stock Bank v Macmillan and Arthur observed that, despite the new development in the area of the law of negligence as presented in the Anns case, it stands at the present time as good law. His Lordship said:

> "So far as English law is concerned, Macmillan's case has until now been accepted as a binding precedent on the question under consideration though it would be true to say that leading writers on banking law, notably Sir John Paget and many of the banking community have never extended it a very warm welcome."[52]

## The Policy Considerations Underlying the Narrow Conception of Negligence in the Law of Negotiable Instruments.

The reasons which may have led the English courts to persist in their refusal to impose upon the proprietor of blank instruments a duty to exercise reasonable care in the safe custody of his instruments in favour of a bona fide third party acquirer are three in number. In the first place, it is argued that the imposition of such a duty would establish a liability against the proprietor of blank instruments in favour of an indeterminate number of people. This is a form of "the floodgate argument". It is normally advanced in instances where no sufficient proximity exists between the negligent party and the plaintiff. In the second place,it is argued that the damage resulting from the breach of the above duty does not represent a risk to life, limb or property. The damage resulting from the careless custody of blank instruments takes the form of "economic loss" only. Thus blank instruments are not "dangerous" articles as such. Accordingly, the proprietor of such instruments need not provide reasonable precautions to provide against their coming into the possession of a bona fide third party. Finally it is argued that the damage resulting from the

acquisition of forged instruments is not the "direct" consequence of the proprietor's lack of care. The damage resulting from the acquisition of forged instruments is submitted to be the direct consequence of the act of an independent party, namely, the forger.

The Floodgate Argument

(i) The basis of the floodgate argument is to prevent the liability of the negligent party from being indeterminate as to time, people and amount. Such liability, had it been established, would create an undue hardship to the party against whom it is established.

(ii) The liability arising from the negotiation of negotiable instruments is neither indeterminate as to time or amount. Every negotiable instrument has a limit of time within which it may be circulated in the stream of commerce, as a negotiable instrument in the full sense. In the Anglo-American and the Continental Geneva legal systems, time instruments are freely transferable as such until their day of maturity,[53] whilst demand instruments such as cheques and demand bills of exchange are freely transferable for eight days to one year in the Continental Geneva legal systems,[54] whereas they are freely transferable for a reasonable time in the Anglo-American legal systems.[55]

The latter legal systems apply a prima facie presumption as to what constitutes reasonable time.

Under the U.C.C., one month is presumed to be reasonable time.[56]

If however, the instrument in question was in circulation beyond the prescribed time limit, the Anglo-American and the Continental Geneva legal systems deprive the instrument of its practical value. They deem the instrument which circulates beyond the prescribed time limit as an ordinary "chose in action".[57] Accordingly the acquirer of such instrument would not possess a perfect title. Any prior liable party, against whom the instrument is sought to be enforced may set against the acquirer his personal claims and defences.[58]

(iii) As far as the indeterminacy as to the amount is concerned, the sum of money enforceable on negotiable instruments is normally their face value. For a negotiable instrument to be valid, its face value must, by law, be fixed or determinable.[59] However, the enforceable sum may exceed the actual face value of the instrument in instances where the acquirer incurs additional expenses in the course of enforcing his instrument. Examples of such expenses are the drawing up of protest and attorney's fees.[60] To state the obvious, such expenses are consequential of the basic obligation, namely, the face value of the instrument. They arise as a result of the failure to honour the said obligation. Thus, the obligor or purported obligor i.e. the party against whom the instrument is sought to be enforced, ought to expect their occurrence.

(iv) Finally, as far as the indeterminacy as to the number of people to whose favour the liability for the careless custody of blank instruments would run is concerned, it could be replied that the special nature of negotiable instruments dictates the probability of having an indeterminate number of people being involved in the negotiable instrument transaction. The general mercantile custom has long since established in favour of negotiable instruments, the attribute of a chose in action as well as chattels. It, on the one hand made such instruments freely transferable in the stream of commerce and, on the other hand, it empowered the said instruments to transfer with them the incorporated entitlements.[61]

Since, by virtue of the mercantile custom, negotiable instruments are firstly, freely transferable and secondly, they possess the power of transferring with them the incorporated entitlements, remote third parties might come in contact with such instruments. The initial holder acquirer i.e. payee, might without the knowledge of his obligor i.e. the maker or drawer, elect to negotiate the acquired instrument to a third party. As the proprietor of the instrument, the initial acquirer is free to choose the third party to whom he wishes to negotiate it. Thus, any member of the public might be involved in the negotiable instrument transaction. The subsequent acquirer might also elect to negotiate the acquired instrument to another member of the public whereby the ultimate acquirer becomes the holder, i.e. proprietor of the instrument. And by virtue of the negotiable

instrument transaction, he may derive enforceable interests to the incorporated entitlements. Accordingly, an in order to satisfy his interests, he may decide to exercise a right of recourse against the original obligor i.e. the maker or drawer with whom he is not in privity.

From the foregoing, it could be concluded that, since negotiable instruments by their nature, are on offer for every member of the whole world, the involvement of a remote third party in their dealing would be probable. The said party can not accordingly be deemed an alien to the negotiable instrument transaction. The remote obligor on a negotiable instrument or its proprietor, by setting it free in the stream of commerce or by not exercising due care in its safe custody, ought to foresee its coming into the possession of a remote third party. And he ought to foresee that his behaviour as such could induce the third party, to whom the instrument in question was offered for a valuable exchange, to place a reliance on the promise or undertaking incorporated in the signature or purported signature and, ultimately, it could induce the said party to acquire the said document.

Since the involvement of a remote third party is reasonably foreseeable to the maker, prior obligor and the proprietor of a negotiable or blank instrument, the former is presumed to be proximate to the maker, prior obligor and the proprietor. The latter ought, accordingly, to have the remote third party in contemplation whilst they are directing their act. They, accordingly, should

exercise due care so as not to injure the remote third party.[62]

(v) The Anglo-American and the Continental Geneva legal systems recognise the special nature of negotiable instruments as established by the general mercantile custom. They incorporated in their laws the free transferability of negotiable instruments, as well as their chattel nature.[63] Accordingly, they incorporated the rule that the entitlements derivable from the negotiable instrument transaction run in favour of the holder in due course or good faith i.e. the bona fide acquirer. And every member of the public may satisfy the protected holder status.[64] Finally, the ultimate protected holder may, in instances of dissatisfaction, enforce his entitlement against any or all obligors.[65] The party against whom the instrument is sought to be enforced may not set up against the ultimate i.e. remote holder, personal defences and claims which he possesses against his immediate transferee.[66]

It is submitted that the objective underlying the rule of denying to the prior obligor the right of setting up his personal defences against a bona fide third party acquirer is to promote the institution of negotiable instruments. The thesis of allocating the above-mentioned risk to the said party, is based on economic efficiency considerations.[67] The law in the Anglo-American and the Continental Geneva legal systems deems the prior obligor better situated to provide against the

said risk in an economically efficient manner. Due to his election to discharge his underlying obligation by way of negotiating a negotiable instrument and due to his negotiation of the said document in favour of another, he is presumed to have clothed the latter with the lawful holder status. By such behaviour he is presumed to have represented to the whole world that the said party possesses the legal title to the document in question and ultimately he is entitled to procure a valid transfer of its property.

Since the document through which the prior obligor elects to discharge his underlying obligation is negotiable, i.e. freely transferable by nature, he ought to foresee that a remote bona fide third party might be induced by such a representation to acquire the negotiated document. If such an event should occur the prior obligor may not be entitled to draw back from the position which he has created. He may not be entitled to deny the lawful holder status of his immediate transferee, by establishing the existence of a personal defence against him and ultimately he may not be entitled to challenge the protected holder status of the remote bona fide third party, who accepted to acquire the document in question, in reliance on the apparent validity of the representation. The prior obligor is presumed to be better situated to provide against the risk of not obtaining full satisfaction from his immediate transferee as a consideration for the credit incorporated in the negotiated document because he engages directly with such

a party. This he could maintain by either investigating the character of the party with whom he intends to engage or by preserving his right on the document by an express stipulation to that effect.

From the foregoing it could be noted that the Anglo-American and the Geneva legal systems in determining the manner of allocating the risk in instances where it arises from the fraudulent practice of the immediate transferee, place a significant reliance on the notion of foresight. Because they deem the involvement of a remote third party to the negotiable instrument in question, reasonably foreseeable to the prior obligor, they impose upon the latter, the duty to exercise due care in his conduct so as not to injure the third party by setting against him personal claims and defences. They impose, upon the prior obligor, the duty to investigate the character of the party with whom he intends to engage and ultimately they impose upon him the duty to safeguard his interest. In the event that the said party fails to comply with such a duty the legal systems under consideration, in effect, hold him liable in negligence for the resulting loss. This they approach by denying him the right of setting against the bona fide third party acquirer, defences and claims founded on his personal relationship with his immediate transferee.

The Economic Loss Argument

(i) The argument that the damage which takes the form of

economic loss should not be recoverable per se from the negligent party, finds its support in the floodgate argument, namely, that if the category of recoverable damages was to be extended to cover economic loss, the liability of the negligent party might be extended to an indeterminate amount.

In reply, it could be observed that the traditional recoverable damages, namely, damage to life limb and property, represent an economic loss to the plaintiff. This is further reinforced by the fact that such damage is expressed in monetary terms. The court, as well as the plaintiff at the time of execution transforms the physical damage into liquidated damages.

(ii) Secondly, the categorisation of damages into physical and economic is artificial as Lord Roskill in Junior Books v Veitchi has described it.[68] Its application could result in an inefficient allocation of loss. It could allocate the loss to the party least able to provide against it, whilst it, by comparison, could free the party best able to provide against the occurrence of loss from liability. The allocation of loss in this manner could give rise to "moral hazard". The party to whose favour the loss allocation rule would operate might be encouraged to act carelessly.[69]

(iii) An area in which the restriction of recoverable damages to physical damages could result in an inefficient loss allocation rule, is the careless custody of blank instruments. Such an act might induce an independent

party to intercept the misplaced instrument, forge the signature of its proprietor, issue it to his order, and offer it for value to an innocent bona fide third party. The latter might, in reliance on the apparent regularity of the offered instrument, accept to take it for value.

The acquisition of the forged stolen instrument by a bona fide third party represents a loss. The loss is illustrated in the acquirer's allocation of value for a worthless piece of paper. If the proprietor was not liable for the careless custody of his blank instruments, the loss arising from such act would be allocated to the bona fide third party acquirer. Since the offered instrument does not by itself raise any suspicion as to its genuineness, the acquirer is not presumed to be in the best position to provide against the occurrence of loss. The allocation of loss to the third party acquirer would result in undue hardship to him. He would either have to sustain the resulting loss or shop for information concerning the status of the offered instrument in order to safeguard his interest. Either course he chooses would result in an economic detriment against him. He would have to allocate value without receiving an enforceable utility in consideration.

The allocation of loss in the above mentioned manner results in a windfall in favour of the party who is in the position to provide against its occurrence, namely, the proprietor of blank instruments. The proprietor of such instruments, by the exercise of reasonable care in their safe custody, is presumed to be in the position to provide

against the occurrence of loss which may arise from their theft and forgery. The imposition of a duty to exercise reasonable care as to the safe custody of blank instruments does not conflict with his economic interest, nor does the allocation of loss to him, in instances where he fails to exercise reasonable care, conflict with his reasonable expectations.

The imposition of the duty to exercise reasonable care, on the one hand, does not involve the allocation of cost and time in a detrimental manner.[70] The allocation of loss to the proprietor of blank instruments in instances where the loss results from his careless custody, on the other hand, is consistent with the reasonable expectation of a reasonable man. The allocation of loss to him is submitted to be the direct consequence of his failure to exercise reasonable care in instances where the occurrence of loss is reasonably foreseeable.

The fact that the careless custody of blank instruments renders the occurrence of loss reasonably foreseeable is due to the special nature of such instruments. Blank instruments are, after completion, capable of being freely transferable in the stream of commerce. Thus, any member of the public might come in contact with such instruments. The four corners of the instrument do not normally reveal to the third party i.e. to whom it is offered, the existence of any irregularity. Accordingly, the third party might be induced to acquire a worthless forged instrument. Therefore, the proprietor

of blank instruments should use reasonable care to avoid creating loss to bona fide third parties whose involvement in the negotiable instrument transaction is reasonably foreseeable.

The Dangerousness Argument

(i) The essence of the dangerousness argument is that it restricts the right of recovering damages to those instances where the damage in question was the result of the careless control of a dangerous thing, in so far as no proximate relationship exists between the injured and the careless party. If the damage in question was not the result of the improper control of a dangerous thing, such as the making of a false statement or the careless custody of a blank instrument, the said damage would not be recoverable unless the injured could establish the existence of a proximate relationship between himself and the careless party tantamount to a contractual privity and that the latter was in breach of a duty owed to him to exercise care in the making of his statements or the safe custody of his instruments. The said rule was firmly established in the case of Le Lievre v Gould[71] The facts of this case were as follows. Hunt sold land to Lovering. He agreed with the purchasor Lovering that the latter should build two houses on the land. Lovering was unable to finance the construction work. Hunt then agreed to advance the necessary money for this purpose. The money was, however, to be advanced on an instalment

basis, each instalment due after completion of part of the work. The employed architect and surveyor, Mr. Gould, was to certify the progress of the construction work upon which the due instalment could be advanced. Hunt then arranged with Dennes to advance the necessary money for the construction work. In consideration, Hunt agreed to mortgage the land in favour of Dennes. It was also agreed that the money should be paid on an instalment basis and in compliance with the terms of the agreement between Hunt and Lovering. Dennes advanced part of the required money on the basis of the certificates which Gould drafted. Dennes then arranged with Miss Le Lievre to advance the remainder of the money. It was agreed that the advance should be made in compliance with the terms of the original agreement. In consideration, Dennes transferred to Miss Le Lievre the interest which he possessed in the land. Miss Le Lievre advanced the remainder of the required money in compliance with the agreed terms. It was established then that the certificates which Gould drafted were not accurate. They incorporated a false statement as to the progress of the construction work.

The plaintiffs i.e. Dennes and Miss Le Lievre argued that the defendant Gould was under a duty to them to exercise reasonable care in drafting his certificates. They alleged that when Hunt agreed with Gould that the latter should supply certificates of surveyance, he was acting as agent on behalf of them. The defendant Gould counter-argued that there was no sufficient proximity of

relationship between himself and the plaintiffs. By agreeing to supply certificates of surveyance, he was dealing with Hunt and not the plaintiffs.[72]

The court gave judgement in favour of the defendant and observed that since there was no sufficient proximity of relationship between the plaintiffs and the defendant, the latter was under no duty to the former to exercise reasonable care in drafting his certificates.[73] Bowen L.J. in finding in favour of the defendant observed that in instances where the loss results from the careless drafting of statements, the law of England does not impose upon the maker of such statements a duty of care in favour of a party with whom he is not privy. His Lordship observed that the duty to exercise care does not exist in favour of a third party whose relationship to the careless party is not proximate in the strict sense unless the resulting damage arises from the careless control of a dangerous thing. The plaintiffs attempted to establish the presence of a duty to exercise care in favour of remote parties whose involvement is reasonably foreseeable to the careless party. As an authority for their argument they relied on the decision of the court in **Cann v Willson.**[74] Bowen L.J. and the rest of the court refuted the plaintiffs' argument. They observed that the decision in **Cann v Willson** does not stand as good law in light of the later authorities.[75] Bowen L.J. said:

"The plaintiffs' counsel have invoked the authority of Cann v Willson with the view to persuading us there is such a duty. I am not now considering whether the law of England might not be stricter than it is; I can imagine a state of law by which a duty would be imposed upon a person under similar circumstances. We, however, have to consider not what the law might be, but what it is. Is there any duty known to the law in such a case as the present? It is said that Heaven v Pender and cases of that class shew that the defendant had a duty to the plaintiffs. It is idle to refer to cases which were decided under totally different aspects and upon totally different considerations of the law. Take, for example, the case of an owner of a chattel such as a horse, a gun or a carriage, or any other instrument which is in itself of such a character that, if it be used carelessly, it may injure some third person who is near to it; then it is plain as daylight that the owner of that chattel, who is responsible for its management is bound to be careful how he uses it. Exactly in the same way with regard to the owner of premises. If the owner of premises knows that his premises are in a dangerous condition and that people are coming there to work upon them by his own permission and invitation of course he must take reasonable care that those premises do not injure those who are coming there. It is because he has the conduct and control of premises which may injure persons whom he knows are going to use them and who have a right to do so that he is bound to take care to protect those persons who will thus be brought into connection with him. Heaven v Pender was an instance of this class of case. How has it any application to the present case. Only I suppose on the suggestion that a man is responsible for what he states on a certificate to any person whom he may have reason to suppose that the certificate may be shown. But the law of England does not go to that extent. It does not consider what a man writes on paper is like a gun or other dangerous instrument and unless he intended to deceive, the law does not, in the absence of contract, hold him responsible for drawing his certificate carelessly."[76]

(ii) From the foregoing, it appears that the term dangerous, as used by the court above, is given a narrow definition. It is applied as to signify danger to life limb and property. Thus an instrument is deemed to be

dangerous if the inherent dangerousness of the instrument, once it escapes, is that of the kind which could cause physical damage either to the person in question or his property.

Negotiable instruments are not dangerous instruments as such. They do not, if they escape, cause damage to life, limb or property. The damage that negotiable instruments could cause is an economic one. It is illustrated in the third party's acquisition of a worthless piece of paper.

(iii) It is submitted that the narrow conceptions of the terms dangerous and damage are not sound. They emerged in the era when the health of the public was put at risk, due to the Industrial Revolution, in the nineteenth century. At first, damage to health was recoverable when it was caused by dangerous instruments. Later, however, damage to property was added to the list of recoverable damages.[77]

At present, the products of industry are not confined to the narrow conception of dangerous instruments e.g. cars, drugs and chemicals. In fact the word industry is no longer confined to people engaged in the business of manufacturing. Rather the term industry is given a broad conception. It refers to commercial industries such as the credit and banking industry, as well as the narrow conception of the term.

The products of commercial industries are not dangerous in the sense that they cause damage to health or

property but their dangerousness is illustrated in the fact that they can cause financial damage if improperly controlled. Financial losses, in the era where economics is dominating or at least playing a vital role in society are not negligible. In fact it is as serious as the health of a person, or his property.

The Proximate Cause Argument

(i) The argument that for negligence to be pleaded as a cause for full recovery it must be the "proximate" i.e. immediate cause of the resulting damage was first laid down in the context of negotiable instrument fraud by Parke B. in **Bank of Ireland v Evans' Charities Trustees.**[78] This case involved the erroneous transfer of share certificates in reliance on forged powers of attorney. The facts of this case were as follows. The defendant was a corporation operating in Ireland, by virtue of a special charter. It deposited its shares with the Bank of Ireland i.e. the plaintiff. The defendant recruited Mr. Grace as secretary. He, at the relevant time was entrusted with the safe custody of the corporate seal. Without the authority of the trustees, Grace fixed the seal of the corporation on five powers of attorney. The said powers of attorney incorporated transfer orders. They prima facie ordered the Bank of Ireland to transfer the specified shares as directed. The forged powers of attorney were then presented to the plaintiff. The latter, without further enquiry, transferred the shares in

compliance with the powers of attorney. Grace finally misappropriated the proceeds of the transfer to his own interest.

The defendant contested the plaintiff's act of transfer. It defined such act as being without authority, hence it could not confer any legal consequences. The plaintiff counter argued that the defendant is estopped from challenging the validity of the transfers. The trust of the corporate seal with its secretary is presumed to furnish grounds for such an estoppel.[79]

Parke B. gave judgement in favour of the defendant. As to the plaintiff's argument, he observed that for estoppel in the negligence to operate as a cause for full recovery, it must be in or immediately related to the transfer itself. He held:

> "Now we all concur in opinion that the evidence given, which was only of a supposed negligent custody of their corporation seal by the trustees in leaving it in the hands of Mr. Grace whereby he was enabled to commit the forgeries is not sufficient evidence of that species of negligence which alone would warrant a jury in finding that the plaintiffs were disentitled to insist on the transfer being void. We concur with Mr. Justice Jackson and Justices Ball Crampton and Torrens and Chief Justice Lefroy in thinking that the negligence which would deprive the plaintiff of his right to insist that the transfer was invalid must be negligence in or immediately connected with the transfer itself."[80]

Parke B. then referred to **Young v Grote**.[81] He observed that the facts of that case differed substantially from the case at bar. Then he observed

that in the case before him negligence in the safe custody of the corporate seal is not the proximate cause of the loss i.e. the erroneous transfer of shares. Rather the said loss was the result of the independent act of the secretary, Mr. Grace. He held that:

> "The present case is entirely different. If there was negligence in the custody of the seal, it was very remotely connected with the act of transfer. The transfer was not the necessary or ordinary or likely result of that negligence. It never would have been but for the occurrence of a very ordinary event, that persons should be found either so dishonest or so careless as to testify on the face of the instrument that they had seen the seal duly affixed. It is quite impossible that the bankers could have maintained an action for the negligence of the trustees and recovered the damages they had sustained by reason of their having made the transfer."[82]

In Baxendale v Bennett,[83] the court reached a similar ruling. The case involved the theft of an accepted instrument, which purported to be a bill of exchange, from the unlocked writing desk of the acceptor. The facts of this case were as follows. One J.F. Holmes arranged with the defendant to assist him to raise money by way of accepting a bill of exchange. The defendant fixed his signature on a piece of paper which bore an impressed stamp of a bill. The defendant then delivered the piece of paper to Holmes. The latter, after deciding not to raise the money, returned the piece of paper in its delivered state to the defendant. The defendant then kept the piece of paper in an unlocked drawer of his writing table. The writing table was in a chamber to which the

defendant's clerk and others had access. At trial, it was established that the instrument was filled as a bill, bore the signature of W. Cartwright as drawer and the indorsement of another person in favour of the plaintiff. Nevertheless, it was established there that the defendant never delivered the said bill to Cartwright, nor did he intend that the latter should use the bill for his own interest.

The court, in deciding the case, gave judgement in favour of the defendant. It held that the defendant cannot be estopped from denying the validity of the instrument. His negligence in the safe custody of the blank piece of paper cannot be considered as the cause of the loss to the plaintiff. By comparison, the resulting loss was the cause of a crime i.e. the theft of the blank piece of paper and its unauthorised completion by the thief. Had the theft of the blank piece of paper and its subsequent unauthorised completion not taken place, the instrument would not have got into the hands of the plaintiff and ultimately, the latter would not have suffered a loss in his acquisition.[84]

(ii) From the foregoing, it appears that English courts interpret the concept of causation in the law of negligence in a traditional narrow sense. They import the notion of "proximity" i.e. immediateness in the definition of causation. Thus they consider that X act is the cause of Y damage if Y was the direct and natural consequence of X. If, however, an independent

act of a third party interrupted the chain of causation, X would not any longer be deemed to be the cause of Y.[85]

The narrow interpretation of the concept of causation illustrates the English courts' adherence to the traditional common law approach to the law of negligence. The general theory underlying such an approach is to narrow the boundary of negligence and ultimately prevent its application to instances where it could involve claims of indeterminate time, indeterminate amount and indeterminate people.[86] Such approach is consistent with the approach which English courts maintain in determining the presence of a duty to exercise reasonable care.[87] As to both elements, they import the notion of "proximity" in the traditional sense.

(iii) It is submitted that the narrow conception of the causation element is defective in an important respect.[88] Its application, like the application of the narrow conception of the notion of proximity, could result in an inefficient risk allocation rule.

The application of the narrow conception of the element of causation could result in allocating the loss resulting from the careless act to the party who cannot provide against its occurrence in an efficient manner, whilst it protects the party who is in the position to foresee its occurrence and ultimately provide against it.

An example of the instances where the narrow conception of the element of causation could result in an inefficient risk allocation rule is the careless custody

of blank instruments. Its application in the instance under consideration results in allocating the loss resulting from the acquisition of a forged stolen instrument to the bona fide third party acquirer. The bona fide third party acquirer as established above[89] is in no position to provide against the occurrence of loss in the efficient manner where the acquired instrument does not raise suspicion as to its genuineness. The imposition of a duty to shop for information or to refrain from the acquisition of instruments from strangers would either result in a misallocation of wealth or it would impair the function of negotiable instruments as a finance device.[90]

The allocation of loss to the bona fide third party acquirer results, in the instance under consideration, in a windfall in favour of the careless party i.e. the proprietor of the stolen blank instrument. It releases him from being liable for the loss the occurrence of which was firstly, facilitated by his careless act and secondly, was reasonably foreseeable to him. The allocation of loss to the bona fide third party acquirer, as could be noted, discharges the party who is in the position to provide against its occurrence, from the duty to exercise reasonable care in instances where the imposition of such a duty would be efficient. The imposition of a duty to exercise reasonable care does not conflict with his economic interest nor does the allocation of loss to him in instances where his careless custody results in a loss

to a bona fide third party, conflict with his reasonable expectation.[91]

## The Evolution of Causation in the English Law of Negligence

In relatively recent times the law in the English legal system has evidenced a significant evolution in the definition of the concept of causation. The said evolution paralleled the evolution in the establishment of the existence of the duty of care requirement. The essence of the said evolution is that the traditional notion of proximity has been replaced with the notion of foresight i.e. reasonable foreseeability. Courts discarded the traditional notion of proximity due to its inequitable application and imported the notion of reasonable foreseeability as a test for determining the causal relationship between a careless act and the resulting damage. They deemed the causal relationship to exist between a careless act and the resulting damage, as long as a reasonable man, in the circumstances in question, would have foreseen the occurrence of the damage as a result of a particular careless act.

The case of **Overseas Tankship U.K. Ltd. v Morts Dock & Engineering Co. Ltd.**[92] is submitted to be the turning point in English legal history as far as the concept of causation is concerned. The facts of this case were as follows. The appellants were the charterers of an oil burning vessel called the Wagon Mound. The vessel was

moored to their wharf in Sydney Harbour for refuelling. In the course of refuelling, the service men of the appellants spilled fuel oil onto the water. A few yards away, the respondent was carrying out, at his wharf, repair work for another vessel. The work which was carried out to the vessel involved welding activity. Whilst the repair to the vessel was being carried out, the manager in charge of the work noticed that the spilled fuel oil had reached the site of the activity. He immediately ordered the work to stop. After making enquiry, he was told that fuel oil is not inflammable in the water. Accordingly, he ordered the work to resume. Nevertheless, he ordered his employees to take all due caution so as to avoid dropping inflammable material onto the water. Two days later, the fuel oil in the water caught fire and the fire caused damage to the vessel, as well as the respondent's wharf.

The Privy Council, in deciding the case, reversed the decision of the Court of Appeal of New South Wales. It allowed damages to the respondent to the extent that the spillage of fuel oil had caused his work to stop. It denied the said party's entitlement to recover the damage caused to the vessel at his wharf, as well as damage to his wharf. In reaching its decision, the Privy Council applied "the reasonable foreseeability test". It held that since the damage to the vessel or the wharf was not foreseeable, it may not be recoverable.[93]

The Applicability of the Notion of Foresight to the Law of Negotiable Instruments.

(i) As far as the question turns on the applicability of the notion of reasonable foreseeability as a test for determining the existence of causal relationship, it appears that English law has not yet developed to the stage where courts are prepared to extend the application of the reasonable foreseeability test to determine the existence of causal relationship in the context of negotiable instruments. In Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd.[94] and Others, the counsel for the defendants attempted to invoke the decision in Overseas Tankship U.K. Ltd. v Morts Dock & Engineering Co. Ltd. He, accordingly, attempted to establish that the reasonable foreseeability test as laid down by the Privy Council in that case is applicable as a test determining the existence of a causal relationship in the context of negotiable instruments.[95] The Privy Council, as to this particular question, dismissed counsel's contention. It held that the rule as developed in the Overseas Tankship U.K. Ltd. v Morts Dock and Engineering Co. Ltd. had no application to the case at bar. It accordingly, reinstated the rule as laid down by Parke B. in The Bank of Ireland v Evans' Charities Trustees and affirmed by the House of Lords in London Joint Stock Bank v Macmillan and Arthur, namely, for negligence to be pleaded as a basis for full recovery, it must be negligence "in the transaction".[96]

(ii) Apparently, the reason which restrained English Courts from extending the application of the notion of reasonable foreseeability as a test for determining the existence of a causal relationship between the careless act of the proprietor of a negotiable instrument and the damage suffered by the bona fide third party's acquisition of it, is that English law does not apply the same test in determining the existence of a duty of care in favour of the bona fide third party acquirer.[97] If the court was to apply the notion of reasonable foreseeability to determine the existence of a causal relationship, it would come to a decision inconsistent with its policy. It would allow recovery in instances where the law does not establish the existence of a duty of care in favour of the party who sought to claim the recovery of the resulting damage.

(iii) The foregoing interpretation could be inferred from the reason which led the Privy Council to reach its decision in the case of Overseas Tankship U.K. Ltd.[98] There it was said that since the test of reasonable foreseeability determines the existence of a duty of care, the same test for the sake of consistency should be applied to determine the remoteness of damage i.e. the existence of a causal relationship.[99]

From the foregoing, it could be concluded that English law as it currently stands does not establish against the proprietor of a blank instrument a duty in favour of a bona fide third party. It moreover does not

establish a causal relationship between the proprietor's careless custody of his blank instruments and the damage resulting to the acquirer from such act. It accordingly does not establish against the proprietor of blank instruments a liability based on negligence in favour of the bona fide third party acquirer. The latter ultimately may not enforce the acquired forged instrument against the purported maker/drawer i.e. the proprietor of a blank instrument from whom it was stolen, completed, signed in his name and negotiated to him for value

## The Rule of Contributory Negligence and Its Impact on Determining the Risk Allocation Rule

It is suggested that English law allows the acquirer of a stolen property to re-allocate to the true owner of the said property i.e. the proprietor, a part of the damage resulting from his acquisition if he could establish that the said party was "negligent" in safeguarding his property.[100] The law in this instance deems the damage resulting from the acquisition of a stolen property as being partly the result of the proprietor's own negligence and partly the result of the acquirer's own negligence. The negligence of the latter is illustrated in his acquisition from a stranger,whilst the negligence of the proprietor is illustrated in his failure to safeguard his property. Such an application, it is suggested, could be inferred from the 1945 Law

Reform Contributory Negligence Act. Section I of this act reads in part:

> "Where any person suffers damage as a result partly of his own fault and partly of the fault of any other person or persons a claim in respect of that damage shall not be defeated by reason of the fault of the person suffering the damage but the damages recoverable in respect thereof shall be reduced to such an extent as the court thinks just and equitable having regard to the claimant share in the responsibility for the damage."

It is also suggested that the acquirer in re-allocating a part of his loss to the careless proprietor need not establish the existence of a breach of duty owed to him by the careless proprietor. The law imposes upon every person a duty to exercise due care in safeguarding his property. Lord Denning said in this connection:

> "Negligence depends on a breach of duty whereas contributory negligence does not. Negligence is a man's carelessness in breach of duty to others. Contributory negligence is a man's carelessness in looking after his own safety. He is guilty of contributory negligence if he ought reasonably to have foreseen that, if he did not act as a reasonably prudent man, he might hurt himself ..."[101]

<u>The Application of the Rule of Contributory Negligence in Favour of the Bona Fide Third Party Acquirer.</u>

(i) At the outset, for Section I of the 1945 Law Reform's Contributory Negligence Act to operate as a basis

for apportioning loss, the said loss must be the result of an "act of conversion". For the act of conversion to be tortious, it must involve the unlawful interference with a valuable property of another. Forged instruments per se do not possess an enforceable value. This is due to their non-involvement of a valid signature, the presence of which vests the instrument in question with the currency attribute. Once the said instrument was divested of its currency it forfeits the value inherent in its negotiability nature. Ultimately, it operates in the hands of its acquirer as a worthless piece of paper.

In instances where the drawee detects the forgery of the presented instrument and he ultimately refuses its payment, the acquirer of such a document would not benefit from Section I of the 1945 Law Reform's Contributory Negligence Act. Due to the worthless nature of the acquired instrument, the defence of contributory negligence would not be available to the party in question. The purported maker/drawer i.e. the party against whom the acquirer intends to recoup in full or in part the loss resulting from his acquisition, would not need to raise against the latter the defence of conversion. By securing the non-payment of the stolen blank instrument, the purported maker/drawer is not presumed to forfeit a valuable property.

Since the purported maker/drawer would not be interested to bring an action in conversion against the acquirer, the latter party would not be able to avail himself of the advantage of the rule of contributory

negligence. Contributory negligence is a defence and not an independent cause of action. By virtue of Section I of the 1945 Law Reform's Contributory Negligence Act, for the defence of contributory negligence to be applicable, it must be set up to defeat a claim raised by another competing party, namely the proprietor of a stolen property. Since the purported maker or drawer of a stolen forged instrument, as has been shown above,[102] would not, due to the worthless nature of the converted property, claim a property interest in the acquired instrument, it could be concluded from the foregoing that, in instances of dishonour, the acquirer of a forged instrument cannot rely on the rule of contributory negligence as a basis for recouping a portion of the loss resulting from his acquisition.

(ii) The acquirer of a forged instrument may, by comparison, benefit from the rule of contributory negligence in instances of payment. The proceeds which he obtains from the drawee possess an enforceable value. This is illustrated by their involvement of an absolute credit. The purported maker/drawer, i.e. the party from whom the blank instrument was stolen, completed, signed, negotiated and honoured, would, in such an instance, possess an enforceable interest in the paid proceeds. This becomes more apparent when the purported maker/drawer cannot demand from the drawee payor the recredit of the erroneously paid proceeds. Such an instance would occur when the latter was declared insolvent or when, as between

himself and the purported maker/drawer, he was legally discharged from the underlying obligation. An example of such an instance is when the drawee, at the time of opening an account with his customer, stipulates that the latter shall not challenge the former's act of payment if the said payment was the result of the customer's own negligence. Such a stipulation is submitted to validate the act of payment which otherwise would have been rendered invalid. Its immediate impact, accordingly, is to establish an operative discharge in favour of the drawee payor.[103]

For the purported maker/drawer to assert his interest in the paid proceeds, he would have to sue the acquirer recipient. In such an instance, the acquirer recipient stands as a defendant in an action of conversion. The plaintiff in such an action, e.g. the purported maker/drawer purports to claim in his favour an exclusive property right to the paid proceeds. He purports to establish that the erroneously paid proceeds belong to him and, accordingly, they should be restored to his possession. By virtue of Section I of the 1945 Law Reform's Contributory Negligence Act, the acquirer recipient, in his position as a defendant, may invoke the rule of contributory negligence to defeat the purported maker/drawer's claim of full recovery.

(iii) It has been suggested that the rule of entitling the acquirer recipient to the right of re-allocating a portion of the loss resulting from his acquisition of a

forged instrument to the careless purported maker/drawer is not in conflict with the holdings in the long established earlier authorities.[104] It is submitted that the courts in the said cases were not confronted with the question whether the third party, into whose hands a forged instrument may bona fide come, can set up the defence of "contributory negligence" in its modern sense, and ultimately recover a part of the loss caused to him by his acquisition. Neither the courts in those cases nor the parties did address themselves to such a question. The said courts were in fact concerned with laying down the rule for negligence as a basis for "full recovery" only.[105]

Evaluation of the Rule of Contributory Negligence

(i) To state the obvious, although the application of the contributory negligence rule to the law of negotiable instruments brings about some improvement to English law, the said improvement is not wholly satisfactory. The rule of contributory negligence as could be noted, divides the resulting loss between the competing parties e.g. the original true owner and the acquirer recipient. The above application is acceptable as long as the parties to whom the loss was allocated were in the position to avoid the occurrence of the said loss in an efficient manner. The provision against the occurrence of loss would be efficient if the cost and time evolving from it generates an enforceable value in favour of the party to whom the

duty to provide against the occurrence of loss was allocated. Thus, a party would be in the position to provide against the occurrence of loss efficiently, if he was in the position to derive an enforceable value from the cost and time evolving from the provision against the occurrence of loss.[106]

If the said party was unable to derive an enforceable value from the evolving time and cost, he would not be in the position to provide against the occurrence of loss in an efficient manner. The allocation of a duty to provide against the occurrence of loss to the said party, would result in an undue hardship to him. He would have to allocate time and cost without receiving an enforceable value in consideration.

(ii) The rule of contributory negligence does not address itself to such a distinction. It allocates the loss in instances where its occurrence results from the acquisition of a stolen property to the competing parties regardless of their capacity to provide against its occurrence. Such an application could result in an inefficient risk allocation rule. It could result in allocating part of the loss in question to an innocent party who is in no position to provide against it efficiently.

An example of such an instance is the allocation to the bona fide acquirer recipient of a part of the loss resulting from his acquisition in a situation where the said loss was facilitated by the purported maker/drawer's

own carelessness in the safe custody of his blank instruments. In this instance, the acquirer recipient of a forged instrument is not presumed to be in a position to provide against the occurrence of loss. In the absence of surrounding suspicious circumstances, the said party would not be able to unveil the forgery. The four corners of a forged instrument would not, on their own, alert the mind of the third party to whom it was offered for a valuable exchange, to any irregularity in its contents.

If the acquirer recipient was burdened with the duty to shop for information concerning the status of the offered instrument, he would have to incur costs and allocate time.[107] Both time and cost are valuable assets. For their assumption to be economically valid, they should generate enforceable value in favour of the party to whom they are allocated.

In the instance under consideration, the assumption of time and cost does not generate enforceable value in favour of the third party to whom the instrument was offered for a valuable exchange. The value which the third party derives from his assumption of cost and time is undermined by the fact that the said party, due to his status as such might not be in the position to absorb them. Ultimately, the assumption of cost and time in this instance would result in a misallocation of wealth.

(iii) Finally the improvement which the rule of contributory negligence has brought about to English law

has been impaired by the 1977 Torts (Interference with Goods) Act. Section II of this act provides that contributory negligence is no defence for recovering part of the loss resulting from the conversion of someone's property. Section II reads in part:

> "Contributory negligence is no defence in proceedings founded on conversion or on intentional prejudice to goods."

As an application of the above section it seems that the acquirer recipient of a forged instrument which has been erroneously paid cannot, in instances of payment, re-allocate to the purported maker/drawer a part of the loss resulting from his acquisition, notwithstanding the fact that the purported maker/drawer's own careless act has facilitated the occurrence of loss. In law the acquirer recipient is deemed to be the convertor of the purported maker/drawer's property, namely the proceeds of the erroneous payment. And by virtue of Section II of the Torts (Interference with Goods) Act, the loss arising from the conversion of someone's property cannot be apportioned by the application of the rules of contributory negligence.

The Uniform Commercial Code

(i) The position in the U.C.C. is dissimilar to that of the English legal system. It is submitted that the draftsmen of Article 3 of the U.C.C. broke away from the traditional common law conception of proximity. They

incorporated in subsection 406 of Article 3 a general liability rule based on negligence. The said subsection provides that any person who substantially contributes by his own negligence to the fraudulent making or alteration of a negotiable instrument is "precluded" from asserting the act of forgery as a defence for his liability. The scope of the above rule is not confined to establishing liability against the negligent party in favour of a party with whom the former is in contractual privity only, such as the drawee. Rather, the scope of the rule under consideration applies in favour of remote parties i.e. the holder in due course. Article 3-406 reads:

> "Any person who by his negligence substantially contributes to a material alteration of the instrument or the making of an unauthorised 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."

From the foregoing, it could be inferred that Article 3-406 U.C.C. imposes upon the drawer of a negotiable instrument a duty to exercise reasonable care in favour of bona fide third parties, the involvement of whom in the negotiable instrument transaction, is reasonably foreseeable. Accordingly, the said party would be under a duty to safeguard his interest so as to avoid causing injury to a bona fide third party who might come in contact with the negotiable instrument in question.

The ratio underlying the establishment of such a

general duty of care is dictated by the special nature of negotiable instruments. Due to their nature as documents possessing the attribute of a chose in action on the one hand and the attribute of chattels on the other, negotiable instruments are, firstly, capable of being freely transferable in the stream of commerce, and secondly, they transfer with them the incorporated entitlements. Thus, any member of the public might, in the course of his dealing, come in contact with such instruments. If the offered instrument was vitiated by a form of forgery, the party to whom it is offered for a valuable exchange might sustain a loss by his bona fide acquisition. In order to avoid the occurrence of loss to a bona fide third party whose involvement is reasonably foreseeable, the proprietor i.e. drawer of a negotiable instrument should use reasonable precautions in the making or the safe custody of his instruments.

The official comment to Article 3-406 recognised that the special nature of negotiable instruments dictates the necessity to introduce a general duty of care in favour of remote parties i.e. holders in due course as well as parties privy with the careless party. Paragraph 2 of the official comment reads:

> "The section extends the above principle to the protection of a holder in due course and of payors who may not technically be drawers. It rejects decisions which have held that the maker of a note owes no duty of care to the holder because at the time the instrument is drawn there is no contract between them. By drawing the instrument and 'setting it afloat upon a sea of strangers' the maker or drawer voluntarily enters into a relation with later holders which justifies his responsibility."

(ii) Some doubt has been cast upon the words "substantially contributes" i.e. the key words for Article 3-406. Some courts were of the view that the words substantially contributes manifest the draftsmen's intention to apply the traditional common law conception of causation.[108] The said courts inferred from the words substantially contributes that the careless behaviour of the party in question e.g. the drawer, should be the "immediate" and "direct" cause of the loss. Such interpretation, as could be noted, is identical to that established in the English legal system by Parke B. in The Bank of Ireland v Evans' Charities Trustees.[109] Thus, if the loss resulting from the acquisition of a negotiable instrument was the direct cause of the fraudulent practice of an independent party, such as the theft of a blank instrument by a thief, the forgery of the proprietor's signature and the fraudulent negotiation of it to a bona fide third party, the proprietor's careless custody of his blank instruments would not, under the above interpretation, be deemed to be the proximate cause of the loss. Accordingly, the careless custody of blank instruments would not be deemed to have substantially contributed to the loss and ultimately the proprietor of such instruments would not be liable in negligence to the bona fide third party acquirer.

Other courts, by comparison, were of the view that the draftsmen of Article 3-406 intended to break away from the traditional common law conception of causation and adopt the broad concept of causation as manifested by the

recent development in the law of tort.[110] Thus the words "substantially contributes" as they appear in Article 3-406 must have been intended to shorten the chain of causation and signify the "cause in fact". The act would be deemed in fact the cause of a loss when a reasonable man considers such act as the cause of the said loss.[111] A reasonable man would consider a certain act as the cause of a certain loss if the occurrence of the said loss was foreseeable as a result of the said act.[112] Thus, it seems that the careless custody of blank instruments under the above approach, may be defined as an act which substantially contributes to the fraudulent making of negotiable instruments. Accordingly, the proprietor of such instruments could be precluded from asserting the forgery as a defence for his liability. The careless custody of blank instruments might induce a dishonest party to intercept it. The acquisition of such an instrument would enable him to use the stolen instrument as genuine. Bona fide third parties might finally be misled in their dealings. They might rely on the prima facie regularity of the instrument and accept to take it for value. As could be noted, the careless custody of blank instruments might facilitate the occurrence of loss to a bona fide third party. Since, due to the special nature of negotiable instruments, the bona fide third party's involvement in the negotiable instrument transaction is reasonably foreseeable, the fact that the careless custody will create a loss to a bona fide third party would also be foreseeable.

The reason underlying the above judicial diversity is due to the fact that neither the U.C.C. nor its official comment attempt to define negligence. The illustrations incorporated in paragraph 5 of the official comment to Article 3-406 do not, it is submitted, provide a guideline as to how the negligence of the party in question should be determined, nor do they provide an exhaustive list in which the negligence of the drawer of a negotiable instrument could be established as a basis for complete recovery. In this legislative lacuna, the courts are left to struggle and infer the intention of the draftsmen of the U.C.C.

(iii) The decision of the court in Bagby v Merrill Lynch Pierce Fenner & Smith Inc.[113] illustrates the narrow conception of the element of causation. The facts of this case were as follows. Mrs. Bagby discovered, following the death of her husband, that she and her two children were beneficiaries of the Savings and Profit Sharing Pension Fund of Sears Roebuck and Company, the husband's former employer. Before the children could receive benefits from the fund, Mrs. Bagby had to be appointed as their legal guardian and to achieve this end she hired a Kansas City, Missouri attorney named Marshall Lyons. She was duly appointed and Lyons sent the required documents to Sears.

Shortly thereafter, as part of the pension plan, Sears issued several shares of its own stock to Mrs. Bagby registered in her name both individually and as guardian

of the children. Unfortunately, Sears sent the stock to Lyons and he decided to sell it for his own benefit. Enter Merrill Lynch, Pierce Fenner & Smith Inc. stockbrokers. Without Mrs. Bagby's knowledge, Lyons opened an account for her with Merrill Lynch and on four occasions in the spring of 1968 had Merrill Lynch sell the Sears stock and issue cheques payable to Anna Bagby but delivered to him. He then forged her name to the backs of the cheques, signed his own name and deposited the cheques in his personal account with a local bank which forwarded them to the drawee bank, the Commerce Bank of Kansas City and received payment.

Mrs. Bagby eventually found out what was going on and sued Merrill Lynch for conversion of the shares of stock. Merrill Lynch brought a third party action against its bank, the Commerce Bank of Kansas City for paying the cheques without a proper indorsement, and this bank passed on the lawsuit in the form of a fourth party action against Lyon's Bank, which had guaranteed the validity of the payee's indorsement when making collection of the cheques.

Mrs. Bagby's suit was settled, but Merrill Lynch's third party action went to trial in a federal court in Missouri. The banks based their defence on Section 3-406[114] of the Uniform Commercial Code. To establish Merrill Lynch's negligence the banks proved that both New York Stock Exchange rules and Merrill Lynch's own operations manual established a strict "Know Your Customer" rule and forbade stockbrokers to deal with a

purported attorney without checking with the customer himself, getting a written power of attorney and sending duplicates of all communications to the customer as well as to the attorney. Failure of a stockbroker to observe the rigid identification procedures of the New York Stock Exchange rules can result in civil liability under the Federal Securities Exchange Act. The banks argued that, given this absolute duty, Merrill Lynch was negligent in issuing the cheques in question without checking with Mrs. Bagby to ascertain whether she was the customer the rule required them to "know" and if so, whether she authorised Merrill Lynch to deal with her through Lyons.

The court, in analysing Section 3-406 defined the words "substantially contributes" in a narrow sense. It held that the draftsmen of Section 3-406 did not intend to derogate from the pre-code position. Accordingly, it held that the words in question were intended to denote the traditional common law conception of causation. Thus, for a loss to be recoverable, it must be the immediate and direct i.e. proximate consequence of the careless act.

As far as the case under consideration is concerned, the court held that since the loss suffered by the payor bank was the consequence of the fraudulent practice of Lyons i.e. the attorney, the said act is deemed to be the proximate cause of the loss. Although the stockbrokers' i.e. Merrill Lynch's failure to follow its own practice and identify its customer did constitute a careless act, it is not deemed to be the proximate cause of the

loss. The stockbroker's careless act, the court held, constituted negligence in the issuance of the cheques i.e. in their delivery to the attorney and not negligence in their negotiation.[115] That is to say, the stockbroker did not authorise the attorney to transfer the cheque to his own interest. Had the attorney, i.e. Mr. Lyons, not acted fraudulently, the cheques would not have been misappropriated and the defendant bank would not have sustained the loss.[116]

(iv) The decision in **Thompson Maple Products v Citizens National Bank of Corry**[117] illustrates, by comparison, the wide definition of the element of causation. The facts of this case were as follows. The plaintiff was a small closely held corporation principally engaged in the manufacture of bowling pin "blanks" from maple logs. It purchased logs from timber owners in the vicinity of its mill. The timber owners did not, however, provide transport facilities. Accordingly, the hauling of logs was arranged through a few local truckers. Emery Albers was one of the local truckers through whom the plaintiff transported its logs to the mill. He was an entrusted friend of the plaintiff's family for a brief period.

At the mill site, newly delivered logs were scaled by mill personnel to determine their quantity and grade. The employee on duty noted this information together with the name of the owner of the logs, as furnished by the hauler on duplicate "scaling slips". In theory, a copy of the scaling slip was to be given to the hauler and the

original was to be retained by the mill employee until transmitted by him directly to the company's bookkeeper. This ideal procedure was rarely followed. Instead, in a great many instances, the mill employee simply gave both slips to the hauler for delivery to the company office. Office personnel then prepared cheques in payment for the logs, naming as payee the owner indicated on the scaling slips. Blank sets of slips were readily accessible on the company premises.

Due to the above practice Albers conceived his fraud. After procuring blank sets of scaling slips, he filled them in to show substantial, wholly fictitious deliveries of logs, together with the names of local timber owners as suppliers. Albers then delivered the slips to the company bookkeeper who prepared cheques payable to the purported owners. Finally, he volunteered to deliver the cheques to the owners. The bookkeeper customarily entrusted the cheques to him for that purpose. Albers then forged the payee's signature and either cashed the cheques or deposited them to his account at the defendant bank where he was well known.

The plaintiff challenged the defendant's act of payment and accordingly it sought to reverse the charged credit. The plaintiff argued that since the cheques at the time of payment bore forged indorsements, they were invalid. Accordingly, the drawee bank could not act upon them and debit the plaintiff's account with the face value of the cheques.

The defendant argued that the plaintiff is estopped by virtue of Article 3-406 U.C.C. from denying the validity of the cheques and by virtue of the same Article, he is precluded from setting up the forgery as a real defence for his liability. The plaintiff counter-argued that Article 3-406 U.C.C. codifies the pre-code law on this matter. Thus, the words "substantially contributes" should be interpreted to denote the traditional common law conception of causation. That is to say, for a particular loss to be recoverable, it must be the direct and proximate consequence of the careless act. And since the loss represented in this case was the direct consequence of Alber's forgery, the careless custody of blank slips are not presumed to be the direct and proximate cause of the loss in the strict sense.[118]

The court dismissed the plaintiff's contention as to the correct meaning of the words "substantially contributes". It held that the draftsmen of Article 3-406 intended to break away from the pre-code law. The words "substantially contributes" were intended to mean "the cause in fact". The purpose of Article 3-406, the court held, was to shorten the chain of causation. Accordingly, and on the basis of the above definition, the court was able to pass its judgement in favour of the defendant.[119] It considered the plaintiff's careless custody of its blank slips as the proximate cause of the loss to the bank.

(v) The better view is submitted to be that expressed by

the court in Thompson Maple Products v Citizens National Bank of Corry.[120] The wide conception of the element of causation as illustrated by the decision of that court, is consistent with Article 3-406's wide application of the duty of care requirement. For Article 3-406's wide application of the duty of care requirement to be of an enforceable practical value, the element of causation should be interpreted in a compatible manner. The element of causation supplements the duty of care requirement. Its application determines the plaintiff's entitlement to recover the loss resulting from the careless behaviour of the other competing party. If the element of causation was narrowly defined as illustrated by the court in Bagby v Merrill Lynch[121] and ultimately the remote acquirer was denied the right of recovery, the wide application of the duty of care requirement as introduced by Article 3-406 U.C.C. would be of little practical value. Despite the breach of the supposed duty of care, the loss resulting from such a breach would be allocated, due to the narrow conception of the element of causation to the party to whose favour the duty of care is owed e.g. the remote bona fide third party acquirer.

## The Party to Whose Favour the Anglo-American and the Continental Geneva Legal Systems Establish the Risk of Forgery in Instances of Payment.

The Anglo-American and the Continental Geneva legal systems establish the risk arising from the payment of a

forged instrument in favour of:

1) the purported maker/drawer i.e. the party from whom the blank instrument was stolen, fraudulently filled and signed in his name, and

2) the holder in due course or good faith i.e. the party to whose favour the stolen forged instrument is negotiated and to whose favour the drawee makes payment.

The legal systems under consideration approach the said application by firstly, denying to the drawee payor the right to charge to his customer i.e. the purported maker/drawer, the face value of the erroneously paid instrument[122] and secondly, by denying to the drawee payor the right to recover the proceeds of the erroneous payment from the holder in due course or good faith i.e. the bona fide third party acquirer recipient.[123] On the one hand the Anglo-American and the Continental Geneva legal systems deny, on the one hand to the drawee payor the right to charge to the purported maker/drawer the face value of the erroneously paid instrument by denying the binding attribute of a forged signature. Accordingly they do not establish against the purported signatory a liability based on his forged signature. On the other hand, the legal systems under consideration deny the right to recover from the bona fide third party acquirer recipient, the proceeds of the erroneous payment by establishing in favour of the latter, the legal title to the paid proceeds. Accordingly, they establish in favour of the said party the right to retain the erroneously paid proceeds.[124]

The Anglo-American and the Continental Geneva legal systems do not approach the above application absolutely. Rather they introduce certain qualifications to it. The impact of the said qualifications could alter the general risk allocation rule. By virtue of the said qualification, the loss resulting from the forgery of a negotiable instrument might be shifted in its entirety or a proportion of it to the party to whose favour the general risk allocation rule is established.

The Continental Geneva Legal Systems

(i) The majority of the Continental Geneva legal systems stipulate that for the purported maker/drawer and the bona fide third party acquirer recipient to benefit from the rule of allocating the risk of paying a forged instrument to the drawee payor, the purported maker/drawer must be "free from negligence" whilst the bona fide third party acquirer recipient must be the "protected indorsee" of the instrument in question. The requirement that the purported maker/drawer must be free from negligence is submitted to be an application of the general rules of the law of negligence as established in the civil legal systems. Under the said legal systems, every person is under a general duty to exercise reasonable care so as not to injure another.[125] That is to say that, every person owes every member of the public a duty of care. If any member of the public sustains a loss as a result of the careless behaviour of another, the former need not

establish the presence of a specific duty of care in order to recover from the careless party.

(ii) In the context of negotiable instruments it is submitted that the customer of a drawee owes the latter a duty to exercise reasonable care in monitoring his business. He should, firstly, exercise reasonable care in the safe custody of his instruments; secondly, he should use reasonable care in their issuance; thirdly, he should exercise reasonable care in examining periodic statements and, finally, he should exercise reasonable care in selecting his employees and supervising their work. If he fails to observe the said duties and the drawee is, as a result of the customer's negligence, misled as to the genuineness of the presented instrument and accordingly, he is made to pay it, the customer should bear the resulting loss. The drawee should be entitled to charge to his customer the face value of the erroneously paid instruments. The customer's failure to exercise reasonable care is presumed to have caused the loss in question.

(iii) At the Geneva Conference on the Unification of the Laws relating to Bills of Exchange, Promissory Notes and Cheques, the delegates of the represented countries recognised the rule that in instances where the payment of a forged instrument was the result of the customer's fault or the fault of one of his employees, the loss resulting from such payment should be allocated to the customer i.e. the purported maker/drawer. Such recognition could be

inferred from their general approval of the Italian proposal.[125] The Italian proposal codified the rule that the loss resulting from the payment of a forged instrument should be borne by the purported maker drawer if it was established that the occurrence of the said loss was due to the purported maker drawer's own fault or it was the fault of one of his employees. The proposed article reads:

> "The drawee who pays a cheque that has been altered or forged cannot apply to the drawer for repayment unless the latter has committed a fault or unless the forgery, alteration or falsification is attributable to one of his employees. Any stipulation to the contrary is null and void."[127]

(iv) From the foregoing it could be noted that the rule in the Continental Geneva legal systems re-allocates the loss resulting from the payment of a forged instrument in its entirety to the negligent purported maker/drawer. It deems the negligence of the said party the sole cause of the loss. To state the obvious, the above rule is defective in two important respects. In the first place, the loss resulting from the payment of a forged instrument can by no means be attributed to the purported maker/drawer's negligence only. The drawee payor bears a part of the blame for contributing to the occurrence of loss. His failure to employ measures, the purpose of which is to prevent the forgery from materialising in the first place or the purpose of which is to provide for its detection should it occur, is submitted to be a contributing factor to the loss. The imposition of a

duty to exercise a high standard of care, upon the drawee payor, does not result in undue hardship. The observance of such a duty is, firstly, a necessity of the banking business and secondly, is profitable to it.[128] When the party engaged in the banking business promotes his services, the public would be encouraged to deal with him. The drawee would then be able, through service and periodic charges, to distribute the cost incurred in the course of promoting his business among his customers.

It could be concluded from the foregoing that the loss resulting from the payment of a forged instrument should not be allocated in its entirety to the negligent purported maker/drawer. A portion of it should be allocated to the drawee payor. To hold otherwise would result in an inefficient risk allocation rule. A potential risk bearing party, such as the drawee payor would be released from liability if the loss was allocated in its entirely to a single party. Since the Continental Geneva legal systems allocate the loss resulting from the payment of a forged instrument to the negligent purported maker/drawer only, it is presumed in light of the foregoing to allocate the risk in the instances under consideration in an inefficient manner.

(v) In the second place, the allocation of the loss resulting from the payment of a forged instrument to the negligent purported maker/drawer only, prima facie entitles the drawee payor to re-allocate as a matter of right, the loss to the purported maker/drawer, by debiting

the latter's account with the face value of the presented forged instrument. Such an entitlement could lead the drawee payor to allocate the loss resulting from his erroneous payment at his whim and caprice. Accordingly, he might be led to allocate the loss to a wholly innocent customer or to a customer whose conduct in contributing to the loss is negligible by comparison with the conduct of the drawee payor. Such an approach would allocate to the purported maker/drawer the burden of seeking a court settlement for the purpose of establishing his entitlement to be discharged in whole or in part from the loss resulting from the forgery of his signature. This is submitted to be inefficient. The purported maker/drawer, due to his status as a consumer, might not be in the position to seek a court settlement. Due to the large expenses involved in the court settlement, or due to the trivial nature of the dispute between himself and the drawee payor, he might not be able to afford such expenses, or he might think the dispute in question not worth the trouble time and cost involved in the court settlement. Ultimately, the loss resulting from the payment of a forged instrument would be borne by a totally or relatively innocent party in instances where the loss should be borne by the other competing party.

The Protected Indorsee Requirement

(i) As far as the second requirement is concerned, namely that the bona fide third party acquirer recipient

must be the protected indorsee of the instrument in question, it could be observed that the said requirement was originally introduced to define the party to whose favour the negotiability attribute should be established. It was rightly contended that the party who should benefit from the negotiability concept must, firstly, be unaware of the existence of a "triable defence"[129] vitiating the instrument to which he intends to establish his title, and, secondly, he must guard his interest in instances where the circumstances surrounding his acquisition raise suspicion as to the regularity of the instrument in question or the validity of the title of its possessor.

(ii) The knowledge of the existence of a triable defence disqualifies the acquirer from claiming the protected party status. The knowledge of the existence of such a defence presumes bad faith on the part of the said party. That is to say that the knowledge of the existence of a triable defence presumes that the party at the time of acquisition was aware that his acquisition would defeat the other competing party's triable defence and ultimately it would injure the interest of the said party.

(iii) The failure to act reasonably in suspicious circumstances likewise disqualifies the acquirer from claiming the protected party status. The presence of suspicious circumstances is presumed to alert the said party to the irregularity of the transaction in which he intends to engage. That is to say, that the presence of suspicious circumstances attributes to the party at the

time of acquisition a constructive knowledge of the existence of an irregularity in the transaction in question. Accordingly, the said party is presumed to be aware of the existence of a triable defence. Thus, if he determines, despite the presence of suspicious circumstances, to acquire the instrument in question without exercising reasonable care, he is presumed to have acted in bad faith. Ultimately, he is presumed to be aware that his acquisition as such could result in an injury to the other competing party.

(iv) A prima facie case in which the third party acquirer would be held not to possess an actual or constructive knowledge of a triable defence on the negotiable instrument in question would exist if the said party was removed from the other competing party i.e. the party who seeks to set up the defence in question to dismiss his liability on the instrument. The third party acquirer would be removed from the other competing party when his engagement with the said party is separated by an independent transaction concluded with an independent party. The independent transaction of the independent party does not however interrupt the relationship between the remote competing parties, namely the prior liable party and the acquirer of the negotiable instrument, rather it serves as a chain through which the contractual promise or undertaking and property right to the instrument is transferred.

In the context of negotiable instruments, the chain

represented by the independent transaction is technically known as the "indorsement". Through it, the contractual promise or undertaking incorporated in the instrument and the property right of it, pass to the third party acquirer. Due to the fact that the act of indorsement is an independent act created by an independent transaction and by an independent party, its involvement is presumed to remove the indorsee i.e. the third party acquirer from the parties prior to the indorsement. Such act accordingly could prevent the existence of a triable defence from being readily available to the third party acquirer.

(v) The foregoing narrow definition of the protected party has been codified in the Geneva Uniform Laws. Article 16 of the G.U.L. on Bills of Exchange and Promissory Notes incorporates the two requisites of the protected party status. The first paragraph of the said article requires that for an acquirer of a negotiable instrument to claim the advantages of the lawful holder i.e. the party to whose favour the negotiability attributes run, he should establish his title to the instrument in question through "an uninterrupted chain of indorsements". The said requirement, as will be noted, incorporates the requisite that the party who intends to claim the advantages of the lawful holder must be remote from the other competing party who intends to set up a triable defence such as forgery to dismiss his liability on the instrument. Article 16 reads in part:

> "The possessor of a bill of exchange is deemed to be the lawful holder if he establishes his title to the bill through an uninterrupted series of endorsements, even if the last endorsement is in blank. In this connection, cancelled endorsements are deemed not to be written (non écrits). When an endorsement in blank is followed by another endorsement, the person who signed this last endorsement is deemed to have acquired the bill by the endorsement in blank."[130]

The second paragraph of Article 16 G.U.L.(Bills) requires, by comparison, that for the acquirer of a negotiable instrument to establish a good title to the instrument and ultimately to claim the advantages of the lawful holder, he must be, at the time of acquisition, "in good faith" and he must be free from "gross negligence". The second paragraph of Article 16 reads:

> "Where a person has been dispossessed of a bill of exchange in any manner whatsoever, the holder who establishes his right thereto in the manner mentioned in the preceding paragraph is not bound to give up the bill unless he has acquired it in bad faith, or unless in acquiring it he has been guilty of gross negligence."[131]

"Bad faith" in this context is defined so as to denote actual knowledge of a triable defence.[132] "Gross negligence", by comparison, is defined so as to denote the failure to act reasonably in suspicious circumstances.[133] As could be noted, the last mentioned paragraph of Article 16 G.U.L.(Bills) incorporates the second requisite for the protected party status. It could reasonably be inferred from the said paragraph that the party who intends to claim the advantages of the lawful holder, must not

possess an actual or constructive knowledge of the existence of a triable defence.

(vi) The Continental Geneva legal systems seem to apply the above mentioned definition to every instance of negotiable instrument fraud in order to identify the party to whose favour the risk allocation rule should be established and ultimately, the party to whose favour the negotiability attributes should run.[134] A significant instance of negotiable instrument fraud, in which the risk allocation rule is established in favour of the party who satisfies the above definition, is the forgery of negotiable instruments. By virtue of the pre G.U.L. rule to which the majority of the Continental Geneva legal systems adhere, the risk arising from the payment of a forged instrument is allocated to the acquirer of such an instrument unless the said party qualifies as the lawful indorsee of the instrument.[135] In such an instance only, the risk arising from the forgery of a negotiable instrument would be allocated to the drawee payor. He, by virtue of the above rule, may not recover the proceeds of the erroneous payment from the lawful indorsee recipient.

The Considerations Underlying the Narrow Definition of the Protected Party Status.

(i) The considerations underlying the establishment of the protection derivable from the application of the negotiability concept to the party who is firstly, remote

from the other competing party and secondly, who is unaware of the existence of a triable defence, are two in number. In the first place, the convenience of commerce in general dictates the necessity of protecting the bona fide purchasor. If the bona fide purchasor was not protected, commerce in general would suffer a serious set back. The public would be discouraged from dealing with others, the character of whom they are not familiar with. Commercial transactions would, as a result of the foregoing, come to a halt. Genuine and innocent parties would be prejudiced by the resulting setback. They might not be able to derive an enforceable value from their entitlements, once the public is discouraged from dealing with them. The genuine proprietor of an entitlement would, due to the absence of public reliance, not be able to alienate his entitlement.

(ii) The institution of negotiable instruments is an area in which a significant part of commercial transactions is facilitated. Their issuance, indorsement, guaranty, acceptance and payment, incorporate transactions the purpose of which is to settle financial claims. The need to settle financial claims by other than hand exchange of cash money is vital. Money is bulky and it is vulnerable to the risk of theft. Negotiable instruments are submitted to serve as a convenient substitute for cash money.[136] They, firstly, could be utilised to finance every transaction and

secondly, the practice relating to their usage could achieve a satisfactory application.[137]

(iii) In the context of negotiable instruments, the bona fide purchasor of a negotiable instrument is its bona fide acquirer. In order to establish a reasonable protection in favour of the bona fide acquirer of a negotiable instrument and ultimately, promote the institution of such documents, the said acquirer must among other things, be protected against the detrimental alteration in position. The position of the bona fide acquirer of a negotiable instrument is presumed to be altered to his detriment if firstly, he is made to establish his claim on the instrument and answer defences set up against him by a prior party against whom he intends to enforce the instrument and secondly, if he is made to -

1) forego the opportunity to obtain the credit incorporated in the instrument on its due date, or

2) he is made to forego the opportunity to satisfy his claim from a prior liable party.

(iv) The detriment arising from allocating to the bona fide acquirer of a negotiable instrument the duty of establishing his claim is illustrated in the burden involved in establishing such a claim. The acquirer of a negotiable instrument, should the duty to establish his claim be allocated to him, would have to persuade the court of trial or the jury of his satisfaction of the protected holder status and accordingly, he would have to persuade the said institutions of his claim to the

entitlements incorporated in the acquired instrument. To this end, the acquirer would have to establish -

1) that he is a holder of the instrument,

2) that he is in good faith or due course, and

3) that he is not aware of any triable defence vitiating the instrument or the title of its possessor i.e. the party from whom he established his title to the instrument.

The burden of establishing the said facts could be costly and time consuming. If the bona fide acquirer was made to establish his claim, he would have to endure the said cost and time. He, due to his status as such, might not be in the position to derive an enforceable value from the said cost and time or he might not be in the position to absorb them.[138] As could be noted, the assumption of cost and time by the bona fide acquirer could result in an economic detriment against him.

(v) The detriment arising from foregoing the opportunity to obtain the credit incorporated in the negotiable instrument on its due date is illustrated in the bona fide acquirer's inability to utilise the said credit in an efficient manner. The credit incorporated in a negotiable instrument would be utilised efficiently if it could be satisfied on its due date. In such an instance, the acquirer of the said credit would be able to satisfy his interests. He would be able to utilise the available credit to finance other related transactions. If, by comparison, the bona fide acquirer of a negotiable

instrument was not able to obtain a final settlement for his credit on its due date, he might have to disturb the performance of other related transactions or he might have to forego the opportunity to engage in favourable transactions, the finance of which is dependent on the satisfaction of the negotiable instrument's credit.

(vi) Finally, the detriment arising from foregoing the opportunity to enforce the credit incorporated in a negotiable instrument against a prior liable party, is illustrated in the acquirer's forfeiture of a valuable security. Every signature on a negotiable instrument represents a security in favour of the acquirer i.e. holder. It incorporates a contractual promise or undertaking to honour the instrument on its day of maturity.[139] The more securities there are, the more probable the payment of the instrument becomes. Each signatory is individually and collectively liable on the instrument.[140] The acquirer may satisfy his claim from either or all signatories. If the said party was made to forego the opportunity to enforce his claim against a prior liable party, he would be forfeiting a valuable security. Accordingly, the probability of obtaining full satisfaction of his credit would decrease.

(vii) The factor which could give rise to the above mentioned detriments is submitted to be the non-establishment of a good title in favour of the bona fide acquirer. In this instance, the bona fide acquirer would have to produce the evidence for his claim. He would

also have to answer counter claims and defences set up by other competing parties, the impact of which could undermine his claim. The non-establishment of the legal title rule in favour of the bona fide acquirer would result in enabling the drawee payor to challenge the acquirer's i.e. recipient's retention of the paid proceeds. It ultimately would enable the drawee payor to claim the surrender of the paid proceeds from the acquirer recipient. If the latter was compelled to revert to the drawee payor the proceeds of the erroneous payment, he would forego the opportunity to satisfy his credit timely or he would forego the opportunity to enforce his claim against a prior liable party.

Parties on a negotiable instrument are not liable for an indeterminate time. The liability of secondary parties in particular such as the drawer of an accepted instrument and the indorser of a negotiable instrument are liable on the instrument for a short period.[141] Moreover, their liability does not crystallise unless and until the acquirer, i.e. holder, procures timely presentment protest and notice of dishonour.[142] If the acquirer fails to comply with the above duty, the secondarily liable party against whom the acquirer intends to enforce his instrument, might be discharged from liability.[143] The acquirer of the negotiable instrument would be in breach of the above mentioned duties if he failed to act within the two days following the day on which the instrument falls due.[144] Thus if the drawee payor was entitled to recover the proceeds of his payment

from the acquirer recipient, he might deprive the said party of the power to exercise his right of recourse against a secondarily liable party. Accordingly, he would forego to the acquirer,recipient the opportunity to satisfy his claim against a valuable security.[145]

In order to protect the bona fide acquirer of a negotiable instrument from a detrimental change in position, the law should establish in his favour a good title to the instrument in question. By establishing a good title in favour of the bona fide acquirer, the said party would not have to establish his claim to the instrument. The burden of establishing the reverse would be allocated to the other competing party. By establishing a good title in favour of the bona fide acquirer, the said party would establish a good title to the paid proceeds. The drawee payor may not, accordingly, challenge the acquirer recipient's retention of the proceeds, nor may he compel the said acquirer recipient to surrender the said proceeds. Once the drawee payor was denied the right to challenge the acquirer recipient's retention of the proceeds, the latter would not experience the possibility of foregoing the opportunity to obtain a timely satisfaction of his claim or exercise a right of recourse against a valuable security.

The Notion of Finality

(i) In the second place, and as a further consideration

underlying the establishment of the protection derivable from the application of the negotiability concept to the party who is firstly, remote from the other competing party and secondly, who is unaware of the existence of a triable defence, is that dictated by the special nature of negotiable instruments. Negotiable instruments are elected to serve as a substitute for money. In order to facilitate their function as such, it is submitted that they should be clothed with some of the attributes of money. A significant attribute of money is its "finality". Money, it is submitted, confers a final settlement on the reciprocal financial obligations of the parties in question. That is to say, the payment of money confers an absolute discharge in favour of the payor as well as the recipient. Neither may the recipient of the money demand a fresh performance of the debt from his debtor, i.e. the payor, nor may the latter stop the credit incorporated in the money or stop its currency.

(ii) A significant advantage of the finality attribute of money is that it creates reasonable certainty in the commercial community. The payment of money reasonably assures the recipient that the transaction, the performance of which was satisfied by money, is closed. Accordingly, he may utilise the said money to satisfy his interest. He may utilise it to finance other transactions or settle his obligations in prior transactions.

(iii) In order to clothe the negotiable instruments

with finality, the drawee payor should not be entitled to claim the surrender of the proceeds of the instrument from its acquirer recipient. The latter should be entitled to retain the said proceeds. If the drawee payor was entitled to recover the proceeds from the recipient, the latter's financial interest would be impaired. The drawee payor's right of recovery results in an uncertainty as to the recipient's title to the proceeds. The recipient accordingly, would not be able to utilise the proceeds of the payment efficiently. He would either have to forego the opportunity to engage in other transactions, the finance of which is dependent on the status of the paid proceeds or he would have to disturb his commercial engagements.

Evaluation of the Continental Geneva Legal Systems in Determining the Protected Party Status.

(i) To state the obvious, neither the doctrine of "bona fide purchase" as dictated by the convenience of commerce in general, nor the notion of "finality" as dictated by the special nature of negotiable instruments, support the need to restrict the protection derivable from the application of the negotiability concept to the lawful indorsee only. The payee of a negotiable instrument should be entitled to similar protection. In instances where the drawee erroneously pays a forged instrument in favour of its payee, he should not be entitled to recover the proceeds of his payment from the latter. The law

should establish in favour of the payee recipient a good title to the paid proceeds. The payee should accordingly be entitled to retain the proceeds of the erroneous payment.

The payee of a negotiable instrument may be as innocent as the indorsee. His prima facie proximity to the purported maker/drawer by no means suggests the existence of actual proximity. There are instances in which the payee is prima facie proximate to the purported maker/drawer whereas in fact he is remote from him. An example of such an instance is the unauthorised signing of a negotiable instrument in the name of one partner by another partner of the same firm. The party to whose favour the active partner issues the instrument might not be aware of the existence of a triable defence namely, the forgery. The payee in this instance is presumed to be remote from the other competing party i.e. the purported maker/drawer as the indorsee of a negotiable instrument.

(ii) In fact the extension of the protection arising from the application of the negotiability concept in favour of the bona fide payee enforces more effectively the considerations underlying the said protection, namely the doctrine of bona fide purchase and the notion of finality. For the notion of finality to be effective, its application should run in favour of every third party who bona fide relies in his dealing with others on the prima facie regularity of the transaction in which he engages. Such an application would enhance the certainty

in commerce. The commercial community would, accordingly, be encouraged to increase its commercial activities and ultimately commercial transactions would be promoted.

(iii) In order to promote the institution of negotiable instruments, through which a significant number of commercial transactions are facilitated, the notion of finality should establish in favour of the bona fide payee recipient, the advantage of certainty resulting from its application. The fact that the establishment of the advantage of certainty in favour of the bona fide recipient would facilitate the promotion of the institution of negotiable instruments, could be explained on the grounds that a large number of negotiable instruments do not circulate in the stream of commerce. Their chain of acquisition rests with the initial acquirer only, namely the payee who either deposits the instrument for collection or presents it to the drawee for payment.

If the advantage of certainty was to be restricted to the lawful indorsee only, the commercial community would be discouraged from engaging in the acquisition of negotiable instruments. Due to the lack of certainty, they would deem their financial status unsecured. Once the commercial community was discouraged from acquiring negotiable instruments, the objective of promoting the said institution would fail. Ultimately, negotiable instruments would not be capable of efficiently performing their function as substitutes for money.

(iv) As far as the consideration underlying the doctrine of bona fide purchase is concerned, namely the protection against the detrimental alteration in position, it could be observed that the exclusion of the bona fide payee recipient from the category of the protected party would result in a detrimental alteration in his position. The bona fide payee recipient, due to the non-establishment of the good title protection in his favour, would be accountable to the drawee payor for the proceeds of the erroneous payment. He would have, where the drawee payor so elects, to revert to the latter, the proceeds of the erroneous payment. In such an instance, the bona fide payee recipient would forego the opportunity to satisfy his entitlements arising from the underlying obligation which gave rise to the acquisition of the negotiable instrument timely. Accordingly, he would be unable to utilise the said entitlements in an efficient manner. He might have to forego the opportunity to engage in other favourable transactions, the finance of which is dependent on the entitlement arising from his acquisition of the negotiable instrument or he would have to disturb the performance of other related transactions.

(v) In summary, the exclusion of the bona fide payee recipient from the category of the protected party could, due to his inability to obtain a timely satisfaction of his entitlements, damage the financial interest of the said party.

The English Legal System

(i) In allocating the risk arising from the payment of a forged instrument, to the drawee payor, the law in the English legal system requires that the recipient of the proceeds of the erroneous payment must be a "holder in due course".[146] For a party to qualify as the holder in due course of a negotiable instrument and ultimately claim to his favour the protection resulting from the application of the negotiability concept, he must satisfy the following requirements. He firstly, must at the time of acquisition, be in good faith. Secondly, he must not be aware of the existence of any defence vitiating the instrument or the title of its possessor. Thirdly, he must take the instrument for value. Finally, he must establish his title to the instrument through negotiation.[147]

(ii) The most relevant requirements, as far as this section is concerned, are the requirement of "good faith" and the requirement that the party who intends to claim the holder in due course status must establish his title to the instrument through "negotiation". Good faith in this context is defined so as to denote honesty in fact.[148] It is concerned with the actual state of mind of the party in question. A party to a negotiable instrument is deemed to be in good faith as long as he is not guilty of fraud. "Gross negligence" on its own does not import bad faith to the party in question.[149] Thus, a party to a negotiable instrument may be guilty of gross

negligence, but nevertheless he may still qualify as the holder in due course. Accordingly, he may claim to his favour the protection arising from the application of the negotiability concept. In instances of erroneous payment, he may establish a good title to the paid proceeds. The drawee payor may not set up the acquirer recipient's gross negligence so as to claim the recovery of the erroneously paid proceeds. An example where a party to a negotiable instrument would be guilty of gross negligence, but nevertheless may qualify as the holder in due course, is the acquisition of a large negotiable instrument purported to be issued by a firm of stockbrokers, from a person of shoddy appearance, without making reasonable enquiry as to his title.

(iii) The concept of negotiation in the English context of negotiable instruments is defined narrowly. It is defined so as to denote the transfer of negotiable instruments by way of "indorsement". The first transfer, i.e. issue does not, by comparison, fall within the scope of negotiation. Thus the payee of a negotiable instrument cannot per se qualify as the holder in due course.[150] Accordingly, he cannot derive full protection from his acquisition. In particular, and in instances where the instrument to which he establishes his title is proved to be a forgery, he may not claim a good title to its proceeds. The drawee payor may ultimately claim the recovery of the paid proceeds from the payee recipient.

As could be noted, the only party who can qualify as

the holder in due course and claim in full the protection arising from the application of the negotiability concept, is the bona fide indorsee for value of a negotiable instrument. He, in instances of erroneous payment may claim a good title to the proceeds of a forged instrument. The drawee payor may not claim from him the recovery of the said proceeds.

The Considerations underlying the English definition of Protected Party Status.

(i) The considerations underlying the English legal system's definition of the holder in due course i.e. the party to whose favour the protection arising from the application of the negotiability concept should be established, are two in number. In the first place, the objective of promoting the institution of negotiable instruments as a substitute for money dictates the necessity to relax the standard of care of the acquirer of such documents. To this end, the standard of care of the acquirer of a negotiable instrument should be set at the limit where the compliance with such a standard would not result in an economic detriment against the said party. The acquirer of a negotiable instrument would sustain an economic detriment if he was made to exercise care, the impact of which would compel him to incur cost and consume time without being able to derive enforceable value to absorb them. Such an instance would occur if the third party to whom a negotiable instrument is offered for a

valuable exchange was made to exercise reasonable care in his acquisition.

The exercise of reasonable care in the acquisition would necessarily involve shopping for information concerning the status of the offered instrument and the title of its possessor. The compliance with such a standard of care, as has been mentioned above,[151] involves cost and time. The third party to whom the instrument in question is offered for a valuable exchange is not, it is submitted, in a position to derive an enforceable practical value from the evolving cost and time.[152] The compliance with the reasonable standard of care would result in a misallocation of value. Ultimately, the bona fide third party acquirer, i.e. the party to whom such a duty of care is allocated, would be discouraged from the acquisition of negotiable instruments. The objective of promoting such an institution would then fail.

In order to promote the institution of negotiable instruments and ultimately facilitate its function as a substitute for money, the standard of care of the bona fide acquirer of such a document should be set below that of the "reasonable man". His duty of enquiry should be restricted to examining the four corners of the instrument. If the four corners of the instrument in question do not reveal the existence of any irregularity, the bona fide third party to whom the instrument is offered for a valuable exchange, should be protected in his acquisition. He should have a good title to the instrument established in his favour. His good title to

the said instrument should not be defeated by reason that he failed to behave reasonably in his acquisition.

It is argued that the concept of gross negligence in many cases is indistinguishable with ease from the concept of negligence i.e. the failure to behave as a reasonable man. If the bona fide third party acquirer of a negotiable instrument was to be denied the good title protection by reason that he was guilty of gross negligence, the court of trial or the jury might be led to find cases of simple negligence to constitute gross negligence. Accordingly, they might be led to deprive the bona fide acquirer of the good title protection in instances where such a protection should be established in his favour. Due to the possibility that courts or jurors might find the bona fide acquirer of a negotiable instrument guilty of gross negligence in instances of simple negligence, the said party might find himself bound to exercise a higher standard of care in order to avail himself of the good title protection. The exercise of a higher standard of care in this instance might, as has been illustrated above,[153] prove to be detrimental to the said party. Such an application might, accordingly, discourage third parties from acquiring negotiable instruments. The objective of promoting the institution of such instruments as a substitute for money might fail.[154]

(ii) In the second place, and as far as the exclusion of the payee recipient of the proceeds of a forged instrument from the protection arising from the application of the

negotiability concept, is concerned, it is argued that the said party in this instance is not an acquirer of a negotiable instrument in the true sense. Accordingly, he does not qualify for the protection established in favour of the holder in due course, namely, the good title rule. The instrument which incorporates no valid signature is a mere "sham".[155] It possesses no enforceable value in favour of its acquirer. Thus, if the said acquirer, such as the payee, was compelled to revert to the drawee payor the erroneously paid proceeds, he would not sustain any detriment on the instrument. Due to the non-existence of a valid signature, there would not be a party to the instrument the liability of whom could be called into question. Accordingly, there would not be a party against whom a right of recourse could be exercised on the instrument. The right to receive a timely notice of dishonour from the drawee, or the right to be availed of the advantage of knowing whether the instrument is finally paid or not, would be superfluous.

Evaluation of the English definition of Protected Party Status.

(i) As far as the first argument is concerned, namely that due to the difficulty in distinguishing gross negligence from simple negligence and in order to facilitate the promotion of negotiable instruments, the acquirer of such a document should not be deprived of the good title protection by reason of his being guilty of

gross negligence, it could be replied that such protection is too wide. The rule of establishing a good title in favour of the bona fide acquirer independently from the title of his prior transferor, is an exception to the general rule of law, namely no-one can give what he does not have, "nemo dat quod non habet". The above mentioned exception is introduced into the law of negotiable instruments for the sake of commercial convenience and the special nature of the institution of negotiable instruments.

(ii) Since the good title rule is an exception to the general rule of law, it should be applied with rigidity. Any attempt to render the application of the said rule flexible could lead to its extension to instances where neither the convenience of commerce nor the special nature of negotiable instruments dictate such an application.

An example of such an undesirable application is the rule which provides good title protection in favour of the bona fide acquirer who has been guilty of gross negligence in his acquisition. If the acquirer of a negotiable instrument was protected in instances of gross negligence, he in effect would be released from the duty of exercising some care. This of course cannot be intended by the convenience of commerce, nor can it be intended by the desire to facilitate the function of negotiable instruments as a substitute for money. On the one hand, if the convenience of commerce intended to extend the protection evolving from the application of the doctrine

of bona fide purchase, namely the good title rule, in favour of grossly negligent parties, the market would evidence "moral hazard". That is to say that the public would be encouraged to behave recklessly in its acquisition. Such behaviour would increase the rate of fraud and ultimately it would increase the occurrence of loss. The increase of loss in instances where its avoidance is possible by the exercise of some care is incompatible with the policy of the market. Loss in this instance represents a misallocation of wealth.

(iii) On the other hand, the desire to facilitate the function of negotiable instruments as a substitute for money does not dictate the necessity to extend the good title protection to grossly negligent acquirers. In order to clothe negotiable instruments with the attribute of money, they should circulate as clean as money. Their possession should not be clouded with suspicion as to their genuineness or regularity. If such an instance was to exist, the third party to whom the instrument in question is offered for a valuable exchange should not be fool enough to be misled as to its true status without making some enquiry. After all, the third party to whom the instrument is offered for a valuable exchange, is not bound to accept a negotiable instrument as a discharge for his underlying rights. He should insist on the presentation of a more reliable payment instrument.[156]

(iv) As to the argument that gross negligence is indistinguishable with ease from simple negligence, it

could be replied that such an argument is not true. There must be a borderline where a distinction could be drawn between gross negligence and simple negligence. The acquisition of a large negotiable instrument at a large discount rate from a shoddy looking person is not similar to the acquisition of a small negotiable instrument for a consideration equal to its face value from a business-like person without identifying him. The latter instance, as could be noted constitutes simple negligence, but it would be surprising indeed to deem the former instance a case of simple negligence or that it cannot be distinguishable with ease from the case of simple negligence. The trial court, it is submitted, should be able to draw or direct the jury to draw from the facts of each case a line between gross negligence and a case of simple negligence.

The Exclusion of the Bona Fide Payee Recipient from the Scope of the Protected Party.

(i) As far as the second argument is concerned, namely, that the forged instrument is a "sham", hence the payee recipient would not suffer a detriment had he been compelled to revert to the drawee payor the proceeds of the erroneous payment, it could be replied that for an unjustified detriment to be compensated it need not be expressed in the terms of material damage. It suffices that the detriment in question takes the form of foregoing a valuable interest. The advantage of certainty in

commerce in general is submitted to be a valuable asset. The party to whom the advantage of certainty is established can manage his affairs efficiently. He can determine with confidence his status as to prior transactions and organise his financial affairs on the basis of such confidence. By determining his status to a particular prior transaction, the person in question can decide the best way to promote his commercial interest in subsequent transactions.

(ii) The advantage of certainty in the context of negotiable instruments possesses a considerable significance. Negotiable instruments are utilised as a payment device, the purpose of which is to discharge existing monetary obligations. The party to whom they are offered for a valuable exchange accepts to acquire them with the intention that they shall be liquidated at their day of maturity into absolute credit i.e. money, and he would be able to utilise their proceeds to finance other transactions.

(iii) Without the advantage of certainty that the offered instrument would be paid and its payment would be final, the institution of negotiable instruments would not be capable of achieving its intended function, namely as a payment device. If the acquirer of a negotiable instrument was, due to the drawee payor's right of recovering the proceeds of his erroneous payment, made to forego the advantage of certainty, his financial interest would be impaired. He would have to suspend his

commercial engagements, the finance of which is dependent on the credit incorporated in the acquired instrument, or he would have to disturb his business. And finally, because of the fear that the payment of a negotiable instrument would be recovered, the public might be discouraged from the acquisition of such a document. Ultimately, the objective of promoting the institution of negotiable instruments would fail.

(iv) The fact that the objective of promoting the institution of negotiable instruments as a substitute for money would fail becomes more apparent in instances where the payee recipient is denied the advantage of certainty. As has been indicated above, a large number of negotiable instruments are not circulated in the stream of commerce. Their chain of acquisition normally rests with the initial acquirer i.e. payee. Accordingly, a large number of the public, because of the uncertainty as to the finality of payment, would be deterred from the acquisition of negotiable instruments.

<u>The Impact of the Purported Maker/Drawer's Negligence in Determining the Risk Allocation Rule.</u>

(i) In instances where the proceeds of a forged instrument are paid to a holder in due course, i.e. the bona fide indorsee for value, or where the proceeds of the said instruments are paid to the forger, the law in the English legal system allocates the loss resulting from such payments to the drawee payor. In most of the cases,

it denies to the drawee payor the right to recover the loss resulting from his erroneous payment from his customer i.e. the purported maker drawer, whose careless behaviour was a contributing factor to the occurrence of loss. In English law, unless the purported maker/drawer's careless behaviour was "in or immediately connected with the act of negotiation", it would not be sufficient to establish liability in negligence.[157]

(ii) The purported maker/drawer's careless behaviour would constitute negligence in or immediately connected with the negotiation of a negotiable instrument if he enables another person to use the instrument for the purpose of raising money either by negotiating it for value or cashing it with the drawee payor. Examples of such an instance are the establishment in favour of an employee of the power to issue negotiable instruments in the name of his employer[158] and the signing of a blank instrument and delivering it to his agent for the purpose of completing it and using it as a negotiable instrument to raise money.[159] If the employee or agent in such instances misused his authority and misappropriated the proceeds of the instrument in question for his own interest, the employer or principal would be precluded from denying the validity of his instrument. His act of assisting his employee or agent to use a negotiable instrument for the purpose of raising money is deemed to constitute negligence in or immediately connected with the act of negotiation.

(iii) In no other instance of careless behaviour may the drawee payor recover the loss resulting from his payment from the careless customer.[160] It is held that the customer of a drawee does not owe the latter a duty to exercise reasonable care in the safe custody of his blank instruments, in the running of his business, or even in the examination of pass books and returned vouchers.

## The Existence of a Duty to Exercise Care in the Safe Custody of Blank Instruments

(i) As far as the first duty is concerned, namely the duty to exercise reasonable care in the safe custody of blank instruments, Parke B. in **The Bank of Ireland v Evans' Charities Trustees**[161] laid down the rule that no such duty exists in English law. The court in this case ordered the Bank of Ireland to make good the loss caused to the plaintiffs by the former's unauthorised transfer of shares deposited with it for safe custody. It dismissed the bank's argument that the plaintiffs, due to their negligence in entrusting their secretary with the corporate seal, should be estopped from denying the validity of the forged powers of attorney, through which the secretary managed to misappropriate the shares to his own interest.[162]

(ii) In **Baxendale v Bennett**[163] the court reached a similar ruling. It denied to the plaintiff, who was a bona fide indorsee for value of an accepted blank instrument which was stolen from the writing desk of the

acceptor, completed and negotiated as a negotiable instrument, the right of enforcing it against the defendant i.e. the acceptor. It held that the careless custody of blank instruments does not operate as a sufficient ground for finding liability in negligence.[164]

The Existence of a Duty to Exercise Care in the General Running of a Business and the Examination of Statements Accounts and Returned Vouchers.

(i) As far as the second and third duties are concerned, the English Common Law is explicit in denying the existence of the duty to exercise reasonable care in the running of the customer's business or the existence of a duty to exercise reasonable care in the examination of pass books bank statements and returned vouchers.

(ii) In **Kepitigalla Rubber Estates Ltd. v National Bank of India Ltd.**,[165] Bray J. laid down that he could find no authority in English law as to the proposition that the customer owes his bank a duty to exercise reasonable care in the supervision of the running of his business or the duty to exercise reasonable care in the examination of pass books and returned vouchers. The facts of this case were as follows. The plaintiff was a company engaged in cultivating an estate which it owned in Ceylon. It had in its employ a part-time secretary who kept his previous job in the plaintiff's chairman's private business. The plaintiff opened in its own name an account with the defendant. It was agreed between the plaintiff and

defendant that for cheques drawn in the name of the former to be valid, they must incorporate the signatures of its two directors together with the signature of its secretary. For this purpose, the two directors of the plaintiff and its secretary deposited their signatures with the defendant.

Within two months of his employment with the plaintiff, the secretary managed to forge and misappropriate the proceeds of eight cheques. The first forgery was perpetrated by crossing the words "or order" from the face of the cheque issued in favour of Lloyds Bank and signed by one of the directors. Above the crossed words the secretary inserted the words "or bearer" and cashed the cheque with the defendant. In order to conceal his fraud, the secretary inserted the above item in the company's finance book and requested the director who signed the cheque to initial it. The secretary next fixed the chairman's rubber stamp in the column of payments to authenticate the fraudulent entry. At the first shareholder's meeting, the chairman of the company, due to his illness, failed to appear. The finance book was presented to the shareholders for ratification. The directors present at that time were not aware of the forgery and accordingly passed a resolution ratifying the entries in the finance book.

The remaining seven forgeries were, by comparison, perpetrated by forging the signature of two of the directors. The secretary issued the said cheques either to his favour or made them payable to the order of a third

party or bearer. In every instance, he cashed the forged cheques and misappropriated their proceeds. The defendant bank on neither occasion could detect the forgeries. After making payment, it debited the plaintiff's account with the face value of the forged cheques. Moreover, the bank delivered the pass book and the paid vouchers to the secretary. The latter, as could be guessed, never communicated the said pass books or the vouchers to the directors.

When the company learned of the forgeries, it ordered the bank to recredit its account with the debited amount. It argued that the eight cheques in question were forgeries and the bank could not act upon them. Accordingly it could not debit the company's account with their face value. The bank counter-argued that the plaintiff company was negligent on two counts. Firstly, it was negligent in the running of its business for not supervising the job of its secretary and, secondly, it was negligent in not examining its pass books and returned vouchers.

Because of the failure to exercise reasonable care as to the examination of pass books and returned vouchers, the company is deemed to have prevented the bank from avoiding the payment of the subsequent forged cheques.[166]

Bray J. in passing his judgement in favour of the plaintiff company, held that notwithstanding the fact that the plaintiff in the case under consideration, exercised reasonable care, the defendant's argument concerning the existence of a duty to exercise reasonable care in the

running of the business and the duty to exercise reasonable care in examining pass books and returned vouchers do not stand as valid in English law. Bray J. as to the first duty said:

> "Therefore it is that the defendants go further and say that there is a duty to use reasonable care in the carrying out of their business relating to the issuing of mandates. This is a very vague statement of the duty. What is meant I suppose is beyond the care which must be taken in the transaction itself, a customer must in the course of carrying on his business take reasonable precautions to prevent his servants from forging his signature or if the customer be a company the directors must take reasonable precautions to prevent the company's servants from forging their signatures. Now is there any authority for this proposition? I can find none."[167]

As to the contention that the plaintiff owed the defendant a duty to examine pass books and returned vouchers and if the plaintiff does not object as to the regularity of the pass book or the validity of the vouchers it cannot be heard to deny the regularity of the pass book or the validity of the vouchers. Its failure to make such objection is deemed to have conferred a final settlement of its account with the bank. Bray J. said,

> "The last raises a more important point, though I should add that it was not seriously pressed before me. It is this: that when a pass book is taken out of the bank by a customer and some clerk of his and returned without objection there is a settled account between the bank and the customer by which both are bound. I know of no authority in this country for this proposition."[168]

(iii) The decision of Bray J. in Kepitigalla Rubber Estates Ltd. v National Bank of India Ltd. was relied upon in subsequent cases. It was considered as applying the correct interpretation of English law. In London Joint Stock Bank v Macmillan and Arthur,[169] Finlay L.J. cited with approval the decision of Bray J. His Lordship held that for negligence to be a ground for recovery it must be "negligence in the transaction". The failure to exercise reasonable care in the running of a business is not sufficient to establish liability in negligence against the customer of a bank. Finlay L.J. said,

> "Of course the negligence must be in the transaction itself, that is in the manner in which the cheque is drawn. It would be no defence to the banker if the forgery had been that of a clerk of a customer, that the latter had taken the clerk into his service without sufficient inquiry as to his character."[170]

(iv) In the more recent cases, the courts also referred to the decision in Kepitigalla Rubber Estates Ltd. v National Bank of India Ltd. as far as the determination of the case turns on the existence of a duty to exercise reasonable care in the running of the customer's business or the existence of a duty to exercise reasonable care in the examination of pass books and returned vouchers. In the unreported case of Wealden Woodlands (Kent) ltd. v National Westminster Bank Ltd.[171] McNeill J. quoted at length the judgement of Bray J. He saw it as laying down a general rule that the customer of a bank does not owe the latter a duty to exercise reasonable care in the running of his business or in examining pass books and

returned vouchers. The facts of this case were as follows. The plaintiff was a company engaged in the timber business. It had an account with the defendant. It was agreed between the plaintiff and defendant that cheques issued in the name of the former must be signed by two of the company's four directors.

Mr. John Holland was one of the plaintiff's four directors. He was highly regarded among his colleagues. His good character was never doubted. He was entrusted with the job of managing the financial and administrative affairs of the company. He was in fact the most active director. Many issues and queries were referred to him. His job as such was not supervised by his colleagues. Moreover, an oral explanation by him concerning the order of things satisfied the conviction of the other directors as to the regularity of the business.

Mr. Holland, together with his mother, ran a pig farming business. In order to raise money for his private business he, during a period of two years, forged some twenty three cheques. He issued in the name of the company i.e. the plaintiff, cheques in favour of the supplier of his private business, affixed his signature, forged the signature of one of the directors and settled his personal account with the payees. The cheques were presented to the defendant for payment. The forgeries were not detectable by reasonable care. Accordingly, the defendant paid them and debited the plaintiff's account with the face value of the forged cheques. Since Mr. Holland was in charge of the financial and administrative

affairs of the plaintiff company, the other directors did not have the opportunity to examine the bank statements before the annual audit.

When the plaintiff company learned of the forgeries it ordered the defendant bank to recredit its account for the face value of the erroneously paid cheques. It argued that since the cheques bore the forged signature of one of the directors they were deemed invalid. Accordingly the defendant could not act upon them and debit the plaintiff's account. The defendant bank counter-argued that the plaintiff company was negligent in not supervising the job of Mr. Holland and it is estopped from denying the validity of the forged cheques. Such an estoppel arises from the plaintiff's negligence in not examining its bank statements, noticing their irregularity and reporting it to the bank. Had the plaintiff complied with the duty to examine bank statements, it would have assisted the defendant bank to avoid the cashing of the subsequent forged cheques.[172]

McNeill J. in passing his judgement in favour of the plaintiff company dismissed the argument of the defendant bank. He relied in his judgement on the rule laid down by Bray J. in **Kepitigalla Rubber Estates Ltd. v The National Bank of India.**[173] After a lengthy quotation from the judgement of Bray J., McNeill J. commented on the validity of such passages by saying:

> "These passages I find wholly consistent with the other authorities to which I have referred and I note that not merely was it not the subject of appeal but that it stood uncritized for over seventy

> years. I can find no sensible distinction for these purposes between pass books (there under consideration) and loose leaf bank statements."[174]

(v) Finally, in Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd. and Others,[175] the Privy Council dismissed the defendant's argument that the plaintiff owed them a wider duty of care as well as a narrower duty of care. The wider duty of care is related to the general running of business whilst the narrower duty of care is related to the examination of bank statements. Lord Scarman held that in English Law no such duty or duties exist as between the bank customer and his bank. In his judgement which he delivered on behalf of the Privy Council, he referred to the decision of Bray J. in Kepitigalla Rubber Estates Ltd. v The National Bank of India. In doing so, he deemed that decision as expressing the correct rule of law in the English legal system.[176]

## The Considerations Underlying the English Attitude of Denying the Duty to Exercise Care in Favour of the Drawee Payor.

(i) The reasons which led English courts to deny the existence of a duty to exercise reasonable care in the general running of the customer's business or the duty of care to examine bank statements or their equivalent are two in number. In the first place, the breach of such a duty or duties is not deemed to be the "proximate" cause

of the loss resulting from the erroneous payment. In fact, the proximate cause of such a loss is the fraudulent practice of the forger. This reason was first advanced by Parke B. in the Bank of Ireland v Evans' Charities Trustees[177] and echoed throughout by many judges.[178]

(ii) In the second place and as far as the question of the existence of a duty of care arises between the customer and his bank, it is argued that the relationship of the said parties is regulated by a voluntarily made commercial contract, namely the contract of deposit. Accordingly, they can determine in express terms the duty of each party. The bank, in particular, may incorporate in the contract of deposit, special clauses the impact of which is to impose upon its customer the duty to exercise reasonable care in the running of his business and/or the duty to exercise care in the examination of bank statements. The bank may also include in the deposit contract with its customer a clause the impact of which is to render the latter, i.e. the customer, liable for the loss resulting from his failure to exercise the above mentioned duties. In instances where the bank does not make such stipulations, it would be deemed to have assumed the risk resulting from its customer's failure to exercise reasonable care.

(iii) This argument was first advanced by Bray J. in Kepitigalla Rubber Estates v The National Bank of India. It is reported that the judge in that case said:

> "I think Mr. Scrutton's contention equally fails when it is considered apart from authority. It amounts to a contention on the part of the bank that its customers impliedly agree to take precautions in the general course of their business to prevent forgeries on the part of their servants. Upon what is that based? It cannot be said to be necessary to make the contract effective. It cannot be said to have really been in the mind of the customer, or, indeed of the bank, when the relationship of banker and customer was created. What is to be the standard or the extent or number of the precautions to be taken? Applying it to this case, can it be said to have been in the mind of the directors of the company that they were promising to have the pass-book and the cash-book examined at every board meeting and to have a sufficient number of board meetings to prevent forgeries, or that the secretary should be supervised or watched by the chairman? If the bank desire that their customers should make these promises they must expressly stipulate that they shall. I am inclined to think that a banker who required such a stipulation would soon lose a number of his customers."[179]

The same argument was echoed by Lord Scarman in **Tai Hing Cotton Mill Ltd. v Lui Chong Hing Bank Ltd. & Others.** His Lordship said:

> "Their Lordships do not however accept that these parties mutual obligations in tort can be any greater than those to be found expressly or by necessary implication in their contract. If therefore as their Lordships have concluded, no wider duty than that recognised in Macmillan [1918] A.C.777 and Greenwood [1933] A.C.51 can be implied into the banking contract in the absence of express terms to that effect, the banks cannot rely on the law of tort to provide them with greater protection than that for which they have contracted.
>
> For these reasons their Lordships answer the general question by accepting the submission of the company that in the absence of express terms to the contrary the customer's duty is in English law as laid down in Macmillan and Greenwood.

> The customer's duty in relation to forged cheques is, therefore, twofold: he must exercise due care in drawing his cheques so as not to facilitate fraud or forgery and he must inform his bank at once of any unauthorised cheques of which he becomes aware."[180]

Evaluation of the English Attitude Towards the Existence of the Duty to Exercise Care.

(i) As far as the first argument is concerned, it could be replied that the attitude of English Law in determining the existence of a causal relationship stems from its adhesion to a traditional Common law narrow conception of the element of causation. It defines causation so as to denote the natural and direct cause. It deems a particular careless behaviour as the cause of a particular loss if the occurrence of the latter was the natural and direct consequences of the former.[181] To state the obvious, such definition of the concept of causation is unreasonable. Its application results in releasing the careless party from liability in instances where his careless behaviour contributed to the occurrence of loss. Such an application on the other hand, and by reason that it releases the careless party from liability, allocates the loss the occurrence of which was largely due to the said party's careless behaviour, to a relatively innocent party.

An example of such an instance is the payment of a cleverly forged instrument the proprietor of which was careless in its safe custody. The act of payment in such an instance would not have occurred had the proprietor of

the forged instrument exercised care as to its safe custody. The latter's failure to exercise such care is presumed to have contributed to the occurrence of loss. Thus, if the purported maker drawer, i.e. the proprietor of the forged stolen instrument was not liable in negligence, he would be entitled to claim in full to his own interest the credit, the unauthorised payment of which, was largely due to his own careless behaviour. The loss resulting from such careless behaviour i.e. the unauthorised payment of a forged instrument would be allocated in its entirety to a relatively innocent party i.e. the drawee payor. The drawee payor in such an instance is presumed to be relatively innocent because he would not be able to detect a clever forgery by the exercise of reasonable care.

(ii) A further disadvantage of the traditional narrow common law conception of causation is that it gives rise to "moral hazard". It encourages the parties against whom it does not establish a liability for careless behaviour, to behave recklessly. Once the public is encouraged to behave recklessly, the rate of fraud is bound to increase and accordingly the occurrence of loss would likewise increase. Loss occurrence in instances where its avoidance is possible by the exercise of reasonable care is economically inefficient. Loss in this instance represents a misallocation of wealth.[182]

(iii) As far as the second argument is concerned, it could be replied that the establishment of liability on

the basis of the failure to behave reasonably against the careless party and in favour of a party with whom the former is privy is an application of a rule of law. The parties to a particular contract need not expressly stipulate in their contract their desire to adhere to it. The purpose of contract is to regulate that which the law does not regulate, or to derogate, as long as it is "fair and reasonable", from the existing rule of law. In other words, the parties to a particular contract impliedly agree that the general rule of law governs their relationship insofar as they do not stipulate in their contract an express stipulation to the contrary.

(iv) As far as this section is concerned, it is submitted that the relationship between the drawee payor and the purported maker/drawer is regulated by the contract of deposit. By virtue of such a contract, the drawee is deemed in contractual privity with his customer i.e. the purported maker drawer. Since, by virtue of the recent development in the law of tort which the English law has evidenced, the test of "reasonable foreseeability" is imported to determine the existence of a causal relationship,[183] the purported maker/drawer, i.e. the proprietor of the forged stolen instrument should be held accountable for the loss resulting from his careless behaviour in the safe custody of his blank instruments, the general running of his business, and the examination of pass books, bank statements and returned vouchers. It is reasonable to foresee that in the failure to behave

reasonably in the safe custody of blank instruments and so forth that blank instruments would be misused, the drawee might erroneously pay them and their proceeds would be misappropriated. Thus, and in order to provide against the occurrence of such a foreseeable event, the proprietor of blank instruments should take reasonable precaution in the safe custody of his blank instruments, in the general running of his business and the examination of pass books, bank statements and returned vouchers.

The Impact of the Rule of Contributory Negligence on Determining the Problem of Risk Allocation in English Law.

(i) After the passage of the 1945 Law Reform Contributory Negligence Act, it was argued that section one of the said act provided a remedy in favour of the convertor of a negotiable instrument against the careless proprietor of such a document.[184] The said remedy is illustrated in the convertor's right to recover from the careless proprietor, a part of the resulting loss.

(ii) In **Lumsden & Co. v London Trustee Savings Bank**,[185] Donaldson J. relied in his decision on Section I of the 1945 Law Reform Contributory Negligence Act. The facts of this case were as follows. The plaintiff was a firm of stockbrokers. Due to a boom in its business, it required a temporary accountant. After consulting an independent employment agency, it interviewed Mr. James Blake. Blake was an Australian citizen. At the interview, Blake claimed that he came to England to clear

up his father's estate. The person in charge of interviewing Blake was impressed by the latter's character. Accordingly, the firm chose to recruit Mr. Blake as an accountant.

Due to Mr. Blake's high level of skill and apparent honesty, the firm promoted him shortly after his employment to the job of investigating any queries raised on any of the multitude of accounts with the firm. Due to his skill and apparent honesty, Mr. Blake's job was largely unsupervised. In most instances, an oral explanation by him concerning the order of things satisfied the conviction of his employers as to the regularity of the accounts.

The firm, in the habit of issuing its cheques, wrote the name of the intended payee in an abbreviated form. Mr. Blake found in such a practice a good opportunity to perpetrate his fraud. He interposed the character of J.A.G. Brown a fictitious person, to open an account with the defendant. He alleged that he was a self-employed chemist who came to stay with an Australian family in England. He claimed that he had no bank account in Australia and supplied his true identity as a referee. The defendant bank wrote to Mr. Blake requesting a reference from him concerning the character of the intending customer i.e. Brown. The letter reached the accommodation address of Mr. Blake. Mr. Blake certified in a letter that Brown was of good character and probity. The defendant's manager saw Mr. Blake's letter as sufficient to open an account in favour of Brown.

Blake, in his status as the plaintiff's employee issued cheques at various intervals in favour of Brown. He wrote the name Brown in the middle of the line designated for the insertion of the name of the payee and presented them to his employer for signature. Since the manner of drawing the said cheques was in conformity with the firm's practice, Blake's employers could not detect any irregularity. They signed the presented cheques and handed them to Blake for delivery. Blake next inserted the initials J.A.G. before the name Brown and deposited them in his account with the defendant.

In every instance, Blake in his fictitious character emphasised his urgent need for the money. On several occasions, he asserted the fact that he needed the money to pay into his bank account in Australia. Such an assertion did not however raise any suspicion in the mind of the defendant's manager as to the true account of Mr. Brown's assertions, especially that Brown had previously denied that he had an account in Australia. However, all of the deposited cheques were presented for payment and credited into Brown's account.

Shortly before the firm's annual audit, Blake decided to leave for Australia. He drew most of the credit in his account with the defendant and disappeared. When the firm learned of the forgery, it ordered the defendant bank to recredit its account for the face value of the forged cheques. It argued that since the cheques in question were not intended by the issuers to be payable to J.A.G. Brown, the indorsements in the name of the latter were a

forgery. Accordingly they were inoperative and by virtue of section 24 B.E.A., they could not establish a good title in favour of J.A.G. Brown or the defendant bank. Either of them is deemed in law to be a convertor. And because the defendant was negligent in opening an account with Mr. Brown and cashing his cheques, it cannot avail itself of the protection offered in Section 4 of the 1957 Cheques Act.

The defendant bank counter-argued that the plaintiff i.e. the firm of stockbrokers was negligent in issuing its cheques in an abbreviated form without adding the words "and company" or any equivalent expression after the name of the payee. The Bank also argued that the plaintiff was negligent in the running of its business, for not supervising the job of its employees.[186]

Donaldson J. in passing his judgement found both parties to be to some degree, negligent. He held that Section I of the 1945 Law Reform Contributory Negligence Act governs. Accordingly, he found the plaintiff to be 10% negligent and accordingly, he ordered that the plaintiff should be recredited with the full value of the forged cheques less 10%.[187]

(iii) Unlike the instances where the convertor is the bona fide acquirer of a negotiable instrument, Section 11 of the 1977 Torts (Interference with Goods Act) does not restrict the application of the contributory negligence rule to instances where the convertor is a bank.[188] By virtue of Section 47 of the 1979 Banking Act, the defence

of contributory negligence may be pleaded by the defendant bank to reduce its liability. Section 47 reads:

> "In any circumstances in which proof of absence of negligence on the part of a banker would be a defence in proceedings by reason of Section 4 of the Cheques Act 1957, a defence of contributory negligence shall also be available to the banker not withstanding the provision of Section II(1) of the Torts (Interference with Goods) Act 1977."

The Impact of the Tai Hing Case on the Application of the Rule of Contributory Negligence.

(i) Although the decision in **Lumsden & Co. v London Trustee Savings Bank** seems to be fair and reasonable, in that it apportions the loss resulting from the erroneous payment of forged cheques between the negligent parties in a manner compatible with their degree of negligence, it is submitted that such an application has been restricted by the decision of the Privy Council in the later case of **Tai Hing Cotton Mill v Liu Chong Hing Bank Ltd. and Others.**[189] The Privy Council there held that in instances where the question relates to the establishment against the bank's customer of a liability in negligence in favour of the drawee payor, i.e. a party with whom the former is in contractual privity, the contract of deposit should be consulted to determine the existence of such a liability.[190] If the contract fails to stipulate in express terms that the customer shall be liable for the loss resulting from his careless behaviour, the said loss should fall on the drawee payor.

(ii) It could reasonably be inferred from the decision of the Privy Council in the Tai Hing case, that wherever the drawee payor bank wishes to allocate the loss resulting from the careless behaviour of his customer to the latter, he should make such wish explicit in the contract of deposit. The said holding is not confined to the drawee payor's desire to allocate all the loss to his careless customer only. Rather it applies to instances where the intended desire is to allocate a portion of the loss to the said customer.

(iii) From the foregoing, it seems that the protection afforded to the banking industry against the defence of conversion as illustrated by Section I of the 1945 Law Reform Contributory Negligence Act, the decision of Donaldson J. in **Lumsden & Co. v London Trustee Savings Bank** and Section 47 of the 1979 Banking Act, has been severely limited by the decision of the Privy Council in the Tai Hing case. The above mentioned protection it seems, is applicable to instances where the competing party is a collecting bank only. The determination of the existence of the duty to exercise reasonable care in the general running of business or in the examination of pass books, bank statements and returned vouchers by the exclusive reference to the contract of deposit, has caused the law in the English legal system to shy away from the rational risk allocation rule, had the rule of contributory negligence been preserved.

Reconsiderations of the Tai Hing Case

The rule laid down in Kepitigalla Rubber Estates v The National Bank of India Ltd. and reinstated by the Privy Council in the Tai Hing Case is currently under revision. In its report, the Review Committee on Banking Services recommended changes in the present law. It is of the view that when the action in question is raised to address the risk arising from unauthorised payments, the resulting loss should not be allocated in whole to the payor bank in instances where it could be shown that the misconduct of the customer had substantially contributed to the occurrence of the loss in question. The Review Committee is of the opinion that in such an instance it would be unfair and inequitable to throw the whole loss on the payor bank. The contributorily negligent customer ought to bear a part of the loss in question.[191]

From the foregoing, it appears that the Review Committee is in favour of extending the scope of the 1945 Law Reforms Contributory Negligence Act.[192] Such an approach is compatible with the proposed risk allocation rule. Firstly, it allocates to each of the potential competing parties such as the customer and the drawee bank, the duty to take the necessary precautionary measures for the provision against the occurrence of loss. Secondly, it reduces the chances of loss occurrence. Thirdly, it allocates the blame for causing the loss to the persons who were in the position to provide against it. Fourthly, it provides against moral hazard.

Finally, in allocating the loss arising from unauthorised payments on the basis of the 1945 Law Reforms Contributory Negligence Act the recommendation of the Review Committee would be providing against the misallocation of wealth. On the one hand it takes into account in apportioning the loss arising from the unauthorised payment, the gravity of the misconduct of the original true owner i.e. the customer. On the other hand, it allocates to the payor bank the duty to establish the negligence of their customer. Such an approach allocates the duty of litigation to the party who is in he best position to afford it, namely the payor bank.[193]

The Uniform Commercial Code

(i) In allocating the loss resulting from the erroneous payment of a forged instrument to the drawee payor, the U.C.C. requires that:

1) the acquirer recipient must be "a holder in due course" and,

2) the purported maker drawer must be free of negligence substantially contributing to the occurrence of the erroneous payment.

Article 3-302 defines the concept of holder in due course to include every party who establishes his title to the instrument in question through negotiation, provided that he acts in good faith without being aware of the existence of a claim or defence vitiating the instrument or the

title of its possessor, and gives value for the instrument to which he intends to establish his title.[194]

(ii) Unlike the law in the English legal system, the U.C.C. defines the concept of "negotiation" broadly. It deems every act of transfer to constitute negotiation.[195] It includes the first transfer i.e. issue, as well as the transfer by way of indorsements.[196] Thus a payee of an instrument may qualify as the holder in due course.[197]

(iii) Although the concept of "good faith" by virtue of Article 1-201(19) is defined subjectively so as to denote honesty in fact,[198] Article 3-304 together with 1-201(25) restrict the impact of such a definition.[199] They import the reasonable man test in attributing the knowledge of the existence of a triable claim or defence to the acquirer of a negotiable instrument i.e. the party who intends to satisfy the holder in due course status. In instances where the said party could, by the exercise of reasonable care, have noticed the existence of an irregularity on the offered instrument or an irregularity in the title of its possessor, Article 3-302 notwithstanding his good faith, disqualifies him from being a holder in due course.

(iv) The position of the U.C.C. as could be noted is substantially similar to that of the Continental Geneva legal systems.[200] The establishment of the holder in due course or the lawful holder status is not determined by the exclusive reference to the acquirer's actual state of

mind. In making such determination, the U.C.C. and the Continental Geneva legal systems take into account the acquirer's ability to unveil the irregularity vitiating the transaction in which he engages by the exercise of reasonable care. The U.C.C. approaches such a limitation by the import of the concept of "constructive notice". The Continental Geneva legal systems approach a substantially similar limitation by the import of the concept of "gross negligence".[201]

(v) The advantage of such an application is that the acquirer of a negotiable instrument would be denied the right to claim in full the protection arising from the application of the negotiability concept. In particular, he would be denied the right to claim a good title to the said instrument or to its proceeds. The acquirer to whom a constructive knowledge of an irregularity could be attributed or who has been guilty of gross negligence in his acquisition, would in instances of erroneous payment, be compelled to revert to the drawee payor in full or in part the erroneously paid proceeds. Such an application as could be noted, allocates the loss resulting from the erroneous payment in an efficient manner. It, on the one hand, does not allocate the resulting loss in its entirety to a relatively innocent party, rather it allocates the said loss to the party to whose conduct the said loss could reasonably be attributed namely, the grossly negligent acquirer and the acquirer who possesses a constructive knowledge of the existence of an irregularity

in his instrument or in the title of his transferor. On the other hand, the allocation of the loss resulting from the payment of a forged instrument in full or in part to the grossly negligent acquirer or to the acquirer who possesses a constructive knowledge of an irregularity would deter the third party to whom a negotiable instrument is offered for a valuable exchange from behaving carelessly. Accordingly, such an application, as could be noted, provides against the problem of moral hazard. The rate of loss occurrence in such an instance would be reduced. Once the rate of loss occurrence is reduced, the cost that would have been involved to make good the loss would be allocated in more favourable transactions, from which an enforceable value could be derived.

(vi) The U.C.C.'s rule of including the bona fide payee recipient in the category of the protected party, i.e. the holder in due course, offers a better solution than that found in the English as well as the Continental Geneva legal systems.[202] Its application is more compatible with the considerations dictated by the convenience of commerce and the special nature of negotiable instruments. It, on the one hand establishes the good title protection in favour of a bona fide purchasor e.g. the payee of a negotiable instrument whilst it, on the other hand establishes in favour of the said party the advantage of certainty arising from the application of the finality attribute. The extension of the protection arising from

the application of the negotiability concept to include the bona fide payee recipient, encourages the public to engage in the acquisition of negotiable instruments. Once the public is encouraged in the acquisition of negotiable instruments, the institution of such documents would be promoted. Ultimately, the objective of facilitating its function as a substitute for money would be fulfilled.[203]

## The Impact of the Purported Maker/Drawer's Negligence in Determining the Risk Allocation Rule in the U.C.C.

(i) As far as the second requirement is concerned, namely, that the purported maker/drawer must be free from negligence, the U.C.C. in instances where the careless behaviour of the purported maker/drawer "substantially contributes" to the occurrence of loss, establishes in favour of the drawee payor a liability rule against the careless purported maker/drawer. By virtue of Articles 3-406 and 4-406, it enables the drawee payor to set up against the careless purported maker/drawer the defence of "contributory negligence" on the basis of the latter's failure to exercise reasonable care in the safe custody of his blank instruments and signing equipment, the general running of his business and the examination of bank statements.

By virtue of such a defence, the drawee payor may defeat the purported maker/drawer's claim to have his account with the former recredited for the face value of

the erroneous payment. But, in order for the drawee payor to avail himself of the above defence, he must act in good faith and in accordance with the reasonable commercial standards of banking. In instances where he fails to comply with such duty, the loss resulting from his erroneous payment would be allocated to him notwithstanding the fact that the purported maker/drawer was negligent in performing the above mentioned duties.

Article 3-406 U.C.C. lays down a general rule as to the proposition that the maker or drawer of a negotiable instrument owes the drawee payor a general duty to exercise reasonable care so as to prevent the making of a forged instrument. Article 3-406 reads:

> "Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorised 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."

(ii) Article 4-406, by comparison incorporates a narrower duty of care. It allocates to the maker or drawer of a negotiable instrument the duty to examine periodic bank statements and returned items. In instances where the statements and items reveal the existence of any irregularity in their contents, the said article allocates to the maker or drawer the duty to report within a reasonable time to the drawee such irregularities.

Article 4-406 reads in part:

> "1) When a bank sends to its customer a statement of account accompanied by items paid in good faith in support of the debit entries or holds the statement or items pursuant to a request or instructions of its customer or otherwise in a reasonable manner makes the statement and items available to the customer, the customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorised signature or any alteration on an item and must notify the bank promptly after discovery thereof ..."

As far as Article 3-406 is concerned, it is submitted that the incorporated general duty of care embraces every instance of care which a reasonable man would provide for the running of a business of similar size and sophistication to that of the maker/drawer.[204] Thus, the general duty of care incorporated in Section 3-406 would include the exercise of care in the safe custody of blank instruments together with the signing equipment, the exercise of care in the issuing of instruments, the exercise of care in the delivery of instruments, the exercise of care in selecting employees and in supervising their work.[205]

(iii) As far as the duty to exercise care in the examination of periodic bank statements and returned cheques and reporting any irregularity in their contents to the drawee payor, is concerned, courts in the American legal systems are in agreement that in order to establish the existence of such a duty, the said statements and cheques need not be remitted to the customer of the bank i.e. the purported maker/drawer. The remittance of the

said items to the customer's employee or agent would suffice to establish the above mentioned duty.[206] In instances where the bank statements and returned cheques were remitted to the forger himself, the customer i.e. the employer or principal of the former would be deemed in breach of the above duty. Had he behaved as a reasonable employee, he would have determined the irregularity in the remitted statements and cheques and reported it to the drawee payor. Such a holding as could be noted, imposes upon the maker or drawer the duty to supervise the work of his employee or agent to whom he entrusts the job of issuing cheques in the name of the business and the job of reconciling its accounts. The failure to exercise such a duty could preclude the maker/drawer from the right to set up the forgery as a defence to dismiss his liability. The failure to carry out such a duty would ultimately entitle the drawee payor to charge to the maker's or drawer's account the face value of the forged cheques.

Evaluation of the Operativeness of the Negligence Rule in Allocating the Risk of Forgery of an Instrument.

(i) The U.C.C.'s rule of allocating the loss resulting from the erroneous payment of a forged instrument in its entirety to -

1) the drawee payor in instances of his negligence regardless of the negligence of the purported maker/drawer; and

2) the negligent purported maker/drawer with the proviso

that the drawee payor behaves in good faith and in accordance with the reasonable commercial standards of the banking business;

is defective in an important respect. Its application, like that established in the Continental Geneva legal systems results in an economically unjust risk allocation rule. The allocation of the loss resulting from the erroneous payment of a forged instrument to either the drawee payor or the purported maker/drawer, in the above instances, suggests that the blame for causing the said loss is allocated to the said party. This is unacceptable. On the one hand, the negligent purported maker/drawer in every instance bears a proportion of the blame for causing the loss. His failure to behave reasonably in the safe custody of his blank instruments and so forth is presumed to be a substantially contributing factor to the said loss. The imposition of the duty to exercise reasonable care upon the purported maker/drawer is not unduly onerous. The exercise of reasonable care does not normally involve undue cost and time. If such an event was to occur as the case is in instances where the purported maker/drawer engages in the running of a business, the involvement of cost and time would not be unduly onerous. The investment of such cost and time is firstly profitable to his business and secondly the expenses resulting from the investment of cost and time could, through wage control and service

pricing, be distributed among the employees of the business as well as its customers.

(ii) On the other hand, the drawee payor of a forged instrument always bears a proportion of the blame for the loss resulting from his erroneous payment. His failure to exercise the highest care in the provision against fraud occurrence or in the provision for fraud detection is presumed to be a contributing factor to the loss resulting from his erroneous payment. Although the exercise of the highest care involves cost, the investment of such cost is not unduly onerous. Due to the fact that the drawee payor is a party engaged in the business of banking, the investment of cost in the course of exercising the highest standard of care is firstly profitable to his business and secondly it could, through periodic service charges be distributed among his customers.[207]

## The Rule of Negligence in Determining the Risk Allocation Rule under Revised Article 3 U.C.C.

(i) From the foregoing, it could be suggested that where the loss results from the erroneous payment of a forged instrument it should, in the instances under consideration, be apportioned between the drawee payor and the purported maker/drawer in a manner compatible with the degree of their negligence. The American Law Institute and the National Conference on Codification of the Uniform State Laws, in their current revision of Article 3 U.C.C.

recognised the difficulty in the present risk allocation rule. In their current draft of Article 3-405, they propose the rule that in instances where the erroneous payment of a forged instrument results from the purported maker/drawer's own negligence only, the loss would be divided between the drawee payor and the purported maker/drawer, on an equal basis.[208]

Evaluation of the Revised Article 3 Rule in Determining Risk Allocation.

(i) The foregoing rule clearly presents a welcome innovation from the present risk allocation rule in that it does not discharge the drawee payor, who behaves in accordance with the reasonable commercial standards of the banking business yet fails to exercise the highest care, from liability. Nevertheless, it does not go very far to meet the proposed risk allocation rule. By fixing the liability of each of the purported maker/drawer and drawee payor at 50% regardless of their respective degree of negligence, it could result in an unjust application. It, on the one hand allocates 50% of the loss to the party whose behaviour is less blameworthy than that of the other competing party. On the other hand, and due to the fact that drawees, where the paid instrument is proved to be a forgery, would normally find their customers at fault and accordingly debit their accounts with up to 50% of the erroneously paid instrument, the rule of dividing the loss between the competing parties would result in

undue hardship to the innocent purported maker/drawer. The innocent purported maker/drawer in such an instance might have to seek a court settlement in order to establish his entitlement to a full recredit of the erroneously paid proceeds. Such a course, due to the large cost involved in suing the drawee payor or due to the trivial nature of the disputed entitlement, might not be practicable. The purported maker/drawer, however, might not be in the position to absorb the said loss. The purported maker/drawer would have initially to bear a loss the occurrence of which he could not reasonably provide against. And since the said party might be a consumer, he might not be in a position to absorb the said cost. There would not be other parties against whom he could re-allocate the unjustifiable loss.

(ii) Although the divided liability rule is valid, its application should be brought into line with the party's capability to enforce it. In the context of negotiable instrument fraud, and in particular where the fraud in question results in the erroneous payment of a forged instrument, the party best able to enforce an efficient application of the divided liability rule, is the drawee payor. Due to his status as a party engaged in the business of banking, he is in the best position to seek a court settlement in his favour. In instances where he finds such course impracticable he, in his status as a party engaged in the banking business, can re-allocate the

cost involved in suing his customers, to the latter by way of periodic service charges and fees.

(iii) From the foregoing, it could be concluded that the loss resulting from the erroneous payment of a forged instrument should always be initially allocated to the drawee payor. Through court settlement only the said party may allocate to the purported maker drawer a portion of the loss resulting from his erroneous payment. Nevertheless, the proportion of the loss which the drawee payor may allocate to the purported maker drawer should not, at any rate, exceed the latter's degree of fault.

Summary

From the foregoing it could be noted that the Anglo-American and the Continental Geneva legal systems adhere to a uniform risk allocation rule in instances where the risk in question results from the forgery of negotiable instruments. In instances of dishonour, they allocate the resulting loss to the bona fide third party acquirer. In instances of payment they allocate it to the drawee payor. Such a rule as has been shown earlier is compatible with the proposed risk allocation rule. It, on the one hand allocates the risk to the party who can provide against its occurrence more efficiently. On the other hand, it satisfies the interest of the institution of negotiable instruments, as well as the reasonable expectation of the commercial community. Its application facilitates the function of negotiable instruments as a

substitute for money, whereas it determines the existence of a duty to provide against the evolving risk by reference to the party's capability to provide for such a duty or to absorb it. Finally, and by virtue of determining the existence of a duty to provide against the risk in question in the above manner, the allocation of the evolving loss to the acquirer in instances of dishonour and to the drawee payor in instances of payment, is compatible with the objective of protecting the public at large, as well as the notion of fairness and justice. On the one hand it deters the party who is in a position to provide against the occurrence of loss in the efficient manner from behaving carelessly. Once the public is deterred from behaving carelessly the rate of fraud would necessarily decrease. On the other hand, by allocating the risk of forgery of negotiable instruments to the party who is in a position to provide against its occurrence more efficiently, the said risk would be allocated to the party who would suffer the least hardship.

As to the determination of the scope of the above mentioned general rule, the attitude of the Anglo-American and the Continental Geneva legal systems is not uniform. In instances where the legal systems under consideration depart from each other in determining the scope of the rule in question, it cannot be contended that their respective attitude conforms with the proposed risk allocation rule. There must be one legal system or more, less compatible with the said risk allocation rule,

whilst by necessary inference, there must be one legal system or more, closer to it.

The English Legal System

(i) The English legal system is submitted to be the least compatible with the proposed risk allocation rule. It adheres to an absolute application to the general rule. It allocates the loss arising from the forgery of negotiable instruments to the bona fide third party acquirer in instances of dishonour and to the drawee payor in instances of payment. The English legal system adheres to the above rule notwithstanding the fact that the other competing party namely the purported maker/drawer and the bona fide third party acquirer were able to provide against the occurrence of loss. It, on the one hand does not establish against the purported maker/drawer a general duty to exercise reasonable care in the safe custody of blank instruments, in the general running of his business, or in the examination of pass books bank statements and returned vouchers. It accordingly does not establish against the said party a liability on the basis of his failure to exercise reasonable care. It either defines the requirements that could provide the basis for such a liability in a traditional narrow sense or it determines the existence of such a basis by the exclusive reference to the terms of the contract between the competing parties. Through such applications the English legal system restricts the

application of the doctrine of negligence as a basis for establishing liability.

On the other hand, and as far as the acquirer of a negotiable instrument is concerned, the English legal system defines the holder in due course i.e. the party to whose favour the good title protection should be established, in some respects broadly, whilst it defines it in other respects narrowly. It, at the one extreme extends the concept of the holder in due course to the grossly negligent acquirer of a negotiable instrument. That is to say that the English legal system establishes the good title protection in favour of a party who could have unveiled the irregularity of the instrument to which he intends to establish his title by the exercise of reasonable care in instances where the circumstances surrounding his acquisition raise suspicion as to the regularity of the instrument. In such an instance and where the instrument in question is proved to be a forgery and the drawee erroneously pays its proceeds to the grossly negligent acquirer, the English legal system establishes in favour of the latter a good title to the erroneously paid proceeds. The drawee payor may not, in such an instance, demand the return of the proceeds from the recipient.

The English legal system at the other extreme, confines the satisfaction of the holder in due course status to the indorsee of a negotiable instrument only. It excludes the bona fide payee from the good title protection. In instances where the instrument to which

the bona fide payee establishes his title is proved to be a forgery and the drawee erroneously pays its proceeds, the English legal system denies to the former the good title to the erroneously paid proceeds. It entitles the drawee payor to demand from the payee recipient the return of the proceeds.

(ii) The incompatibility of the attitude of the English legal system with the rational risk allocation rule is threefold. In the first place, by defining the requirement of negligence in the traditional common law narrow sense, the English legal system allocates the loss resulting from negotiable instrument fraud, such as the forgery of negotiable instruments, to the less guilty party i.e. the bona fide acquirer in instances of dishonour and the drawee payor in instances of payment. It releases the relatively more guilty party i.e. the purported maker drawer from liability. It affords him full protection in instances where his behaviour is presumed to cause or contribute to the occurrence of loss. Such a rule would encourage the public to behave recklessly. The rate of fraud would then increase and ultimately, loss occurrence would increase. Loss, in instances where its occurrence is avoidable, results in a misallocation of wealth. This is incompatible with market needs where the prime objective is to maximise value.

In the second place, by determining the existence of the basis for liability, by the exclusive reference to the

terms of the contract, the English legal system is presumed to make a capricious determination as to the issue of liability. It determines the issue of liability on a fictitious basis. It reads into the contract which regulates the relationship between the competing parties, an implied term the impact of which is to allocate liability for the occurrence of loss exclusively to one of the competing parties in instances where the contract does not stipulate otherwise. In such an instance, the English law allocates the loss to one of the competing parties, notwithstanding the fact that the other competing party was guilty to some extent of causing the said loss. The rule of the English legal system in determining the existence of liability by the exclusive reference to the terms of the contract, results in allocating the loss in question to a single party in instances where the other competing party bears a portion of the blame for causing or contributing to the occurrence of loss. In such an instance, the party to whose favour the rule operates might be encouraged to behave recklessly. Accordingly, the rate of fraud would increase, loss occurrence would likewise increase and wealth would be misallocated.

In the third place, by defining the holder in due course so as to include every bona fide indorsee, even if he has been guilty of gross negligence and exclude every bona fide payee, the English legal system establishes the good title protection in favour of acquirers, neither the convenience of commerce nor the special nature of negotiable instruments dictate such a protection. It, by

comparison, denies the good title protection to acquirers to whose favour both the convenience of commerce and the special nature of negotiable instruments require the establishment of such a protection. The acquirer to whose favour the convenience of commerce and the special nature of negotiable instruments require the establishment of the good title protection is the acquirer who is unable, from the mere reference to the four corners of the instrument, to which he intends to establish his title, or from the circumstances surrounding his acquisition, to unveil the irregularity vitiating the said instrument. The restriction of the good title protection to such parties is compatible with the objective of the market as well as the notion of finality. The objective of the market is to maximise value. Value would be maximised when it is allocated in channels which could produce the most enforceable utility. A significant method of value maximisation is the avoidance or reduction of losses. In such instances, the value that would have been utilised in repairing the loss had it occurred, would be invested to satisfy other interests. Loss would be avoided or reduced if the commercial community was required to exercise some care in its dealing. In the context of negotiable instruments, the occurrence of loss would be avoided or reduced if the parties engaged in the negotiation and acquisition of such documents were required to exercise some care in their respective activities. Once the said parties exercise some care, the rate of fraud would be reduced. The fraudulent

parties would find the perpetration of fraud more onerous.

The allocation of the duty to exercise some care to the party to a negotiable instrument, in particular the party to whom the instrument is offered for a valuable exchange, is not unduly onerous. The standard of care which the said party ought to comply with is illustrated in his duty to collect information relating to the status of the offered instrument and the status of its possessor, from the four corners of the instrument and the circumstances surrounding its acquisition. Such a duty does not involve unreasonable cost and time. The involvement of unreasonable cost and time arises in instances where the third party to whom the instrument is offered for a valuable exchange was made to carry out a thorough investigation as to the status of the offered instrument and the status of its possessor.[209]

As far as the notion of finality is concerned, it could be observed that the import of such a notion into the law of negotiable instruments is intended to promote the function of the said institution as a substitute for money. For the said objective to be valid, the instrument to which the attributes of money are intended to be established should circulate as clean as money. Neither the four corners of the instrument nor the circumstances surrounding its acquisition should raise suspicion in the mind of the reasonable man as to its irregularity. In instances where the four corners of the instrument or the circumstances surrounding its acquisition raise suspicion as to its irregularity the

third party to whom it is offered should, by making reasonable enquiry, satisfy his conviction as to its genuineness or demand from the party with whom he deals a more reliable payment instrument, as a discharge for his underlying entitlements.

From the foregoing, it could be noted that the English rule of extending the good faith title protection in favour of the grossly negligent indorsee is incompatible with either the needs of the market or the objective of promoting the institution of negotiable instruments. It, on the one hand, encourages the public to behave recklessly in their acquisition. Once the public is encouraged to behave recklessly, the rate of fraud would increase, loss occurrence would likewise increase and ultimately wealth would be misallocated. On the other hand, the above mentioned rule extends the objective of promoting the institution of negotiable instruments beyond its proper limits. It establishes the attributes of money in favour of a document, the four corners of which do not resemble the instrument which it is intended to substitute.

As far as the inconsistency of the English rule of excluding the bona fide payee from the category of the protected party with the convenience of commerce and the notion of finality is concerned, it could be observed that the payee of a negotiable instrument, in instances where he behaves bona fide and takes the instrument in question for value, may qualify as the bona fide purchaser. The good title protection should accordingly be established in

his favour. And due to his status as a bona fide purchasor, he should be afforded the advantage of certainty. Accordingly, he should be entitled to retain the proceeds of the erroneous payment. Finally, by establishing the above mentioned entitlements in favour of the bona fide payee, the significance of the negotiability attribute of negotiable instruments becomes more apparent. This is due to the fact that the large majority of such documents are not circulated in the stream of commerce more than once. If the bona fide payee of a negotiable instrument was to be excluded from the category of the protected party i.e. the protected holder, a large part of the negotiable instrument rules would be superfluous. This is due to the fact that the essence of the said rules is to protect the bona fide lawful holder for value and regulate his entitlements.

The Continental Geneva Legal Systems.

(i) The Continental Geneva legal systems are less removed from the proposed risk allocation rule. They establish against the purported maker/drawer as well as the bona fide acquirer the duty to exercise some care in the course of their dealings. They establish against the purported maker/drawer the duty to exercise reasonable care in the safe custody of blank instruments, the general running of his business and the examination of bank statements. As far as the bona fide acquirer is concerned, the Continental Geneva legal systems establish

against him, the duty to exercise some care in his acquisition. They establish against the said party the duty to investigate the true status of the offered instrument and the true status of its possessor in instances where the four corners of the said instrument or the circumstances surrounding its acquisition indicate the existence of an irregularity.

Should, however, the purported maker/drawer or the bona fide acquirer fail to comply with the above mentioned duty or duties, the Continental Geneva legal systems allocate the resulting loss to him. They entitle the drawee payor to demand a repayment of the erroneously paid proceeds from the careless party. In instances where the drawee payor holds in deposit a credit in favour of the careless purported maker/drawer, he may offset his entitlement from the outstanding credit.

In instances where the recipient is the grossly negligent acquirer, the Continental Geneva legal systems deny him the lawful holder status. Accordingly, they deny him the good title protection. They compel him to revert to the drawee payor the erroneously paid proceeds either in full or in part. In defining the lawful holder status, they require that the party who intends to satisfy the said status should establish his title to the instrument in question through an indorsement. Thus the bona fide payee of a negotiable instrument may not claim in full the protection arising from the application of the negotiability concept. In instances where he receives payment upon a forged instrument, the Continental Geneva

legal systems do not establish in his favour a good title to the erroneously paid proceeds. They entitle the drawee payor to demand the return of the proceeds from the bona fide payee recipient.

(ii) The incompatibility of the Continental Geneva legal systems with the efficient risk allocation rule is threefold. In the first place, they allocate the loss resulting from the erroneous payment of a forged instrument to the negligent purported maker/drawer. They discharge the drawee payor from liability once he behaves reasonably. This is tantamount to suggesting that once the drawee payor behaves reasonably he cannot be blamed for the loss resulting from his erroneous payment. The blame in its entirety falls upon the careless purported maker/drawer. This is not entirely true. The drawee in making payment upon a forged instrument bears in every instance a portion of the blame. As a party with whom credits and a facsimile of the creditors' signatures are deposited and as a party who determines whether or not to pay the presented instrument, he is deemed to possess the last clear chance to unveil the forgery. This he can approach by employing measures the purpose of which is to prevent the forgery from materialising in the first place or by employing measures the purpose of which is to provide for the detection of the forgery should it occur. Although such measures are costly, the drawee in his capacity as a party engaged in the business of banking can, by way of periodic and service charges, re-allocate

the cost involved in the provision of such measures among his customers. Moreover, the assumption of such cost is not unreasonable. It is firstly, a routine application of the banking business and secondly, it generates in favour of the drawee an enforceable value.[210]

In the second place, a further difficulty of allocating the loss resulting from the erroneous payment of a forged instrument to the careless purported maker/drawer, is that the drawee payor in every instance of paying a forged instrument, would assume that the purported maker/drawer behaved carelessly and ultimately he would allocate the resulting loss to the said party. In some cases, the drawee payor's assumption might not be accurate, the loss would then be initially allocated to a relatively or totally innocent party. The latter might then have to seek a court settlement to shift the loss in its entirety or a proportion of it to the drawee payor. Court settlement in some cases might not be practicable. The totally or relatively innocent purported maker/drawer might then have to bear the loss resulting from the erroneous payment. Due to his status as such, the purported maker/drawer might not be in a position to absorb the loss in question. Ultimately, the assumption of the resulting loss in this instance represents a misallocation of wealth to him.

In the third place, the Continental Geneva legal systems' narrow definition of the lawful holder status restricts the function of negotiable instruments as a substitute for money. They exclude the bona fide payee

recipient from the good title protection. They entitle the drawee payor to demand from the payee recipient the return of the proceeds in instances where the payment is made upon a forged instrument. Once the payee recipient is compelled to revert the proceeds of the erroneous payment to the drawee payor, his financial interest would be impaired. Due to the uncertainty as to the status of the paid proceeds, the payee recipient would have to disturb the performance of other transactions or he would have to forego the opportunity to engage in favourable transactions, the finance of which is dependent on the proceeds of the instrument to which he intends to establish his title. Since a large number of negotiable instruments do not circulate in the stream of commerce and due to the detriment resulting from the drawee payor's entitlement to recover the erroneously paid proceeds, the public would be deterred from acquiring negotiable instruments. Once the public is deterred from acquiring negotiable instruments, the objective of promoting the institution of such documents as a substitute for money would fail.

The Uniform Commercial Code

(i) The U.C.C. by comparison is submitted to be more compatible with the rational risk allocation rule. It on the one hand establishes against the purported maker/drawer the duty to exercise reasonable care in the safe custody of blank instruments and the general running

of his business, as well as the examination of bank statements and returned items. In instances where the purported maker/drawer fails to comply with the above duty or duties, the U.C.C. allocates to him the loss resulting from the erroneous payment of a forged instrument.

The U.C.C. on the other hand defines the holder in due course so as to -

1) include the bona fide payee recipient, and

2) exclude the acquirer who could have, by reference to the four corners of the offered instrument, or from the circumstances surrounding its acquisition, unveiled the existence of an irregularity in the said instrument or in the title of its possessor.

The U.C.C. approaches such a rule by the import of the concept of constructive notice. It deems the acquirer who fails to behave reasonably in suspicious circumstances to possess a constructive notice of the existence of an irregularity. Accordingly, it disqualifies him from satisfying the holder in due course status. It denies him the good title protection. It compels him to revert to the drawee payor the proceeds of the erroneous payment.

(ii) The incompatibility of the U.C.C. with the rational risk allocation rule is twofold. It arises from the fact that the U.C.C. allocates the loss resulting from the erroneous payment of a forged instrument to the careless purported maker/drawer, provided that the drawee payor behaves reasonably. In instances where the drawee payor behaves carelessly, the U.C.C. allocates the resulting

loss to the drawee payor, notwithstanding the fact that the purported maker/drawer was careless in his conduct. In the first place, such a rule results in an unreasonable allocation of loss. It allocates the loss resulting from the erroneous payment of a forged instrument to a single party in instances where the competing parties bear a portion of the blame for causing or contributing to the occurrence of loss. In instances where both competing parties are careless, the loss should not be allocated in its entirety to the drawee payor. The careless purported maker/drawer bears a part of the blame for contributing to the loss. This is illustrated in his failure to exercise reasonable care in his conduct. In instances where the purported maker/drawer is careless and the drawee payor behaves reasonably, the latter bears a portion of the blame for contributing to the loss. This is illustrated in his failure to exercise the highest care in providing against the occurrence of forgery in the first place and by the failure to provide for the detection of the forgery should it occur. The establishment of such a high duty against the drawee is not unduly onerous. Due to his status as a party engaged in the business of banking, he is presumed to be in a position to derive enforceable value from the assumption of cost and he is deemed to be in a position to absorb such cost.

In the second place and by virtue of the fact that the drawee payor may allocate the loss in its entirety to the careless purported maker/drawer, the U.C.C. causes the said loss to be allocated to a totally or relatively

innocent party. In some instances, and where the loss arises from the erroneous payment of a forged instrument, the drawee payor would assume that the purported maker/drawer, i.e. his customer, was careless in his conduct. By way of debiting the latter's account for the face value of the erroneously paid proceeds, the drawee would shift the loss to his customer i.e. the purported maker/drawer. In order for the latter to re-allocate the loss to the drawee payor, he would have to seek a court settlement. Court settlement in some instances might be impracticable. Accordingly, the purported maker/drawer would have to bear the loss resulting from the erroneous payment. The purported maker/drawer, due to his status as such, might not be in the position to absorb the said loss. There might not be other parties to whom he may distribute the loss in question. The loss in this instance results in a misallocation of wealth to him.

(iii) The American Law Institute and the National Conference on Codification of the Uniform State Laws, in their current revision of Article 3 U.C.C., have recognised the difficulty arising from the present version of Article 3. Through the divided liability rule, they suggest a partial remedy of the above mentioned difficulties. They recognised the fact that the drawee, in instances of paying a forged instrument, bears some of the blame for the loss resulting from his erroneous payment. Therefore, the A.L.I. and the N.C.C.U.S.L.

proposed that the drawee payor must, in such instances, bear 50% of the resulting loss.

(iv) Although the divided liability rule is an improvement to the current risk rule, it does not offer full satisfaction. Its incompatibility with the efficient risk allocation rule is twofold. In the first place, it divides liability on a rough basis. Accordingly, it could result in an injustice to one of the competing parties who is less guilty than the other competing party. In this instance, the former would have to bear a proportion of the loss, the occurrence of which he is not responsible for. In the second place and in instances where the law divides the loss resulting from the erroneous payment of a forged instrument between the drawee payor and the purported maker/drawer, the former in most cases would assume that his customer i.e. the purported maker/drawer was careless. Accordingly, he would debit the latter's account for the amount to which the said party is liable i.e. 50%. The assumption of the drawee payor might, in some cases, prove to be erroneous. A portion of the loss would then be allocated to a totally innocent purported maker/drawer. The latter would ultimately have to seek a court settlement to re-allocate the loss to the drawee payor. Court settlement might not always be practicable. The purported maker/drawer might have to bear a portion of the resulting loss. Due to his status as such, the said party might not be able to absorb

the said loss. There might not be other parties among whom he can distribute the resulting loss.

The Compatibility of the Rule of UNCITRAL Convention/draft Convention on International Negotiable Instruments in Allocating the Risk of the Forgery of Instruments with the Proposed Risk Allocation Rule

I. Like the Anglo-American and the majority of the Continental Geneva legal systems, UNCITRAL Convention/draft Convention relating to International Negotiable Instruments, allocates the risk arising from the forgery of instruments in general in a manner compatible with the proposed risk allocation rule. It allocates the risk in question to the party who is better situated to provide against it. In instances of dishonour, it allocates it to the immediate taker from the forger, who could well be the bona fide third party acquirer. This is approached by denying to the said party the right of enforcing the forged instrument against its purported maker/drawer.[211] In instances of payment, it allocates the arising risk to the drawee payor. This is approached firstly, by denying to the drawee payor the right of charging his customer i.e. the purported maker/drawer, with the erroneous payment and secondly, by denying to him the right to recover it from the bona fide recipient.[212] It establishes the foregoing rule in favour of every bona fide recipient. It runs in favour of the indorsee as well as the payee.[213]

By allocating the risk arising from the payment of a forged instrument to the drawee payor, UNCITRAL Convention/draft Convention achieves, in an efficient manner, the considerations underlying the allocation of risk in the context of negotiable instruments. In the first place, it promotes the function of the institution of such documents as a substitute for money. In the second place, it protects the reasonable expectations of the parties engaging in the issuance and acquisition of negotiable instruments. In the third place, it affords the commercial community a predictable, certain and uniform rule. In the fourth place, it facilitates the free circulation of such documents. In the fifth place it encourages the commercial community to promote its activities relating to the issuance and acquisition of negotiable instruments. In the sixth place, it allocates the blame for giving rise to the risk to the person who could have avoided it by the exercise of manageable care[214] and finally, it allocates the duty to exercise the care necessary to provide against the occurrence of loss, to the person who would suffer the least hardship from it.[215]

II. However, the compatibility of UNCITRAL Convention/draft Convention with the proposed risk allocation rule, in allocating the risk arising from the forgery of negotiable instruments, does not always materialise. This is due to the fact that UNCITRAL Convention/draft Convention does not define accurately the

party to whose favour the proposed risk allocation rule should be established. It leaves such matters to be determined by the forum, before whom it is raised. Obviously, the latter would be inclined to apply its law in defining the matter raised before it. In such a situation, the risk allocation would evidence a variant interpretation and it might be allocated in a manner incompatible with the proposed risk allocation rule.

An example of the situation where the risk allocation rule under UNCITRAL Convention/draft Convention could evidence a variant interpretation and it could result in an unreasonable application, is that which arises when the purported signatory such as the purported maker or drawer facilitates, by his own conduct, the forgery of his signature. UNCITRAL Convention/draft Convention does not define the instances in which the purported signatory, i.e. the person whose signature was forged, is presumed to have facilitated the forgery of his signature. It leaves the duty of determining such issue to the court of the particular jurisdiction. The latter would have to infer whether or not the conduct of the purported signatory suggests that the person in question had accepted the forged signature as his own, or that he had represented it to another to be his own.[216]

The rule of inferring by reference to the party's own conduct whether or not he had accepted the forged signature as his, or that he represented to another that the said signature is his, is not sufficient for the purpose of formulating a risk allocation rule. It would

have to be considered with the rules relating to the determination as to what constitutes an implied acceptance and an implied representation. This particular question is closely connected with the existence of the duty of care and the notion of proximity. An implied acceptance and representation would be of practical significance when and only when the person to whom the implied acceptance or representation is intended to be attributed, is under a duty to another to take him in contemplation when he is carrying out his act or omission.

In light of the divergences between the Anglo-American and the Continental Geneva legal systems as to the existence of the duty of care, some legal systems might consider the purported signatory's conduct as attributing to him an implied acceptance that the forged signature is his, whilst other legal systems might not so consider. They might not deem that the purported signatory is under a duty to the other competing party, such as the person to whose favour the forged instrument was transferred, to exercise care. Ultimately, it could result in allocating the risk in question in a manner dissimilar to that approached in the former.

An example of the instance whereby the party's conduct could be subject to variant interpretations as to whether or not it constitutes implied acceptance or representation and ultimately, it could give rise to an inconsistent allocation risk, is when one person, such as John Alex, recruits in his business another person, such as Willy Williams, whose dishonesty he is aware of,

entrusts him with the safe custody of the business's cheques and seal and does not exercise an effective supervision on his work. In the North American and the Continental Geneva legal systems, such conduct constitutes an implied representation that Willy Williams is authorised to use the business's seal and to issue cheques in its name. It also attributes to John Alex an implied acceptance of the cheques which bear the business's seal and which purport to be issued in its name.

By virtue of the above interpretation, the legal systems under consideration hold John Alex liable for any loss resulting from Willy Williams' fraudulent practice. Thus, if the latter fraudulently issues a cheque in the name of the business to a bona fide third party, such as Billy Barnes, the North American and the Continental Geneva legal systems hold John Alex liable to Billy Barnes for the loss resulting to him. They entitle the said party to recover the resulting loss from John Alex.

The basis upon which the North American and the Continental Geneva legal systems would infer the existence of an implied acceptance to John Alex, and they would hold him liable for the resulting loss, is submitted to be negligence. This they approach firstly, by establishing against the proprietor of a business, such as John Alex, the duty to exercise care in the general running of his business. In particular, they establish against him the duty to exercise care in the selection of his employees, or alternatively, they establish against him the duty to exercise care in the supervision of their work.[217]

Secondly, they establish such a duty in favour of any party who would sustain damage as a result of the proprietor's breach of the duty of care, notwithstanding his remoteness from the latter.[218] Thus, if the proprietor fails to comply with his duty of care and his behaviour as such results in a loss to another, as is the case in the above illustration, the North American and the Continental Geneva legal systems hold him liable for the resulting loss in favour of the injured party.

By comparison, the English legal system, as it presently stands, does not interpret John Alex's conduct as constituting an implied acceptance of the forged signature, nor does it constitute an implied representation that the signature is that of the business. The legal system under consideration does not allocate to the proprietor of a business, such as John Alex, the duty to exercise care in the general running of his business.[219] It does not hold the proprietor liable in negligence for the resulting loss in favour of a third party such as Billy Barnes.[220] Ultimately, it allocates the loss arising from the fraudulent person's malpractice to the third party with whom the forged instrument, such as the cheque in the above illustration, was cashed.

The allocation of the loss resulting from the forgery of an instrument to the bona fide third party is incompatible with the proposed risk allocation rule, in instances such as that mentioned above. It tends to allocate the resulting loss in an economically inefficient manner. It tends to allocate the duty to provide against

the occurrence of loss to the bona fide third party. It tends to suggest that the said party should bear the blame for not providing against it.

To state the obvious, in such instances, the bona fide third party should not be burdened with the duty of providing against the occurrence of loss. Such a duty could compel him to exercise undue care. It could require him to invest cost and time the involvement of which does not generate to him a practical enforceable value, nor would it be absorbable by him. That is to say that the allocation to the bona fide third party of the duty to provide against the forgery of instruments and ultimately, against the occurrence of loss, could result in an economic hardship to him.[221]

In fact, the loss in instances such as the above should be allocated to the purported signatory i.e. the proprietor of the business, as far as the above illustration is concerned. The said party, such as John Alex, should be held liable for the loss resulting to Billy Barnes from his employee's fraudulent practice. His employment of a dishonest person in the job of the safekeeping of the business's seal and cheques and his failure to exercise care in the supervision of his work, should be considered as the dominating factor in facilitating the forgery and in causing the loss. If he was afforded protection in such an instance, he would be assisted in gaining a windfall from his own negligence. He would also be encouraged to behave recklessly. Ultimately, he would increase the rate of loss occurrence

and he would create a situation of misallocation of value.

The allocation to the purported signatory of the duty to exercise reasonable care is not unduly onerous. It does not involve more than the exercise of some care in the safe custody of his negotiable instruments. In instances where it involves the exercise of a high standard of care, such as that involved in the running of a business, it generates a practical enforceable value. It promotes his reputation in the market, it increases his reliability, it attracts credit in his favour and ultimately it promotes his business whereby he would be enabled to spread the cost arising from his exercise of a high standard of care, among his employees and customers.[222]

III. Another defect of the rule relating to the allocation of the risk of the forgery of instruments under UNCITRAL Convention/draft Convention is that it does not spell out the liability for the loss resulting from the erroneous payment of a forged instrument in instances where the said loss was facilitated by the purported maker's/drawer's conduct. The Convention/draft Convention only suggests as an exception to the general rule that the purported maker/drawer would be liable for the loss resulting from the forgery of his signature when it could be inferred from his conduct that he had accepted the forged signature as his or that he had impliedly represented it to be his.[223] It does not determine the extent of the purported maker/drawer's liability.

In light of the existing risk allocation rules, the foregoing legislative lacuna could result in an inefficient rule. It could enable the legal systems under consideration to infer that the liability of the purported maker/drawer is preclusionary. That is to say that it precludes the said party from denying the operativeness of his forged signature. By necessary inference, such signature could establish against him the liability for the resulting loss in full. Ultimately, it could enable the drawee payor to charge his customer i.e. the purported marker/drawer with the full face value of the forged instrument.[224]

To state the obvious, the loss resulting from the erroneous payment of a forged instrument which has been facilitated by the purported maker/drawer's own conduct should not be allocated in whole to the latter. The purported maker/drawer's conduct in facilitating the forgery of his instrument is by no means the sole cause of the loss arising from the erroneous payment. The drawee payor always bears a portion of the blame for causing the said loss. His blameworthiness in causing the loss is demonstrated in his failure to exercise a high standard of care.[225] Due to his engagement in the banking business, the allocation to the drawee of the duty to exercise a high standard of care is not unduly onerous. The exercise of a high standard of care is firstly, profitable to his business and secondly, the cost arising from its provision is absorbable by spreading it among the beneficiaries of the banking business.[226]

CHAPTER SIX

BACK NOTES - (1.-226.)

1. See p.231 supra.

2. Ibid.

3. See pp.256-257 supra.

4. See pp.257-258 supra.

5. The general rule is established by Kelly v Solari (1841) 9 M and W 54 whilst the exception to the general rule was first established by Price v Neale (1762) 3 Burr 1355. For the facts of the said cases and the decision of the courts see pp.260-261 supra.

6. See p.271 supra.

7. (1762) 3 Burr 1355.

8. Ibid. p.872.

9. cf. The argument of plaintiff's counsel in London & River Plate Bank v Bank of Liverpool (1896) 1 QB 7.

10. (1896) 1 QB 7. For the facts of this case see pp.263-264 supra.

11. Ibid. p.11.

12. The exercise of a high standard of care denotes the standard of care as that of the highly prudent and rational man. It involves the provision of every precautionary measure the purpose of which is to avoid the occurrence of an accident and ultimately, the occurrence of loss. In the context of negotiable instruments, the accident which is intended to be provided against, as far as this chapter is concerned, is the forgery of a blank instrument. The loss which is intended to be provided against, by comparison, is that resulting from the bona fide acquisition or the erroneous payment of a forged instrument.

The precautionary measures which could provide against the forgery of an instrument are the establishment of (1) a strict test of safekeeping, (2) a tight test of supervision on the business in question, and (3) a thorough investigation concerning the regularity of the transaction in which the party in question intends to engage. The exercise of a high standard of care, as has been shown in the previous chapter, cf. pages 225-235, involves cost and time. In order to maintain an efficient risk allocation rule, the above mentioned care should be established against the party who is in the position to derive an enforceable value from its

application or to the party who is in the position to absorb it cf. p.60. In instances where the said party fails to comply with the prescribed standard of care, the loss resulting from his failure as such should be allocated in its entirety to him unless the said party could show that the loss in question was partly the result of the careless behaviour of another party. In such an instance, the former may re-allocate a proportion of the resulting loss to the contributorally careless party.

The thesis underlying the allocation to the contributorally careless party of a proportion of the resulting loss, in instances where the other competing party could validly be convicted of not exercising a high standard of care, is to provide against moral hazard. Moral hazard would be provided against once the public was deterred from behaving carelessly. By allocating to every member of the public the duty to exercise some care, the rate of loss occurrence would be reduced, wealth would be appropriated to maximise value. Value maximisation is submitted to be the objective of an economically efficient market.

13. See pp.390-391.

14. Negligence in this context is intended to denote the narrower sense of the term. It involves the failure to exercise the care of that of the reasonable man cf. pp.396-398.

15. See pp.397-398.

16. Zweigert & Kötz, Introduction to Comparative Law II, pp.267-273 and 283 et seq., see also Art. 277 823 and 826 of German BGB and 1382 and 1383 French Code Civil.

17. See Minutes of the Geneva Conference L. N. Doc. No. C.194 M.77 1931 II B,pp.306-311.

18. The original wording of the Italian proposal read as follows,

> "The drawee is responsible for the consequences of forgery and alterations unless a fault or negligence is attributable to the drawer."

The Italian government accepted to amend the original wording of its proposed article so as to meet the Yugoslav and the Czechoslovak counterparts. The Yugoslav proposal read,

> "The loss arising out of the payment of a forged or altered cheque must be borne by the alleged drawer of the forged or altered cheque, if he or his employees responsible for cheques can be shown to be guilty of some fault connected with the forgery or alteration of the cheque; otherwise such loss must be borne by the drawee."

The Czechoslovak proposal read,

> "The alleged drawer of the forged cheque or of the altered cheque shall not be liable in respect of the damage resulting from payment of the forged or altered cheque unless some fault attaches to him as regards the forgery or alteration or the said forgery or alteration had been committed by his employees responsible for dealing with cheques; otherwise the damage shall be borne by the drawee. Any agreement to the contrary shall be deemed null and void."

The common principle underlying the above proposed provisions is that they throw off the loss resulting from the forgery of negotiable instruments on to the party whose negligence occasioned it. In instances where the negligence of the purported maker/drawer was the cause of the loss they allow the drawee/payor to shift the said loss to the former.

19. cf. pp.365-367 supra.

20. For the concept of negligence to operate as a cause of action in the English legal system, the plaintiff victim must show that

1) the negligent party i.e. defendant owed him a duty to exercise reasonable care.

2) the defendant was in breach of his duty.

3) a recoverable damage resulted from the breach of the duty.

4) the breach of the duty was the proximate cause of the damage.

21. cf. the decisions in Leigh & Sillivan v Aliakmon Ltd. [1986] AC 785 and Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd. [1986] AC 80 cited on pp.408 and 410 infra.

22. (1794) 5 Term Rep 683.

23. In Scholfield v Earl of Londesborough [1896] AC 514 Charles J. attempted in the court of first instance to lay down a similar rule. He observed,

> "A person who signs a negotiable instrument with the intention that it should be delivered to a series of holders, incurs a duty to those who take the instrument not to be guilty of negligence with reference to the form of the instrument and that if he signs it negligently in such a shape as to render alterations easy in the result he is responsible on the altered instrument."

Nevertheless the Court of Appeal and the House of Lords in the said case as well as in the case of London Joint Stock Bank v Macmillan and Arthur [1918] AC 777 rejected his contention and further established the rule that the drawer of a negotiable instrument and its acceptor are not liable in negligence to a remote indorsee i.e. acquirer. Their liability as such is restricted to the party with whom they are in privity, see text below.

24. (1863) 2 Hand C. 175.

25. [1918] AC 777.

26. For the general thesis underlying the correct rule as laid down by Blackburn J. in Swan v North British Australasian Co. see the passage quoted above, p.399 supra.

27. [1896] A.C. 514.

28. For the reading of Pothier's proposition and its import in English law see the decision of Best J. in Young v Grote (1827) 4 Bing 253.

29. Scholfield v The Earl of Londesborough [1896] A.C. p.514.

30. Ibid. pp.531-532.

31. Ibid. p.536.

32. [1918] A.C. 777.

33. Ibid. pp.805-807. The six Law Lords who decided the case of Scholfield v The Earl of Londesborough in the House of Lords were Lord Halsbury, Lord Watson, Lord Macnaghten, Lord Morris, Lord Shand and Lord Davey.

The five Law Lords who affirmed the decision in Young v Grote and the limited application of Pothier's proposition were the above mentioned peers apart from Lord Halsbury. Lord Macnaghten in this connection said,

"Whatever may be the better ground for supporting the decision in Young v Grote, it is obvious, on referring to the report in Bingham that the court went very much on the authority of the doctrine laid down by Pothier, that in cases of mandate generally, and particularly in the case of banker and customer, if the person who receives the mandate is misled through the fault of the person who gives it, the loss must fall exclusively on the giver. That is not unreasonable; but the doctrine has no application to the present case. There is no mandate as between the acceptor of a bill and a subsequent holder."

Lord Morris says that in Young v Grote the document was in blank and adds,

"Even if well decided on its particular facts, and a case between banker and customer, I fail to see how it governs this case, where the defendant accepted a regularly filled-up bill."

Lord Shand says,

"As to the case of Young v Grote I find nothing in the grounds of the judgement which supports the proposition that an indorsee of a bill of exchange for value has a legal claim against the acceptor, against whom no want of bona fides can be alleged, for a sum beyond the amount for which the acceptance was given on the ground of negligence in his having given his acceptance to a bill in such a form and impressed with such a stamp as enabled the drawer to commit a forgery by enlarging the amount for which the acceptance was granted in such a way as to escape detection by the indorsee."

And finally Lord Davey said,

"I only desire to say that in my opinion our judgement in this case is outside the case of Young v Grote. The doctrine in that case was one arising out of the relation of mandant and mandatory, which does not exist in the case of the acceptor and holder of a bill of exchange."

For the relevant part of Lord Watson's judgement see the passage quoted on p.403 supra.

34. cf. Winfield and Jolowiez on Tort, (1984) p.72. Salmond & Heusten, Law of Torts, (1987) pp.219-222.

35. [1932] A.C. 562.

36. Lord Atkin's passage reads,

"The rule that you are to love your neighbour becomes in law you must not injure your neighbour and the lawyer's question, 'Who is my neighbour?', receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably forsee would be likely to injure your neighbour. Who, then, in law is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called into question."

37. [1978] A.C. 728.

38. Ibid. pp.751-752.

39. [1982] 3 All E.R., 201.

40. Ibid. pp.212-214.

41. The impact of the development in the law of negligence has very recently witnessed a significant setback. Shortly before the submission of this work, the doctrine enunciated in the Anns case has been overruled. (cf. the decision in Murphy v Brentwood [1909] 2 All E.R. 908). This suggests that in English law negligence is not considered as a cause of action in recovering economic damages unless the injurer and the injured were privy.

42. [1986] AC 785.

43. Ibid. 815.

44. Leigh and Sillivan Ltd. v Aliakman Ltd. [1986] AC 785 per Ld. Brandon of Oakbrook,
and Siman General Contracting Co. v Pilkington Glass Ltd. [18 Feb. 1988] Times Law Report.

45. [1986] AC 80.

46. [1896] AC 514.

47. [1918] AC 777.

48. Ibid. pp.91-96.

49. (1885) 5 H L Cas 389.

50. [1918] AC 777.

51. Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd. [1986] AC 103.

52. Ibid. p.103.

53. The maturity of a time instrument in the Anglo-American and Continental Geneva legal systems, is its day of payment,
cf. Sections 11, 14 and 45 B.E.A. and Articles 23 and 38 G.U.L.(Bills).

In the Continental Geneva legal systems however the law extends the maturity of a time instrument to two days beyond its day of payment thus a negotiable instrument may circulate in the stream of commerce in its full negotiability attribute beyond its day of payment,
cf. Articles 38 and 20 G.U.L.(Bills).

In the English legal system by comparison, and prior to the 1971 Banking Act, the law gave the holder of a negotiable instrument three days of grace within which he may demand with full force the enforcement of his instrument,
cf. Section 11 B.E.A.

Thus it could be reasonably inferred that a time instrument may circulate in its full negotiability attribute during the said days of grace, but since the

1971 Banking Act, days of grace have been abolished. Thus the law as it stands at present requires that time instruments must be presented on their day of payment. If they were in circulation beyond the said day they forfeit their negotiability attribute. The law deems such an instrument in such an instance an ordinary chose in action.

54. Article 29 G.U.L.(Cheques) provides that cheques may be circulated for 8 days only. Their time of maturity may be extended to 21 or 72 days depending on whether the cheque is drawn and payable in one continent or in different continents. By virtue of Annex 2 of the Reservations on the Uniform Laws as to Cheques, every contracting state preserves its right to prolong the maturity of cheques. Article 34 G.U.L.(Bills) by comparison provides that bills payable on demand may be in circulation up to one year. The drawer of the bill may abridge the said period.

55. cf. Sections 10 and 45 B.E.A. and Articles 3-304, 3-503 and 3-108 U.C.C.

56. cf. Articles 3-304 and 3-503 U.C.C.

57. cf. Article 20 G.U.L.(Bills) and Section 36 B.E.A.

58. The rule that the party against whom the acquirer intends to enforce his instrument may set up against him, i.e. the acquirer, his personal defences, in instances where the acquired instrument was in circulation beyond its prescribed time limit, is expressly mentioned in Article 36 B.E.A. This article reads in part,

> "2 Where an overdue bill is negotiated it can only be negotiated subject to any defect of title affecting it at its maturity and thenceforward no person who takes it can acquire or give a better title than that which the person from whom he took it had."

The Geneva legal systems approach a substantially similar rule to that of the B.E.A. by cross-referring to the rules of assignment. Article 20 G.U.L.(Bills) deems the instrument i.e. bill of exchange which circulates beyond the prescribed time limit as an ordinary assignment of right. It is submitted in the civil legal systems that the assignee of a right stands in the shoes of his assignor. The rights to which he establishes his title are identical to that of his assignor. Thus the original debtor, i.e. the party against whom the assignee intends to enforce his right may dismiss his liability by setting up against the latter, personal defences which he possesses against his immediate creditor, i.e. assignor.

59. cf. Section 3 B.E.A., Article 3-104 U.C.C., Article 1 G.U.L.(Bills) and Article 1 G.U.L.(Cheques).

60. cf. Section 57 B.E.A. and Article 48 G.U.L.(Bills).

61. cf. Jenks, The Early History of Negotiable Instruments, (1893), 9 L. Q. Rev., p.70.
Holdsworth, The Origins and Early History of Negotiable Instruments, I & II, (1915), 31 L. Q. Rev. pp.12, 173.
Holden, History of Negotiable Instruments in English Law (1955).

62. It could be argued that the theory of establishing the liability in negligence on the basis of foresight is over-conceptual. For the said theory to be of a valid application, it should take into account the policy considerations that could have an impact upon it. It is submitted that the policy considerations limiting or restricting the application of the theory of foresight to the law of negotiable instruments as a test for determining the existence of a duty to exercise care are firstly, artificial, and secondly, they are formulated in a traditional manner which does not conform with the modern trend in the law. For a detailed account of the policy considerations that could restrict the application of the theory of foresight to the law of negotiable instruments, and for a detailed account of their invalidity cf. pp. 415-436.

63. The free transferability attribute of negotiable instruments could be inferred from their free negotiability character. In both the Anglo-American and the Continental Geneva legal systems, negotiable instruments are negotiable by indorsement and/or delivery. cf. Section 31 B.E.A., Articles 11-14 G.U.L.(Bills).

Furthermore the said legal systems, in special circumstances, dispense with the necessity of actual delivery. In instances of incomplete instruments they create a prima facie presumption of delivery in favour of the holder in due course or good faith.
cf. Section 21 B.E.A., Article 3-115 U.C.C. and Article 10 G.U.L.(Bills).

Thus if the holder of a dishonoured instrument elects to exercise a right of recourse against a prior liable party, the latter may not set up against him the defence of lack of delivery to dismiss his liability.
cf. Article 3-306 U.C.C. and Article 16 G.U.L.(Bills).

The chattel attribute of negotiable instruments could be inferred from the fact that the Anglo-American and the Continental Geneva legal systems run the contractual promise or undertaking in favour of the holder of the instrument. They establish in his favour the right to enforce his instrument against a prior liable party with whom he is not in privity,
cf. Section 38 B.E.A. and Article 37 G.U.L.(Bills).

64. Ibid.

65. Section 38 B.E.A. reads in part,

"The rights and powers of the holder of a bill are as follows ...
(2) Where he is a holder in due course, he holds the bill free from any defect of title to prior parties, as well as from more personal defences available to prior parties among themselves, and may enforce payment against all parties liable on the bill."

And Article 47 G.U.L.(Bills) reads in part,

> "All drawers, acceptors endorsers or guarantors by aval of a bill of exchange are jointly and severally liable to the holder.
> The holder has the right of proceeding against all these persons individually or collectively without being required to observe the order in which they have become bound ..."

66. cf. Article 38 B.E.A., for reading of relevant sub-section see n. above.
And Article 3-305 U.C.C. It reads in part,

> "To the extent that a holder is a holder in due course he takes the instrument free from,
> (1) All claims to it on the part of any person and
> (2) All defences of any party to the instrument with whom the holder has not dealt ..."

And cf. Article 17 G.U.L.(Bills). It reads,

> "Persons sued on a bill of exchange cannot set up against the holder, defences founded on their personal relations with the drawer or with previous holders, unless the holder, in acquiring the bill, has knowingly acted to the detriment of the debtor."

67. Weinberg, Commercial Paper in Economic Theory & Legal History, (1981-82), Ky. L. J. 567.

68. [1982] 3 All ER 213.

69. For the meaning of moral hazard see p.162 and accompanying n.

70. See p.100.

71. [1893] 1 QB 491.

72. Ibid. 494.

73. Ibid. 491.

74. (1888) 39 Ch O 39.
The rule laid down by the court in Cann v Willson suggests that a party could owe a duty of care in making his statement in favour of another notwithstanding the existence of a contractual privity between them.

The facts of this case were as follows. One, Sparks, desired to obtain an advance of money on mortgaging his property. He agreed with the intended mortgagee i.e. the plaintiff, that the mortgage money would be advanced in reliance on the valuation made by an independent party. The intended mortgagor then arranged with the defendant to value his property. The statement of valuation was remitted to the intended mortgagee through his solicitor. The mortgagee after the mortgagor's default in payment sought to enforce the mortgage. Nevertheless it was established that the statement of valuation was false and the mortgagee, i.e. the plaintiff could not obtain full satisfaction of his mortgage. The court passed its judgement in favour of the plaintiff. It held that the defendant independently of contract was liable to the plaintiff. He owed him a duty to exercise reasonable care in making his statement.

75. The court in dismissing the plaintiffs argument relied on the authority of Heaven v Pender (1883) 11 QBD 503 and Derry v Peak (1889) 14 App Cas 337. The latter is submitted to be the leading case in denying the existence of a duty of care in making statements in favour of a party not in contractual privity with the careless maker of statements.

76. [1893] 1QB 501, 502.

77. cf. Economic Loss in Products Liability Jurisprudence, (1966), 66 Col. L. Rev. 919.

78. (1855) 5 HL Cas 389.

79. Ibid. p.954.

80. Ibid. p.959.

81. (1827) 4 Bing 253.
For the facts and the decision of the court see p.63.

82. Bank of Ireland v Evans' Charities Trustees (1855) 5 HL Cas 959.

83. (1878) 3 QBD 525.

84. Ibid.

85. In relatively recent times the English legal system witnessed a welcome evolution in the law of tort. The Privy Council in Overseas Tankship U.K. Ltd. v Morts Dock and Engineering Co. Ltd. shifted from the traditional conception of causation. It held that the test of direct and natural cause was unsatisfactory and it substituted the notion of foresight as a test for determining the existence of a causal relationship, cf. p.86 et seq. Unfortunately the decision in Overseas Tankship U.K. was not admitted as laying down a general rule of law. In the area of negotiable instruments in particular courts

are reluctant to extend the notion of reasonable foreseeability as a test for determining the existence of a causal relationship. The Privy Council in Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank, dismissed the defendants' argument that the rule of foresight as laid down in the Overseas Tankship case, applied to the case under consideration. It reinstated the traditional law of causation as laid down by earlier authorities. It deemed the direct and proximate cause as the test for determining the causal relationship in the law of negotiable instruments, cf. pp.438-440 infra.

86. cf. the floodgate argument p.415 and accompanying n.

87. For a brief outline as to how English law determines the existence of a duty of care in the context of negotiable instruments see pp.398-404 and 410-415.

88. For a classic work on the concept of causation see - Hart and Honoré, Causation in the Law, (1987).

89. See pp.332-339.

90. See pp.354-359 supra.

91. See pp.371-373

92. [1961] AC 388.

93. Ibid.

94. [1986] AC 80.
For the facts of the case and the decision of the court see pp.410-415.

95. Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank Ltd. and Others. [1986] AC 90 and 91.

96. Ibid. p.104.

97. The fact that English law does not import into the law of negotiable instruments the test of reasonable foreseeability in determining the existence of a duty to exercise reasonable care could be inferred from several court decisions. In Swan v North British Australasian (1863) 2 Hand C 175, Scholfield v Earl of Londesborough [1895] 1 QB 536 and London Joint Stock Bank v Macmillan and Arthur, [1918] AC 777 the courts were of the opinion that in order for the duty to exercise care to exist, the parties to a negotiable instrument must be privy. When Lord Wilberforce in Anns v Merton London Borough [1978] AC 728 attempted to formulate a general test for establishing the duty to exercise care, the Privy Council in Leigh & Sillivan v Aliakman Shipping [1986] AC 785 restricted Wilberforce's test by suggesting that the application of the said test is confined to novel instances for which no English authority could be found. In Tai Hing Cotton Mill v Liu Chong Hing Bank [1986] AC 80

the Privy Council followed suit. It dismissed the argument of the counsel for the defendants that the development which English law evidenced in the law of tort, especially that illustrated by the decision in the Anns case applies to the law of negotiable instruments. The Privy Council in delivering its judgement relied exclusively on the rule established by the earlier authorities such as London Joint Stock Bank v Macmillan & Arthur. It held that the determination of the existence of a duty to exercise reasonable care depends on the proximity of the parties and the test of reasonable foreseeability has no application in this context. For a more detailed account of the above mentioned cases and the rule laid down there, see pp.399-400, 401-404, 410-415, 438-440.

98. [1961] AC 388.

99. Ibid. 423.

100. Goldring, Negligence of the Plaintiff in Conversion, (1977), 11 Melbourne Univ. L. Rev. 91.
Burnett, Conversion by an Involuntary Bailee, (1960), 76 L. Q. Rev. 364.

101. Froom v Butcher [1975] 3 WLR 379.

102. cf. pp.441-442.

103. It is submitted that such a stipulation is valid in English law. Bray J. in Kepitigalla Rubber Estates v National Bank of India Ltd. [1909] 2 K.B.1010 and Lord Scarman in Tai Hing Cotton Mill v Liu Chong Hing Bank and Others [1986] AC 80 emphasized such a point. They held that had the defendant bank in those cases stipulated that their customer, i.e. the plaintiff, should bear the loss resulting from his careless behaviour, such a stipulation would have been valid and should the customer behave carelessly, the bank would be entitled to re-allocate the resulting loss in full or in part as the case may be to the said party.

104. Goldring, Negligence of the Plaintiff in Conversion, (1977), 11 Melbourne Univ. L. Rev., 98, 99.
Burnett, Conversion by an Involuntary Bailee, (1960), 76 L. Q. Rev., 374, 375.

105. Ibid.

106. cf. pp.134-138 supra.

107. See pp.332-334 supra.

108. Bagby v Merrill Lynch Pierce Fenner and Smith, 348, F.Supp. 969.
For the facts of this case see pp.453-456 infra.
cf. East Gadsden Bank v First City National Bank of Gadsden, 50 Ala App 576 281 So 2d 431 (1973) and

Commercial Credit Equipment v First Alabama Bank of Montgomery 636 F 2d 1051 (5th Cir 1981).

109. (1855) 5 HL Cas 389.
For the facts of this case, the decision of the court and the rule laid down by Parke B. see pp.430-432 supra.

110. cf. Thompson Maple Products v Citizens National Bank of Corry, 211 Pa Super 42, 234 A2d 32 (1967).
For the facts of this case and the decision of the court see below pp.456-458 infra.
cf. also Gresham State Bank v O. & K. Construction Co. 231 Ore 106, 370 P2d 726 1 U.C.C. Rep. Serv. 276 (1962).
The development of the law of tort as to the definition of causation is manifested in Article 431 of the Restatement Second of the Law of Tort. It substitutes the cause in fact, for the direct and proximate cause. It considers a particular careless act to be the cause of a particular loss as long as a reasonable man deems it so.
Article 431 reads:

> "The actor's negligent conduct is a legal cause of harm to another if
> (a) his conduct is a substantial factor in bringing about the harm and
> (b) there is no rule of law relieving the actor from liability because of the manner in which his negligence has resulted in the harm."

The comment to Article 431 of Restatement Second of Law of Torts makes it clear that the term 'legal cause' as it appears in the above quoted article corresponds to the cause in the factual sense and not to the cause in the philosophic sense.

> "... In order to be a legal cause of another's harm it is not enough that the harm would not have occurred had the actor not been negligent. Except as stated in 432(2) this is necessary but it is not of itself sufficient. The negligence must also be a substantial factor in bringing about the plaintiff's harm. The word substantial is used to denote the fact that the defendant's conduct has such an effect in producing the harm, as to lead reasonable men to regard it as a cause, using that word in the popular sense in which there always lurks the idea of responsibility rather than in the so-called philosophic sense which includes every one of the great number of events without which any happening would not have occurred. Each of these events is a cause in the so-called philosophic sense yet the effect of many of them is so insignificant that no ordinary mind would think of them as causes."

Article 433 of the Restatement incorporates the considerations relevant for determining whether the

careless act of someone is deemed to be a substantial factor for the resulting loss. Clause (b) of this article states that the careless act of someone is deemed to be a substantial factor in causing the loss in question if the intervening force or forces were brought about as a result of the situation which the careless act created. Comment b. of this Article provides that, the fact that the party injured was remote in space from the careless party is not a sufficient reason to deny the causal relationship between the careless act and the resulting injury, in instances where the careless party realised or ought to realise that his careless act would result in an injury to the remote party.

By virtue of Article 443 of the Restatement, an intervening force or forces are not deemed to interrupt the chain of causation as long as their intervention is a normal consequence of the situation created by the negligent party's careless act. By virtue of Article 448 the criminal or tortious act of an independent party is not deemed to be a superseding force whereby the chain of causation could be interrupted, as long as the careless party realised or ought to realise that his careless act would create a situation whereby the criminal or tortious act of the independent party would be facilitated. The criminal or tortious act of the latter is deemed in such an instance to be the normal consequence of the situation created by the careless act of the negligent party.

111. cf. Comment b. for Article 431 Restatement Second of the Law of Tort.

112. cf. Article 435 Restatement Second of the Law of Tort, also Articles 443 and 448.

113. 348 F. supp. 969 1972.

114. For the reading of 3-406 and its implications, see pp.448-451 supra.

115. Ibid.

116. Ibid.

117. 211 Pa Super 42 (1967).

118. Ibid.

119. Ibid.

120. cf. Whaley, Negligence and Negotiable Instruments (1974), 53 N. C. L. Rev. 26.
Hinchey, Forgery And Alteration Claims, (1982), 10 Pepperdine L. Rev. 13-14.
Hinchey, Negligence and Bank U.C.C. Defences, The Forum 292.
Feulner - Check Forgeries, (1970), 12 Arizona L. Rev. 430.

121. 348 F. Supp. 969 1972.
For the facts of this case and the court's conception of causation see pp.453-456 supra.

122. cf. pp.256-259 supra.

123. cf. pp.259-272 supra.

124. This could be inferred from the provisions of Sections 29 and 54 B.E.A. Articles 3-302 and 3-418 U.C.C. as well as from the common law decisions such as London and River Plate Bank v Bank of Liverpool [1896] 1 QB 7. They provide in substance that the bona fide acquirer of a forged instrument may as between himself and the drawee payor qualify as the holder in due course. The forgery of the purported maker or drawer's signature does not impair his protected status. In other words the Anglo-American legal systems define the concept of the holder in due course in a broad sense, in instances where payment is erroneously made on a forged instrument. In such an instance they dispense with the genuineness of signature as a requirement for establishing the holder in due course status. By establishing the holder in due course status in favour of the bona fide acquirer they establish in favour of the said party a good title to the erroneously paid proceeds. This is reinforced by the fact that they deny to the drawee payor, the right to claim the erroneously paid proceeds from the bona fide acquirer/recipient.

The establishment of the protected holder status and ultimately the good title rule in favour of the bona fide acquirer recipient, in the Continental Geneva legal systems could be inferred from the pre-G.U.L. practice, whereby the drawee payor is denied the right to recover the erroneously paid proceeds from the bona fide indorsee recipient. Had the law not established in favour of the bona fide acquirer a good title to the erroneously paid proceeds, it would have entitled the drawee payor to recover the paid proceeds from the said party. The pre-G.U.L. rule could be inferred from the elaborate reading of Article 16 G.U.L.(Bills), Articles 53, 19, 20, 21, and 35 G.U.L.(Cheques) as well as paragraph 97 of the Official Report of the Drafting Committee of the Geneva Convention on the Uniform Law relating to Cheques. They provide in substance that, the bona fide indorsee of a negotiable instrument may qualify as the lawful holder, i.e. the protected holder, notwithstanding the fact that the instrument to which he establishes his title was vitiated by a forgery. Once the said party receives the payment of the instrument he is presumed to receive what he is legally entitled to. Accordingly the drawee payor may not demand the repayment of the erroneously paid proceeds.

125. cf. Articles 277, 823 and 826 of German BGB and Articles 1382 and 1383 of French Code Civil.

126. cf. the Minutes to the Geneva Conference on the Unification of the Laws Relating to Bills of Exchange Promissory Notes and Cheques, Second Session, L. N. Doc. No. C.194 M.77. 1931 II B, pp.306-311.

127. For the reading of the original provision of the Italian proposal and the proposals submitted by the Yugoslav and Czechoslovak delegates see n.18 above.

128. For a more detailed account of this argument see pp.340-342 supra.

129. The expression triable defence means the defence which ought to be tried. This expression is analogous to the triable issue as applied by McNeill J. in Wealden Woodlands (Kent) Ltd. v National Westminster Bank Ltd., Queens Bench, The Times 12 March 1983, 133 NLJ 719 (Transcript Nunnery). In the context of negotiable instruments, the expression triable defence denotes the defence, which the party against whom the instrument is sought to be enforced, may set up against the party who sought to enforce the instrument in order to defeat the latter's good title protection. Examples of such defence are personal defences arising between the above mentioned competing parties and real defences such as the defence of forgery.

130. The corresponding provision of the first paragraph of Article 16 G.U.L.(Bills) in the Convention on Cheques is Article 19 G.U.L.(Cheques). Its wording is identical to that of the first paragraph of Article 16.

131. The corresponding provision of the second paragraph of Article 16 G.U.L.(Bills) in the Convention on Cheques is Article 21. Its wording is almost identical to that of the second paragraph of Article 16.

132. The above mentioned definition of bad faith could be inferred from the Minutes to the Geneva Conference on the Unification of Laws relating to Bills of Exchange Promissory Notes and Cheques 1st Session, L.N. Doc. No. C.360 M. 151. 1930. II. In examining Article 16 G.U.L.(Bills) Mr. Quassowski, the German delegate to the Conference proposed that the term bad faith should be defined in the Convention on the Uniform Laws. He proposed that bad faith should be defined so as to denote actual or constructive knowledge of the invalidity of the prior transferor's title. The delegates of other countries, in particular Mr. Giannini of Italy, were not in favour of the German proposal. They were of the opinion that the incorporation of the definition of the term bad faith might create confusion in the law. It might be thought that bad faith in the context of negotiable instruments has a different connotation than that found in other areas of the law. After a private deliberation with the German delegate the conference deleted the German proposal. Nevertheless, it was agreed

that bad faith should be interpreted as it was expressed in the German proposal, cf. pp.197-201 of the Minutes.

In the course of examining the impact of the provisions of Article 17 G.U.L.(Bills) on the acquirer's satisfaction of the lawful i.e. protected holder status, the delegates of the represented countries pointed out that the provision of the article in question does not apply to determine the meaning of bad faith as it appears in Article 16. It was observed that bad faith in the latter article denotes the knowledge of the invalidity of the prior transferor's title, whilst bad faith in instances where the title of the acquirer is valid but where the instrument to which he establishes his title is vitiated by a personal defence such as the failure of consideration, is defined so as to denote the knowledge that the acquisition of the instrument would cause a detriment to a prior liable party, cf. pp.291-294 of the Minutes.

For a detailed examination of Article 17 G.U.L. (Bills) and the variant court interpretations, see:
Greene, Personal Defences under the Geneva Uniform Law, (1962), 46 Marq. L. Rev. 281.

133. cf. Balough, Critical Remarks on the Laws of Bills of Exchange of the Geneva Convention, (1935), X Tulane L. Rev., 37-39.

134. Although the Continental Geneva legal systems deny to the grossly negligent acquirer the lawful i.e. protected holder status, they entitle him in some instances to re-allocate a portion of the loss resulting from the erroneous payment of a forged instrument to the drawee payor. The grossly negligent acquirer may in the Continental Geneva legal systems re-allocate a portion of the resulting loss to the drawee payor in instances where the latter's right of recovery results in a detrimental alteration in the position of the former.

In the Continental Civil legal systems the causing of, or contributing to, a detrimental alteration in position is actionable. They allocate to the party, who by his conduct causes or contributes to the detrimental alteration in the position of another, the loss resulting from his conduct. They deny him the right to claim in restitution the recovery of the erroneously paid proceeds, cf. Article 818 BGB and Article 1377 Code Civil also Planiol et Ripert, Traité Pratique de Droit Civil 746.

In instances where a portion of the blame for causing the loss in question could be attributed to the party to whom the detrimental alteration in position is caused, the Continental Civil legal systems would, through the doctrine of comparative negligence re-allocate a portion of the resulting loss to the other competing party. In determining the manner of dividing the loss in question they take into account the degree of fault of the

competing parties. The party who is most at fault bears most of the loss. For the application of the doctrine of comparative negligence to the law of negotiable instruments cf. consensus opinion expressed by delegates to Geneva Conference on Unification of Laws relating to Bills of Exchange, Promissory Notes and Cheques, 2nd Session, L. N. Doc. No. C.194 M.77. 1931 II B, p.311.

The acquirer of a negotiable instrument would suffer a detrimental alteration in position where the drawee payor's right of recovery deprives the former from exercising his right of recourse on the instrument against a prior liable party. This of course requires the presence of a party the liability of whom the drawee payor's right of recovery may discharge. An example of such a party is the innocent indorser. The indorser of a negotiable instrument is a party secondarily liable on the instrument. His liability crystallises after the dishonour of the negotiable instrument and when the acquirer complies with the duty of procuring timely protest and notice of dishonour.
cf. pp.52-54 supra.

For the drawing up of a protest and for the giving of notice to be timely it must be within two or four days following the maturity day of the instrument or the day of drawing up the protest.
cf. Articles 44 and 45 G.U.L.(Bills).

The failure to carry out such a duty could discharge the secondarily liable party on the instrument.
cf. Article 53 G.U.L. (Bills).

If the drawee payor was allowed to recover the erroneously paid proceeds from the grossly negligent acquirer, the timing of his right of recovery may overlap with the time within which the acquirer may exercise his right of recourse against the secondarily liable party. Accordingly, the acquirer would forfeit a valuable security.
cf. illustration on pp.355-358 supra.

The detriment which the acquirer would suffer as a result of failure to exercise his right of recourse is that he would have to establish his claim against the secondarily liable party and he would have to answer claims set up against him by the latter. The burden of establishing such a claim involves cost and time. Both cost and time are valuable assets. For their assumption to be economically justifiable they must generate an enforceable value. As it has been established earlier, see pp.332-338, and as will be shown below, the involvement of cost and time do not generate an enforceable value in favour of the bona fide acquirer. On the contrary they result in a misallocation of wealth to him and ultimately they could impair the objective of promoting the function of negotiable instruments as a substitute for money.

135. For the pre-G.U.L. rule, according to which the drawee payor is denied the right of recovering the erroneously paid proceeds from the bona fide indorsee see pp.271-272 supra.

136. For a detailed account concerning the convenience of negotiable instruments as substitutes for money and their superiority over other credit institutions, see pp.100-107 supra.

137. Ibid.

138. For a more detailed account of this argument see pp.332-338 supra.

139. cf. Sections 54 and 55 B.E.A. and Articles 9, 15 and 47 G.U.L.(Bills).

140. cf. Article 47 G.U.L.(Bills).

141. By virtue of Article 70 G.U.L.(Bills), secondary parties to a bill of exchange i.e. negotiable instrument are liable on their undertakings for one year only. It runs from the maturity day of the instrument or from the day on which the certificate of protest ought to be drawn. The holder who fails to exercise his right of recourse within the prescribed time limit forfeits his right of recovery from the secondarily liable parties.

142. cf. Articles 44 and 45 G.U.L.(Bills).

143. cf. Article 53 G.U.L.(Bills).

144. cf. Article 44 G.U.L.(Bills).

145. For an illustration of the instance in which the failure to notify the acquirer of the dishonour could result in the forfeiture of a valuable security, see pp.355-358 supra.

146. cf. Section 54 B.E.A.

147. Section 29 B.E.A. defines the requirements for establishing the holder in due course. It reads:

> "(1) A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions; namely,
>
> (a) That he became the holder of it before it was overdue and without notice that it had been previously dishonoured, if such was the fact:
>
> (b) That he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it."

148. cf. Section 90 B.E.A. It defines good faith as follows,

> "A thing is deemed to be done in good faith, within the meaning of this Act, where it is in fact done honestly, whether it is done negligently or not."

149. London Joint Stock Bank v Simmons [1892] AC 201
Manchester Trust Co. v Furness [1895] 2 QB 539
Lloyds Bank v Swiss Bankverein (1913) 108LT143.
Nevertheless in instances where gross negligence amounts to the wilful abstention from making inquiry in suspicious circumstances the law may infer the existence of bad faith on the part of the grossly negligent acquirer and ultimately it may disqualify him from being a holder in due course.
See May v Chapman (1847) 16 M & W 355 approved in Raphael v Bank of England (1855) 17 CB 161.

150. cf. Lewis v Clay (1897) 67 LJ QB 224
Herdman v Wheeler [1902] 1 KB 361
Talbot v Von Boris [1911] KB 854

Moulton L.J., however, in Lloyds Bank v Cooke [1907] 1 KB 794, pointed out that the concept of holder in due course is the counterpart of the bona fide purchaser without notice, accordingly he was of the opinion that a bona fide payee of a negotiable instrument may qualify as the holder in due course. Finally in Jones v Waring & Gillow [1926] AC670 the House of Lords dismissed Moulton L.J.'s contention. The Law Lords in Jones v Waring and Gillow expressed the view that the payee of a negotiable instrument may not per se qualify as the holder in due course. Nevertheless in instances where the payee re-acquires the instrument from its holder, he may qualify as the holder in due course, if at the time of re-acquisition he was acting in good faith and without being aware of the existence of a defect vitiating the said instrument. The payee's satisfaction of the holder in due course status is an application of the 'umbrella' doctrine. The essence of the said doctrine is to establish in favour of the taker from the holder in due course, the status of his immediate transferor, i.e. the holder in due course.

The establishment of the holder in due course status in favour of the payee in instances of re-acquisition could be inferred from the decision of,
Jade International Steel Stahl v Nicholas Robert (Steels) Ltd. (1978) Lloyds Rep. 13.
This case involved the dishonour of a bill of exchange discounted with a German bank in favour of the drawer. After the bill was dishonoured the German bank settled his claim with the drawer and delivered the bill to him. The drawer next sued the defendant on the bill. The latter attempted to defeat the drawer's cause of action on the basis that the said party was not a holder in due course. The court dismissed the defendant's argument and held that

since the drawer i.e. the plaintiff acquired the bill from a holder in due course i.e. the German bank, he is presumed to establish the entitlements possessed by his transferor. Accordingly, he is deemed in law to qualify as the holder in due course.

Although the above-mentioned case was concerned with determining the position of the drawer of a bill of exchange, the same ruling may be applied to the bona fide payee. The resemblance between the payee recipient of a forged instrument and the drawer of a dishonoured instrument is that they stand in a similar position as between themselves and the other competing party, namely the drawee payor and the drawee who dishonours the instrument. In both instances the payee recipient and the drawer of a dishonoured instrument are deemed to be immediate to the other competing party, in the first place. Their remoteness from the latter party arises from the intervention of an independent party in the chain of negotiation.

151. See pp.332-38 supra.

152. Ibid.

153. See pp.354-358 supra.

154. cf. the observation of Mr. Gutteridge the representative of the British Government to the Geneva Conference on the Unification of Laws relating to Bills of Exchange, Promissory Notes and Cheques, 1st Session. L. N. Doc. No. C.360 M.151. 1930 II, pp.198 -199.

155. Per Halsbury L.J. in Bank of England v Vagliano Bros. [1899] AC 107.
Per Findlay L.J. in Imperial Bank of Canada v Bank of Hamilton [1903] AC 49.
And per Kerr L.J. in National Westminster Bank Ltd. v Barclays Bank International Ltd. and Another [1975] QB 654.

156. Examples of reliable payment instruments are cashier's cheques, accepted instruments and money.

157. cf. Bank of Ireland v Evans' Charities Trustees (1855) 5 HLC 389.
Swan v North British Australasian Co. (1863) 2 H & C 175.
London Joint Stock Bank v Macmillan and Arthur [1918] AC 777.
Tai Hing Cotton Mills Ltd. v Liu Chong Hing Bank 1986 AC 80.
For the facts of the above cases and the rule laid down there see pp.399-400, 410-415, 430-432.

158. Lloyds Bank v Cooke [1907] 1 KB 794.

159. cf. Young v Grote (1827) 4 Bing 253.
For the facts and the decision of the court see pp.228-230 supra.

160. In English law there is another instance in which the drawee payor may recover from the purported maker drawer the loss resulting from the erroneous payment of a forged instrument. This occurs when the purported maker drawer abstains from informing the drawee of the forgery of which he, i.e. the purported maker drawer had an actual knowledge and the drawee pays the vitiated instrument in ignorance of the said forgery.
cf. Greenwood v Martins Bank [1932] 1 KB 371.
Brown v Westminster Bank Ltd. [1964] 2 Lloyds Rep 187.

The law in such an instance does not base the liability of the purported maker drawer on the negligent conduct of the said party rather it deems the purported maker drawer's failure to inform the drawee of the forgery as representing to the latter that the purported instrument is genuine and ultimately it impliedly authorises the drawee to pay the instrument when presented to him. If the latter so acts and the presented instrument is proved to be a forgery the purported maker drawer may not resile from the situation which he has created by his omission to inform the drawee timely. The law deems him to have misrepresented to the drawee the true status of the erroneously paid instrument. Ultimately the law estops the purported maker drawer from denying the validity of his statement.

161. (1855) 5 HL Cas 389.
For the facts of the case and rule laid down by Parke B. see pp.430-432.

162. Ibid.

163. (1878) 3 QBD 525.

164. For a detailed account of the facts and the decision of the court, see pp.432-433.

165. [1909] 2 KB 1010.

166. Ibid. p.1017.

167. Ibid. p.1023.

168. Ibid. p.1027.

169. [1918] AC 777.

170. Ibid. p.795.

171. The Times 12 March 1983 133 NLJ 719.

172. Ibid.

173. For the relevant passage of Bray J. in Kepitigalla Rubber Estates Ltd. v National Bank of India see p.498 supra.

174. Wealden Woodlands (Kent) Ltd. v National Westminster Bank Ltd., The Times 12 March 1983 133 NLJ 719.

175. [1986] AC 80.

176. For a detailed account of the facts of this case and the decison of the Privy Council see pp.405-410 supra.

177. (1855) 5 HL Cas 959.

178. Per Bray J. in Kepitigalla Rubber Estates v National Bank of India [1909] 2 KB 1025.
Per Finlay L.J. in London Joint Stock Bank v Macmillan and Arthur [1918] AC 795.
Per Lord Scarman in Tai Hing Cotton Mill Ltd. v Liu Chong Hing Bank [1986] AC 103.

179. [1909] 2 KB 1025.

180. [1986] AC 107-108.

181. For a detailed account of the English narrow conception of causation see pp.430-436 supra.

182. For a detailed account of this argument see pp.434-436 supra.

183. cf. the rule laid down by the Privy Council in, Overseas Tankship (UK) Ltd. v Morts Dock & Engineering Co. Ltd. [1961] AC 388.
For the facts of this case and the import of the reasonable foreseeability test in determining the existence of the causal relationship into English Law see pp.436-437 supra.

184. For the reading of Section I of 1945 Law Reform Contributory Negligence Act see p.441.

185. [1971] 1 Lloyd's Rep 114.

186. Ibid. pp.115-117.

187. Ibid. pp.120-121.

188. For the reading of Section II of 1977 Torts Interference with goods Act and its impact on the application of the rule of contributory negligence see p.448 supra.

189. [1986] AC 80.

190. See p.504 supra for the relevant passage of the judgement of the Privy Council.

191. cf. The report of the Review Committee on Banking Services (1989) Cm 622 Ch.6.

192. For the reading of the relevant section of the 1945 Law Reforms Contributory Negligence Act see p.441.

193. As to the argument that drawee banks are presumed to be in the best position to assume the burden of litigation see pp.369-370.

194. Article 3-302 reads in part,

> "(1) A holder in due course is 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 dishonoured or of any defence against or claim to it on the part of any person ...."

195. Article 3-202 defines negotiation as follows:

> "Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder."

By virtue of Article 3-102 the issuance of a negotiable instrument constitutes a form of negotiation. It involves the delivery i.e. transfer of the instrument to its initial holder i.e. payee.

196. cf. Article 3-102 and 3-202 U.C.C.

197. This is explicitly mentioned in Article 3-302 U.C.C. It reads in part,

> "(2) A payee may be a holder in due course ..."

198. Article 1-201 (19) reads,

> "Good faith means honesty in fact in the conduct or transaction concerned."

199. Article 3-304 does not attempt to define the concept of notice. It, for the said purpose, cross refers to the general definitions embodied in Article 1-201. Sub-section 25 determines the particular party to have a notice of the existence of a defence if,

> "..(a) he has actual knowledge of it or
> (b) he has received a notice or notification of it or
> (c) from all the facts and circumstances known to him at the time in question, he has reason to know that it exists."

200. As to the position of the Continental Geneva legal systems in determining the circumstances in which the acquirer of a negotiable instrument would be deemed to have knowledge of the existence of a triable defence and ultimately the instances in which the said party would be disqualified from claiming the protected i.e. lawful holder status see pp.465-470 supra.

201. Ibid.

202. For the English legal system's position in determining the party to whose favour the protection arising from the application of the negotiability concept is established see pp.482-484 supra.

For the position of the Continental Geneva legal systems in determining the party to whose favour the protection arising from the application of the negotiability concept is established see pp.465-470 supra.

203. For a more detailed account of this argument see pp.351-352 supra.

204. cf. White and Summers, The Uniform Commercial Code (1980), p.626.
Hinchey, Negligence and Bank U.C.C. Defences, The Forum, p.287.

205. cf. 67 A. L. R., 3rd Series, p.144.

206. cf. cases cited in 67 A.L.R. 3rd Series pp.169-173 M. Jackson v 1st National Bank of Memphis Inc. 55 Tenn App 545, the court by comparison was of the opinion that in order to hold the purported maker drawer liable for not examining the remitted bank statements and for not reporting the existence of an irregularity in their contents, the said items should be remitted to the said party. The remittance of the bank statements to the forger himself does not suffice to estop the purported maker drawer from denying the existence of an irregularity in their contents. In such an instance he would not be charged with the duty of examining the remitted statements and reporting their irregularity to the drawee payor.

The holding of the court in the above mentioned case has been criticised by many writers and it is submitted that the better view is that expressed by the majority of the courts, see text above.
cf. White and Summers, Uniform Commercial Code, p.630.

207. For a more detailed account of this argument see pp.340-342 supra.

208. cf. Rubin, Proposed Revision of U.C.C. Articles 3 and 4, (1988), 43 The Bus. Law., pp.650-651.

209. cf. pp.332-336 supra.

210. For a detailed account of this argument see pp.335-337 supra..

211. cf. Articles 33 and 34 of the Convention on International Bills of Exchange and International Promissory Notes.
cf. also Articles 31 and 32 of the draft Convention on International Cheques.

For the reading of the above mentioned articles and their implication see pp.243, 253 and 254 supra.

212. cf. Articles 5, 25, 33, 34, 45 and 72 of the Convention on International Bills of Exchange and International Promissory Notes.
See also Articles 5, 25, 31, 32 and 61 of the draft Convention on International Cheques.
For the reading of the above mentioned articles and their implication see pp.285-288, 293-295 supra.

213. This is due to the fact that the concept of holder is defined in a broad sense. It applies to the initial transferees such as the payee as well as remote transferees. In this context, Article 15 of the Convention on International Bills of Exchange and International Promissory Notes reads in part ...

"1) A person is a holder if he is:

a) The payee in possession of the instrument.

b) In possession of an instrument which has been endorsed to him or on which the last endorsement is in blank and on which there appears an uninterrupted series of indorsements, even if any endorsement was forged or was signed by an agent without authority."

The counterpart of the above mentioned article is Article 16 of the draft Convention on International Cheques. The wording of the latter article is substantially similar to the wording of Article 15 of the Convention on International Bills of Exchange and International Promissory Notes.

214. The term manageable care is the author's own expression. It is not synonymous with the concept of reasonable care as it is interpreted in the Anglo-American and the Continental civil legal systems. The latter incorporates a quasi-abstract test for determining the required standard of care. It examines the care of the party in question with that of an independent person who is similarly situated. It deems the behaviour of the party whose care is under examination to be reasonable when and only when it conforms with the behaviour of the independent person.

By comparison, the term manageable care involves a flexible test. It could be higher than that involved in the concept of reasonable care, as commonly interpreted, and it could involve a lower standard of care. It takes into account, in determining the required standard of care, the party's capability to exercise it in the economic sense. It allocates to the party in question the care, the compliance with which would not cause him an undue economic detriment.

The necessity to prescribe a higher standard of care than that involved in the concept of reasonable care in the commonly interpreted sense would arise when:

1) the allocation of reasonable care to the party in question would not function to provide against the occurrence of risk,

2) the allocation of reasonable care to the other competing party would result in an economic detriment to him, and

3) the allocation of a higher standard of care to the former party generates a practical enforceable value to him, or it results in the least hardship to him than that which would result to the other competing party had the duty to exercise care been allocated to him.

An example of the instance where the prescription of a high standard of care is necessary against the occurrence of risk is that arising in the context of negotiable instruments. As could be noted from an earlier discussion, the risk of the forgery of such documents might not be avoided by the exercise of reasonable care. In instances where it could be prevented by the exercise of reasonable care, the party who would be in the position to provide against it by the exercise of such care might have to invest cost and time in an economically detrimental manner. The risk arising from the forgery of instruments could be provided against in an efficient manner when, by comparison, the drawee was required to exercise a high standard of care in examining the genuineness of the instrument presented to him for payment cf. pp.361-364 supra. The provision of such care is not undeuly onerous to the drawee. It is firstly, profitable to his business and secondly, the cost arising from the exercise of a high standard of care could be absorbed by spreading it among his customers.

On the other hand, the necessity to prescribe a lower standard of care would arise when the allocation of the duty to exercise reasonable care in the commonly interpreted sense would result in an undue hardship to the party to whom it is intended to be allocated i.e. when it requires him to invest cost and time in situations where the said cost and time do not generate a practical enforceable value to him, nor would they be absorbed by him. In like situations, the standard of care that ought to be allocated to the party in question should be lessened so as to conform with his capability to provide for it in an efficient manner.

An example of the instance where the allocation of the duty to exercise reasonable care in the sense under discussion could result in an undue hardship to the party to whom it is intended to be allocated, is that arising in the context of negotiable instruments. The bona fide third party acquirer of a negotiable instrument is

incapable of complying with the duty to exercise reasonable care in an efficient manner. This is due to the fact that the compliance with such a duty involves the investment of cost and time. Furthermore, due to his capacity as such, he is not normally in the position to absorb the said cost and time.

The concept of manageable care is introduced to mitigate the unreasonableness of the concept of reasonable care as it is commonly interpreted. It achieves the said objective by replacing the quasi abstract standard of care with a more flexible one which takes into account the party's capability to comply with it in the economic sense. By such an approach, it mitigates the gravity of hardship that would result from the exercise of care.

215. For a detailed analysis of the fact that the allocation of the risk of the forgery of instruments to the drawee payor is compatible with the considerations underlying the risk allocation rule in the context of negotiable instruments cf. pp.351-361 supra.

216. The fact that the conduct of the particular party is the relevant factor in attributing to him an implied acceptance or representation that the forged signature is his and the fact that the court of each legal system has the exclusive jurisdiction to infer from the particular circumstances the existence of implied acceptance or representation could be gathered from the report of the United Nations Commission on International Trade Law. cf. U.N. Doc A/41/17, 1986, P.29.

217. cf. Article 3-306 and Article 4-206 U.C.C.
See also Articles 812 BGB and Article 13 82 Code Civil.
For a brief analysis of the implication of the foregoing articles and their application to the law of negotiable instruments see pp.395-398, 443-446 supra.

218. Ibid.

219. cf. Kepitigalla Rubber Estates Ltd. v National Bank of India Ltd. [1909] 2 KD 1010.
London Joint Stock Bank v MacMillan and Arthur [1918] AC 777.
Wealden Woodlands (Kent) Ltd. v National Westminster Bank Ltd., The Times 12 MARCH 1983 133 NLJ 719 (Transcript: Nunnery).
Tai Hing Cotton Mill Ltd. v Lui Chung Hing Bank and Another [1986] AC 80.
For the facts of the above mentioned cases and the decision of the courts cf. pp.399-400, 410-415, 495-502 supra.

220. cf. Scholfield v Earl of Londesborough [1986] AC 514,
London Joint Stock Bank v Macmillan and Arthur [1918] AC 777.
For the reading of the relevant passages which laid down

the rule that proprietors of instruments do not owe the person to whose possession such documents may come, a duty of care, see pp.400-403 supra.

221. For a more detailed account of the fact that the allocation to the bona fide third party acquirer of the duty to exercise care in the provision against the forgery of instruments could result in an economic detriment to him, see pp.332-336 supra.

222. For a brief account of the argument that the allocation to the proprietor of instruments of the duty to exercise care in the selection and supervision of his employees is economically efficient, see p.521.

223. cf. Article 34 of the Convention on International Bills of Exchange and International Promissory Notes and Article 32 of the draft Convention on International Cheques.
The former article reads:-

> "A forged signature on an instrument does not impose any liability on the person whose signature was forged. However, if he consents to be bound by the forged signature or represents that it is his own, he is liable as if he had signed the instrument himself."

224. The fact that Articles 34 and 32 of the Convention/draft Convention could result in an inefficient application is reinforced by the fact that the law of the Anglo-American and the Continental Geneva legal systems as it presently stands, incorporates a preclusionary rule. The immediate impact of such a rule is that it holds the negligent proprietor liable in full for the loss resulting from the erroneous payment of a forged instrument. It prevents the said party from re-allocating a portion of the loss in question to the drawee payor. It discharges the latter absolutely from liability as long as he behaves with reasonable care in paying the presented forged instrument.

For a more detailed account of the application of the preclusionary rule in the Anglo-American and the Continental Geneva legal systems and for a brief account of its implication in the legal systems under consideration cf. pp.462-465, 492-494, 517-521 supra.

225. For a more detailed account of the fact that the drawee is always in the position to provide against the occurrence of loss in instances of forged instruments and for a detailed account of the form of the care, the compliance with which could provide against the risk in question, cf. pp.328-330. 339-361 supra.

226. For a more detailed account of the fact that the allocation to the drawee of the duty to exercise a high standard of care is economically efficient cf. pp. 340-342 supra.