**Employer Responsibility**

Welcome to this podcast on Employer Responsibility brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is to address three situations where employers have responsibility for employee fraud related to instruments. First, where there is a fraudulent indorsement on an instrument either sent to the employer or issued by the employer. Second, where the employee has fraudulently caused the issuance of instruments by the employer. Third, where the employer has been negligent. I find that students often get confused about selecting the correct rule for employer responsibility, so it is worth the time to sort this out. Oh and yes, again, this deals with instruments, typically paper checks and promissory notes. While consumers and businesses don’t use paper checks as much as they did in the past, these are often large value instruments and fraud remains a problem. Not only is this a practice issue, but the employer rules are covered in Article 3 of the Uniform Commercial Code, which is tested by a number of states on the bar examination. These loss shifting rules are favorites on bar exams.

Again, there are three primary rules at play for employers: the employer responsibility rule for fraudulent indorsements of 3-405, the fictitious payee rule of 3-404 and the negligence rule of 3-406. It is important to try and use the correct terminology so be on the lookout for the following: employee, fraudulent indorsement, responsibility, ordinary care, issuer, indorsement, payee, fictitious persons, person whose intent determines to whom an instrument is payable, holder, indorsement, person entitled to enforce (sometimes called a PETE) and negligence.

Let’s begin with the rule of 3-405. This rule is often called the employer responsibility rule, but it only covers employer responsibility for *fraudulent indorsements* by employees. That is, it leaves other employee fraud not related to indorsements for other rules, most often the fictitious payee rule of 3-404. The rule applies when an employer entrusts an employee with responsibility with respect to an instrument and the employee, or a person acting in concert with the employee, makes a fraudulent indorsement on the instrument. If the rule applies, then the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. This obligation is owed to a person paying the instrument in good faith or taking it for value or collection. A primary limitation on this rule is that there is an apportionment of loss if the person claiming protection of the rule failed to exercise ordinary care that substantially contributed to the loss from the fraud. The indorsement is valid and within the scope of the rule, so long as it is at least made in a name substantially similar to the payee or even if not indorsed is deposited in a depositary bank in an account in a substantially similar name. When this rule applies, the employer usually takes the loss.

As always, I find an example is helpful. Let’s presume that two months ago Carpenter entered into a contract with Lawyer to build bookshelves for $3000. Two weeks ago, Carpenter hired Administrator to help Carpenter manage the business. Carpenter put Administrator in charge of opening the mail, recording incoming payments from customers, indorsing checks on behalf of Carpenter and depositing the checks to Carpenter’s account at First Bank. Five days ago, Administrator opened Carpenter’s mail and found a check. The check was from Lawyer in the amount of $3000, payable to Carpenter and drawn on Lawyer’s account at Second Bank. Administrator takes the check and cashes it at Check Now, a check-cashing business. Check Now deposits the check at its bank. Second Bank pays the check and Administrator disappears. Carpenter demands that Check Now repay the $3000 to Carpenter. Does Carpenter recover the $3000?

As is often the case with employee fraud, Carpenter will not be up to recover the $3000 from Check Now under the employer responsibility rule. Carpenter entrusted Administrator with authority to indorse and deposit checks. As such, the fraudulent indorsement made on the back of the check from Lawyer is effective in favor of Check Now because it took the check for value when it paid Administrator on the check. There is nothing to suggest the Check Now failed to exercise ordinary care in cashing the check presented by Administrator. This is a basic application of the employer responsibility rule for fraudulent indorsements made by employees. Note that this rule applies because the fraud perpetrated by Administrator was made on the back of the check in the form of an indorsement, thus triggering the rule.

Notice that the employer responsibility rule only covers fraudulent indorsements. It does not cover fraud with respect to instruments the employee has somehow been able to issue. Employee fraud related to the issuance of instruments is covered by a different rule, called the fictitious payee rule of 3-404. This rule usually applies when an employer has given an employee responsibility to issue or order the issuance of checks for them. Students often get this one wrong, so pay close attention here. The rule applies when a person whose intent determines to whom an instrument is payable does not intend the person to have any interest in the instrument (or simply makes the instrument out to a payee that doesn’t even exist because it is a fictitious person). Notice that this involves the issuance of an instrument. It is a fraud initially perpetrated on the front side of an instrument. If the rule applies THEN a person in possession of the instrument is its holder AND an indorsement in the name of the payee stated on the instrument is effective in favor of a person (usually a bank) who in good faith pays the instrument.

Let’s look at an example of this type of employee fraud. Let’s stick with Carpenter and Administrator. Let’s presume that Administrator would also prepare checks for Carpenter to sign to pay office expenses. Administrator causes Carpenter to issue a check to First Electrical Company, a company that provides electrical service to the office. While First Electrical does business with Carpenter, there was no money outstanding and Administrator plans to steal the check. After Carpenter delivers the signed check to Administrator, Administrator signs the payee’s name on the check beneath an indorsement that reads “pay to the order of Administrator.” Administrator then cashes the check at First Bank. When the fraud is discovered, can Carpenter recover from First Bank?

The answer is no. Carpenter will take the loss under the fictitious payee rule. First, Administrator is a person whose intent determines to whom an instrument is payable. Even though Administrator doesn’t write the checks, Carpenter has given her authority to order checks. Second, even though First Electrical Company is real, Administrator does not intend it to have any interest in the check. The fictitious payee rule applies to make any person in possession of the instrument its holder. Meaning, Administrator was the holder of the instrument and, therefore, became a PETE. Also, the indorsement of Administrator is effective as the indorsement of First Electrical Company in favor of First Bank who in good faith paid on the check. So, Carpenter takes the loss.

So where might this go wrong? Well, most of the time if students get employer responsibility incorrect it is because they choose the wrong rule. Most often students confuse the employer responsibility rule for fraudulent indorsements with the fictitious payee rule. Notice that if the first fraud done by Administrator on an instrument relates to the issuance of the instrument, then the fictitious payee rule usually applies to place liability on the employer. However, if the first fraud done by Administrator on an instrument relates to an indorsement, then the employer responsibility rule usually applies to place liability on the employer. So, ask yourself if the fraud done by Administrator relates to the front of the check, fictitious payee rule, or indorsements on the back of the check, employer responsibility rule for fraudulent indorsements. Do not use both rules. If there is fraud related to the front of the instrument, there’s no need to use the employer responsibility rule for the indorsement because the fictitious payee rule will actually validate the indorsement, so the employer responsibility rule does not apply.

Finally, if neither of these rules seem to apply, you might want to consider whether the employer was negligent under 3-406. If the negligence substantially contributed to an alteration or the making of an instrument, then the employer bears the loss. An example of this might be where an employer leaves a signature rubber stamp near the unsigned checks. If another party is also negligent though, the loss is allocated between them.

At this point, you should be able to identify when the employer responsibility for fraudulent indorsements, fictitious payees and negligence rules leave responsibility for losses on employers.

I hope you’ve enjoyed this podcast on Employer Responsibility.

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