**Fiduciary Duty and Liability of Representatives on Instruments**

Welcome to this podcast on Fiduciary Duty and Liability of Representatives on Instruments brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is: (i) when a person that takes an instrument from a fiduciary has notice of the breach of fiduciary duty; and (ii) when a representative is bound individually on an instrument. Why is this important? Oftentimes an examination question will simply ask who is liable, but then have an employee of the business sign a check or promissory note, often for personal obligations. This podcast covers the rules of §§3-307 and 3-402. Please read those sections carefully.

Let’s begin with when a taker of an instrument has notice of a breach of a fiduciary duty under § 3-307. A common situation on the bar examination is where a corporate officer pays a personal debt using the corporate checkbook. For purposes of the rule, a represented person is a principal, beneficiary, partnership, corporation, or other person to whom a duty is owed. A fiduciary is an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument. In a typical situation, the corporate officer would be the fiduciary and the represented person would be the corporation.

 Why is this important? You may recall that pursuant to § 3-302, a taker of an instrument cannot be a holder in due course if the instrument was taken with notice of a claim under § 3-306. Such a claim would include a breach of fiduciary duty arising from misapplication of the proceeds of an instrument under
§ 3-307. Therefore, the taker of an instrument might be precluded from holder in due course status, which would allow the assertion of defenses to payment on the instrument.

In order for this rule to apply, three elements must be present: (i) an instrument is taken from a fiduciary for payment, for collection or for value; (ii) the taker has knowledge of the fiduciary status of the fiduciary; and (iii) the represented person makes a claim to the instrument or its proceeds on the basis that the transaction with the fiduciary is a breach of fiduciary duty.

Let’s look at a problem. Employer owns and operates Widgets, Inc. To pay Creditor, Employer signed a blank check from the Widgets business account and delivered it to Fiona Financial, the company’s Chief Financial Advisor of more than 20 years. Employer instructed Fiona to complete the check by typing in Creditor’s name and the amount of $60,000, which was owed to Creditor. The check contained the Widgets company name and logo printed on the face of the check. Thinking the company owed her for her long service, Fiona fraudulently completed the check by typing in the name Harriet as payee on the check. Fiona owed Harriet $65,000 for a personal loan Harriet made to Fiona, which was now in default. Harriet had threatened to sue Fiona, contending that Fiona had made big bucks as the CFO of Widgets. Fiona then delivered the check to Harriet in payment for her overdue loan. Thereafter, Harriet quickly took the check to her bank which properly made payment to Harriet.

In this problem, Widgets is the represented person. Fiona is the fiduciary. Harriet is the taker of the instrument. Does the rule of § 3-307 apply? First, the instrument was taken from a fiduciary (here Fiona) for payment. Second, the taker (here Harriet) has knowledge of Fiona’s fiduciary status as C.F.O. of Widgets. The third element will be satisfied if Widgets makes a claim to the instrument, on the basis that the transaction with Fiona is a breach of fiduciary duty. So, yes, it seems the rule of § 3-307 might apply.

Under § 3-307, important, but somewhat complicated, rules with respect to notice of breach of fiduciary duty apply. The first and most straightforward of the rules is that a notice of a breach of fiduciary duty, by the fiduciary, is also notice as to a claim that will be made by the represented person. The remaining rules about notice of the breach of fiduciary duty turn on how the instrument is issued, so pay close attention.

If an instrument is payable to *the represented person or the fiduciary*, the taker has *notice of the breach of fiduciary duty*, but only if any one of three things are true: (i) the instrument is taken as payment of or as security for a debt known by the taker to be the personal debt of the fiduciary; (ii) the instrument is taken in a transaction known by the taker to be for the personal benefit of the fiduciary; or (iii) the instrument is deposited to an account other than the account of the fiduciary, as such, or an account of represented person.

If the instrument is issued by the *represented person or the fiduciary in that capacity* and *made payable to the fiduciary personally*, the taker does not have notice of the breach of fiduciary duty, unless the taker knows of the breach of fiduciary duty.

Finally, if an instrument is issued by the represented person or the fiduciary as such *to the taker as payee*, the taker has notice of the breach of fiduciary duty, if the instrument satisfies one of three conditions: (i) the instrument is taken as payment or as security for a debt known by the taker to be the personal debt of the fiduciary; (ii) the instrument is taken in a transaction known by the taker to be for the personal benefit of the fiduciary; or (iii) the instrument is deposited to an account other than the account of the fiduciary, as such, or accounts of the represented person.

Let’s return to our problem with Fiona and Widgets. The last rule applies because we have an instrument that is issued by the represented person to the taker as payee. But we still need one of the three conditions to be met. Here, the first condition seems to be met where the instrument of Widgets was taken as payment for a personal debt of Fiona. Moreover, it would seem that the taker would know that the transaction would be for the personal benefit of Fiona as this relates to a personal loan. Because the rule applies, Harriet would have notice of the breach of fiduciary duty by Fiona and would have notice of a claim by Widgets. The notice of claim would prevent Harriet from being a holder in due course. As such, Widgets could assert the defense of fraud against Harriet. While the rules might seem complicated, they essentially turn on whether we can impute knowledge of the breach of fiduciary duty by Fiona to Harriet as taker of the instrument.

Before we conclude, a word about liability of representatives under § 3-402. Keep in mind that sometimes a representative of a business may be the signer and will bind the represented person under the rules of agency pursuant to § 3-402. The representative is not signing the instrument in their personal capacity and will not be liable on the instrument, so long as the signature unambiguously indicates that it is made on behalf of the represented person. However, the representative could be liable as a signer of an instrument in their own capacity if the signature does not unambiguously indicate the representative capacity or the represented person is not identified in the instrument, unless the representative can prove that the original parties did not intend the represented to be liable on the instrument. That said, in cases of this ambiguity, the representative will be liable to a holder in due course without notice of the representative capacity.

As an example, presume Widgets needs a loan to purchase a new piece of packaging equipment from Supply Co. Emily, the president of Widgets, signs a promissory note that indicates that Widgets is the maker of the note. Underneath the signature line where Emily signs her name reads Emily Employer, President of Widgets. In this case, Emily would not have personal liability on the promissory note, because she did not sign in her personal capacity and the signature unambiguously indicates that she is signing on behalf of the company, Widgets.

At this point, you should be able to identify who are represented persons and fiduciaries, determine when a taker of an instrument has notice of a breach of fiduciary duty and a claim of the represented person and when a representative will have personal liability on the instrument that they sign in their representative capacity.

I hope you’ve enjoyed this podcast on Fiduciary Duty and Liability of Representatives on Instruments.

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