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Recommended Citation
John D. O'Malley, Subrogation Against Banks on Forged Checks, 51 Cornell L. Rev. 441 (1966)
Available at: http://scholarship.law.cornell.edu/clr/vol51/iss3/1

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SUBROGATION AGAINST BANKS ON FORGED CHECKS

John D. O'Malley†

The compensated surety defense, as embodied in the superior equity and election of remedies theories, has proved to be a juridical thorn in the sensitive sides of insurance companies which have sought recovery from banks honoring forged or altered checks. The author explores the development of the defense, including the role insurance companies have played in it, and the maneuvers used to avoid its effect through such devices as assignments, loan receipts, and agreements to withhold claim. At the end of the article, a table depicts the application of the compensated surety defense in all states which have decided the specific issue.

INTRODUCTION

While judicial opinions abound with expressions that sureties are "favorites of the law," an even less than circumspect examination of the cases will reveal that such magniloquence applies only to the now practically extinct gratuitous, individual surety. Contracts of surety are, according to Story, the oldest of which there are records. They are said to antedate the Christian era by many centuries, and several scriptural references can be found. The Romans developed a highly refined and complex system of suretyship under the Justinian Code. And in Saxon and Norman England, the surety was recognized as necessary in most legal transactions. In ancient practice, the surety assumed liability for ....

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1 E.g., American Sur. Co. v. Lewis State Bank, 58 F.2d 559 (5th Cir. 1932) (Fla.); State v. Churchill, 48 Ark. 426, 3 S.W. 352 (1887).

2 2 Story, Contracts 319 (5th ed. 1874).

3 Morgan, "The History and Economics of Suretyship," 12 Cornell L.Q. 153 (1926), states: The contract of suretyship antedates the Christian era by more than 2500 years. The Library of Sargon I, King of Accad and Sumer (circa 2750 B.C.) contains a tablet which records the making of such a contract. .. The Code of Hammurabi (circa 2250 B.C.) enacted only 500 years after the time of Sargon I, provided for a system of state fidelity insurance ....


another's obligation because of blood relationship, friendship, or the expectation of favor, but not for payment. So repugnant was the notion of a compensated surety that in Scotland the lords of session in 1711 annulled, as contra bonos mores, a bond given as payment to a surety.\footnote{7} In view of the gratuitous undertaking of the individual surety and the often harsh consequences visited upon him by reason of the principal's default, the courts regarded him with favor and sought to ameliorate his lot by relieving him of liability wherever possible. The surety's contracts were regarded strictissimi juris, and since the contract was usually drawn by the obligee, all conflicts and ambiguities were resolved in the surety's favor. In the wake of the application of equitable principles, the right of subrogation evolved. Upon payment of the principal's obligation, the surety became subrogated or substituted to all rights which could be exercised by the obligee.

The development of the professional, compensated surety, particularly in corporate form, is of recent origin. In the United States the first surety company was incorporated in New York in 1865,\footnote{8} and it was not until 1894 that the federal government authorized corporate sureties to execute bonds in favor of the United States.\footnote{9}

With the advent of the incorporated surety company, the "favorite of the law" ceased to exist.\footnote{10} The compensated surety, upon careful underwriting and rating, assumed risks calculated to produce a profit. Consequently, the surety was no longer regarded as the gracious accommodator in need of the paternalistic protection of the courts. Conflicts and ambiguities were resolved against the paid surety and in favor of the obligee because now the contract was written by the surety instead

\footnote{7} King v. Ker, 2 Fount. Dec. 631 (1711).
\footnote{8} The Fidelity Insurance Company. See Morgan, "The History and Economics of Suretyship (pt. 2)," 12 Cornell L.Q. 487 (1927).
Prior to 1894, all bonds of indemnity in favor of the United States were executed by individuals. Because of the insolvency of individual bondsmen, judgments obtained against them in many instances were worthless. At nearly every session of Congress, bills were introduced for the relief of debtors who had guaranteed the obligation of another to the United States.
\footnote{10} Loyd, supra note 6, at 66-67, states:
The trend of American decisions is to distinguish between individual and corporate suretyship and to deny favors to the latter because the transaction is essentially insurance, undertaken by companies organized to conduct such a business for profit upon terms usually prescribed by themselves. . . . It may be questioned whether compensation is a proper criterion for discriminating between agreements where the strictissimi juris rule is sought to be applied. . . . The distinction is, no doubt, in part due to a reluctance to admit that the rule . . . has little justification in modern law and may prove the entering wedge for its repudiation. Surety companies it is needless to say are a convenience to the public; it is important that they continue sound and that their rates be as moderate as is commensurate with the risk, and the risk will be lessened by a wise, consistent, and uniform administration of the law of guaranty in all cases.
of the obligee. The transformed judicial climate was unmistakable, and a statement by the court in considering a matter of contract interpretation in Tebbets v. Mercantile Credit Guar. Co. aptly expressed the new posture:

The cases cited by defendant in error holding that a surety is a "favorite of the law," and that a claim against him is strictissimi juris, have no application. Corporations entering into contracts like the one at bar may call themselves "guarantee" or "surety" companies, but their business is in all essential particulars that of insurers, who, upon careful calculation of the risks of such business, and with such restrictions of their liability as may seem to them sufficient to make it safe, undertake to assure persons against loss, in return for premiums sufficiently high to make such business commercially profitable. Their contracts are, in fact, policies of insurance, and should be treated as such.

It has been argued with considerable persuasion that there should be some difference between the application of legal principles to a gratuitous surety and to a paid surety. And with more than 4000 years behind the development of law in the field of suretyship, it is not surprising that the courts have experienced difficulty in attempting to fuse the concepts of the gratuitous surety into the framework of modern corporate suretyship. However, the result is that in certain areas, such as subrogation, the rules of law are easier to state than to explain.

**Subrogation**

**General Principles**

Subrogation is the right of a surety to be substituted to the position of the obligee (creditor) whom it pays. In being placed in the position of the obligee, the surety is entitled to enforce any right or claim the obligee has against the defaulting principal. Although the right of sub-

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11 73 Fed. 95 (2d Cir. 1896) (N.Y.).
12 Id. at 97.
13 Arnold, supra note 9, at 172-73, states:

At least three differences between the individual and the corporate surety may be suggested. First, the private surety becomes such as an accommodation for the principal. His act is gratuitous. He might lose by having to pay the principal's obligation, but usually he has received no benefit. The corporate surety seldom becomes liable without being paid a premium. It is in business for a profit. Its existence depends upon receiving sufficient compensation from the principals for whom it becomes bound. Second, the private surety generally does not prepare the note or bond which he signs, but writes his name on the line indicated by the principal or obligee. The language to which he subscribes is not his own. The corporate surety very infrequently signs an instrument prepared by another. It subscribes to its own language, on its own forms, prepared by its own employees. Third, the obligation of the private surety is often assumed in haste, on the oral representation of the principal as to his financial conditions and the scope of the guaranty. It is unusual that legal advice is sought before he signs, and frequently the surety is ignorant of business and technical requirements. On the other hand, the corporate surety never relies upon the statements of the principal without corroboration; it requires written answers to an elaborate questionnaire; and it provides a staff of competent legal advisors.
14 Arant, Suretyship, § 79, at 357 (1931).
The right of subrogation was recognized in Roman law as early as the first century of the Roman Empire,\(^{15}\) under the common law system it was developed as a device of pure equity.\(^{16}\) Since the surety performed under contractual duty the obligation of another, justice required that the surety be entitled to recover his loss from the one who in equity should have paid it.\(^{17}\) In the context of the right of subrogation in matters of check forgery or alteration, the surety is substituted to the position of its insured when, under various fidelity, forgery, or bankers blanket bonds,\(^{18}\) it has paid a loss caused by the principal—the forger.\(^{19}\) The right of a compensated surety to subrogation is no different from that of a gratuitous surety.\(^{20}\) The mere fact that a surety is paid does not of itself limit the surety’s remedies in seeking recovery from the forger. But the prospect of recovery from a forger is not a particularly bright one since forgers are rarely building estates through such activities. In view of this fact, the surety normally seeks to recoup its loss by being subrogated to the collateral contract rights of its insured—specifically, to the insured’s rights against a bank. Where, for example, an insured drawer’s signature

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\(^{15}\) Loyd, supra note 6, at 44.

\(^{16}\) In Hodgson v. Shaw, 3 Myl. & K. 183, 190-91, 40 Eng. Rep. 70, 73 (Ch. 1834), Lord Brougham stated:

The rule here is undoubted, and it is one founded on the plainest principles of natural reason and justice, that the surety paying off a debt shall stand in the place of the creditor, and have all the rights which he has, for the purpose of obtaining his reimbursement. It is hardly possible to put this right of substitution too high, and the right results more from equity than from contract or quasi contract; unless in so far as the known equity may be supposed to be imported into any transaction, and so to raise a contract by implication.... "A surety"... "will be entitled to every remedy which the creditor has against the principal debtor; to enforce every security and all means of payment; to stand in the place of the creditor, not only through the medium of contract, but even by means of securities entered into without the knowledge of the surety; having a right to have those securities transferred to him, though there was no stipulation for that, and to avail himself of all those securities against the debtor."\(^{17}\)

\(^{17}\) Sheldon, Subrogation § 11, at 15 (2d ed. 1893), states:

In short, the doctrine of subrogation is that one who has been compelled to pay a debt which ought to have been paid by another is entitled to exercise all the remedies which the creditor possessed against that other.... But the burden is always on one who claims this equity to show that he is entitled to it.

\(^{18}\) For an excellent, comprehensive treatment of forgery coverage, see Farnsworth, "Insurance Against Check Forgery," 60 Colum. L. Rev. 284 (1960).

\(^{19}\) In cases of subrogation against banks, the forger most frequently encountered is an embezzling employee. See note 37 infra and accompanying text.

\(^{20}\) In Fidelity & Deposit Co. v. State Bank, 117 Ore. 1, 7, 242 Pac. 823, 825 (1926), the court said:

There is no distinction between the right of a paid surety to subrogation and one who has entered gratuitously into a contract of suretyship. Both are clothed with all the rights, remedies, priorities, and securities of the party to whom the debt of the principal was paid, and stand in his shoes, whether the creditor be a sovereign state or a private individual. This arises from the universal application by courts of equity of well-settled principles of equitable jurisprudence, defining the rights of a subrogee.

And in Wasco County v. New England Equitable Ins. Co., 88 Ore. 465, 471, 172 Pac. 126, 128 (1918), it was stated:

The fact that the insurance company is a compensated surety does not affect its right to claim the benefits of subrogation.... A court of equity grants the right of subrogation because the surety has paid the debt of the principal, and the right of subrogation is not dependent upon whether the surety was or was not paid to sign the bond. It is enough that the surety was obliged to pay and did pay the debt.
is forged and the drawee bank has honored the check by payment, the
drawer can recover his loss from any one of three sources: (1) a fidelity
or depositor’s forgery bond, (2) the forger, or (3) the drawee bank.
The drawer’s rights to indemnification from his surety or from the
drawee bank are founded upon separate and distinct contractual obliga-
tions; the one arising from a contract of insurance, the other from a
contract of deposit. It is when a surety attempts as subrogee to enforce
the insured’s collateral rights based upon a contract of deposit, breach
of warranty, or on other contractual or quasi-contractual theories, that
the right of subrogation is vigorously contested.21

Liability of Banks on Forged Checks

Subrogation claims against banks on checks bearing forged or un-
authorized signatures or alterations arise, in general, out of the following
situations:

1. Against the drawee bank
   (a) by the subrogee of the drawer-depositor when the bank has
       honored by payment a check containing any forgery, un-
       authorized signature, or alteration, or
   (b) by the subrogee of the true owner (payee or special in-
       dorsee) when a check is paid over a forgery of the true
       owner’s indorsement;

2. Against the cashing or depositary bank
   (a) by the subrogee of a drawee bank which has honored by
       payment a check containing a forged or unauthorized in-
       dorment or an alteration, or
   (b) by the subrogee of the drawer or the true owner of a check
       paid by the drawee bank over a forgery or unauthorized
       indorsement of the true owner’s signature.

The contractual relationship between a bank and its depositor requires
that the bank pay out only in accordance with the orders given by the

21 It is not entirely clear under common law that a personal surety was entitled to be
subrogated to the collateral rights of the obligee. The case of Dehn v. Heckman, 12 Ohio
St. 181 (1861), demonstrates the early reluctance to permit subrogation to collateral rights.
Dehn was the indorser of two notes, executed by Cummin, which were transferred to one
Markey. When the notes matured, Markey placed them for collection with Heckman, a
justice of the peace. Due to Heckman’s failure to perform his statutory duties, payment
could not be obtained from the maker and Dehn, as indorser, became obligated to pay the
notes. Upon making payment, Dehn took an assignment from Markey of his cause of action
against Heckman. In holding that Dehn’s failure to perform his statutory duties, payment
could not be obtained from the maker and Dehn, as indorser, became obligated to pay the
notes. Upon making payment, Dehn took an assignment from Markey of his cause of action
against Heckman. In holding that Dehn was entitled only to nominal damages from Heck-
man, the court reasoned that Dehn, as assignee, could seek to recover only what Markey
has lost and this was nothing since Dehn paid the debt. The court gave no weight to the
fact that payment did not come from the person whose primary obligation it was to pay
the notes. The emphasis of the court was on the fact of payment itself and not that the
obligation of the primary party, the maker Cummin, was still outstanding and payment
could have been collected from him but for the negligence of Heckman.
Consequently, a bank may not charge the depositor's account for any check containing a forged or unauthorized signature of the drawer, a forged or unauthorized indorsement, or an alteration. A depositor who is insured against forgery or alteration may choose to present such a claim to his own insurance company rather than to the drawee bank for any one of several reasons. The depositor may have an immediate need for the funds involved and cannot accept the delay in reimbursement which is normally incident to the bank's investigation of the circumstances surrounding the forgery. Also, a forgery claim may jeopardize delicate and varied financial relationships between the depositor and the bank, the least of which may be a checking account.

On the other hand, the depositor's demand for a recredit to his account may be adamantly resisted by the bank if it believes it possesses a valid defense to the depositor's claim, such as where the depositor has failed to exercise reasonable care and promptness in discovering and giving notice to the bank of a forgery or alteration, or has through some act ratified the forgery, or has negligently contributed to the forgery or alteration. Any of these acts or omissions may, if established, preclude

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22 In Denbigh v. First Nat'l Bank, 102 Wash. 546, 552, 174 Pac. 475, 478 (1918), the court stated:

The implied contract between the bank and its depositor is that the bank will pay out the funds of the depositor only upon order from the depositor to that effect. It follows then, that if the bank pays out funds upon the instrument purporting to be the check of its depositor, the signature upon which turns out to be a forgery, no right exists in the bank to charge the amount of the item against the account of the depositor, since the payment was wholly without any authority from him. This is elementary, and needs the citation of no authorities.

23 These rules have been incorporated into the Uniform Commercial Code in several sections. UCC § 4-401(1) provides that "a bank may charge...any item...properly payable from that account..." A check is not properly payable if it contains a forged or unauthorized drawer's signature, UCC §§ 3-401(1), -404(1), a forged or unauthorized indorsement, UCC § 3-404(1), or an alteration, UCC § 3-407, except that a bank can charge to the account the original tenor of an altered item, UCC § 4-401(2)(a).

24 This is particularly likely where the forger is the depositor's own employee and the bank is aware that any loss to the depositor is covered by a fidelity bond.

25 Under UCC § 4-406(5), if a bank waives or fails to assert a defense to a depositor's claim, it cannot make claim for its loss against any collecting bank or prior party based upon an unauthorized signature or alteration. The draftsmen of the Code expressly rejected decisions such as National Sur. Corp. v. Federal Reserve Bank, 188 Misc. 207, 70 N.Y.S.2d 636 (N.Y.C. Munic. Ct.), aff'd, 188 Misc. 213, 70 N.Y.S.2d 642 (App. T. 1st Dep't 1946), wherein the drawee bank agreed to waive the benefit of an absolute time limitation statute for notice of forgery, so that the surety could recover from the collecting banks on the basis of a forged indorsement; and Fallick v. Amalgamated Bank, 232 App. Div. 127, 249 N.Y. Supp. 238 (1st Dep't 1931), in which it was held in a suit by the drawee bank that a collecting bank could not assert the defense that the drawer's negligence facilitated forgery of the payee's indorsement.

26 The obligation of a depositor to discover and promptly report forgeries and alterations springs from the contract of deposit and is well established in the common law and, before the adoption of the Uniform Commercial Code, under the separate statutes of forty jurisdictions. The UCC incorporates various principles of case and statutory law in defining the depositor's obligations. See UCC § 4-406 (Customer's Duty To Discover and Report Unauthorized Signature or Alteration).

27 Neal v. First Nat'l Bank, 26 Ind. App. 503 (1901); see UCC § 3-404(2) & comment 3.

28 UCC § 3-406, comment 7, states:
the depositor from recovering from the drawee bank, but they do not usually affect his right to present a claim to his own insurance company.\(^\text{29}\)

Unlike the time-honored rule of *Price v. Neal*,\(^\text{30}\) that a payment based on a forgery of the drawer's signature is not recoverable from a bank or other party in good faith to whom such payment was made, when a drawee bank honors by payment a check bearing a forged or unauthorized indorsement or an alteration, it can recover its loss from the collecting bank or other prior parties.\(^\text{31}\) The principle underlying this rule is founded upon the quasi-contractual obligation to repay money received through mutual mistake of fact or else on the express warranty that "prior indorsements are guaranteed."\(^\text{32}\) In most instances, the cashing or depositary bank will, upon demand and presentation of an affidavit of forgery or alteration, grant an immediate recredit to the drawee bank. However, if the demand is not acceded to, the drawee bank can present a claim for the loss under its own blanket bond and its insurance company, upon payment, will be subrogated to the bank's rights against the cashing or depositary bank.

It is not uncommon, where payment has been made of a check contain-

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\(^\text{29}\) If the bank possesses a defense to the depositor's claim, the same defense can, of course, be urged against the depositor's subrogated insurance carrier since the subrogee acquires no rights superior to those of the depositor.

\(^\text{30}\) See Britton, Bills and Notes § 139 (1943), and the collection of cases cited id. at 392 n.2.

\(^\text{31}\) The rule has been continued in the UCC by providing under warranties of presentment that each prior party warrants to the drawee bank that "he has good title to the item . . . and . . . the item has not been materially altered . . ." UCC § 4-207(1)(a), (c). If an alteration is involved, however, a holder in due course is entitled to retain the amount for which the instrument was originally drawn payable, and the drawee bank may charge the drawer's account for that amount. UCC § 4-401(2)(a).

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ing a forged indorsement, that claim is made against the drawee bank by the subrogee of the payee or other true owner whose indorsement has been forged and who has been indemnified by his own insurance carrier. There was at common law and under the Uniform Negotiable Instruments Law a conflict of authority concerning the right of a payee to proceed directly against the drawee bank instead of against the drawer, but the Uniform Commercial Code resolves the conflict by providing that the drawee bank is liable in conversion for the face amount of the check to the payee or other owner. But recovery by the payee or other owner from a collecting or depositary bank, which has acted in good faith and in accordance with reasonable commercial standards, is now limited by the Uniform Commercial Code to the amount of the proceeds remaining in the bank's possession.

**THE COMPENSATED SURETY DEFENSE**

The overwhelming majority of cases involving subrogation against banks on forged checks have arisen out of losses caused by dishonest employees whose employers have been indemnified under the provisions of a fidelity bond. The carriers have sought to be subrogated to the rights of the employer-depositor against the drawee bank when the bank has paid checks on which the employee has forged the drawer's signature, or forged the payee's indorsement to checks properly drawn by the drawer.


34 An action against the drawer is on the obligation represented by the check.

35 **UCC** § 3-419.


When a drawer presents a direct claim against a collecting bank, by-passing the drawee bank, it may be indicative of an attempt to circumvent a defense possessed by the drawee bank, contrary to the intent of **UCC** § 4-406(5). See note 25 supra. For a Code case denying the drawer's right to recover from a collecting bank, see Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962).


employer; or against the cashing or depositary bank or indorser that received payment of checks containing forged indorsements. There are also cases where the employee has stolen and forged the indorsement on checks payable to the employer, and the employer's surety has attempted to enforce the employer's rights against the cashing or depositary bank which received payment from the drawee bank. In one case a dishonest employee raised the amount for which a properly drawn check was made payable, and subrogation was sought against the drawee bank.

In still other situations, insurers of drawee banks have sought to enforce the bank's rights against a cashing bank or other prior party when payment had been made on checks containing forged indorsements.

The persistent refusal of banks and others to acknowledge the right of an insurance company to be subrogated to its insured's collateral contract rights against third parties has led to the development of what is commonly termed the compensated surety defense. The form that the defense takes in check cases is that a paid surety is not entitled to be

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45 See note 74 infra and accompanying text.
subrogated to the rights of its insured against a bank which, although legally liable under principles of negotiable instruments law, is otherwise innocent in that it did not actively or passively participate in the fraud perpetrated by the forger.46

**Superior Equity Theory**

The rationale most commonly seized upon in support of the compensated surety defense is embodied in the superior equity theory. The theory is that subrogation, being a right equitable in origin, will not be recognized unless the subrogee has an equity superior to that of the other party, and a paid surety's equity is inferior or, at best, only equal to that of an innocent bank which was also wronged by the fraud of the forger. The first case to apply the superior equity concept in a forgery situation was *American Bonding Co. v. First Nat'l Bank.*47 The Kentucky Court of Appeals, in denying recovery to a fidelity insurer in an action against a drawee bank on checks raised by the depositor's employee, stated simply that it was unable to "understand upon what principle of equity the appellant here is entitled to be subrogated."48 The decision, at least in result, became an instantaneous success. It was one of those rare, perfect accidents of time and need that sometimes throw court and public into each others' arms. The theory is perhaps best stated in *American Sur. Co. v. Bank of California:*49

The right of subrogation is a creature of equity, applicable where one person is required to pay a debt for which another is primarily responsible, and which the latter should in equity discharge. In theory one person is substituted to the claim of another, but only when the equities as between the parties preponderate in favor of the plaintiff. That is, a surety's right of recovery from a third party through subrogation does not follow, as of course, upon proof that the losing but recompensed party could have recovered from the third party. Accordingly, subrogation will not operate against an innocent person wronged by a principal's fraud. A surety may pursue the independent right of action of the original creditor against a third person, but it must appear that said third person participated in the wrongful act involved or that he was negligent, for the right to recover from a third person is merely conditional in contrast to the right to recover from the principal which is absolute. The equities of the one asking for subrogation must be superior to those of his adversary. If the equities are equal or if the defendant has the greater equity, subrogation will not be applied to shift the loss.50

Although the majority of courts have found the superior equity theory

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46 In all jurisdictions, subrogation is permitted against a negligent bank. See note 64 infra and accompanying text.
48 Id at 394, 85 S.W. at 190.
49 133 F.2d 160 (9th Cir. 1943) (Ore.).
50 Id. at 162-63.
a sufficiently persuasive argument in support of the paid surety defense,\(^{51}\) the theory has not been entirely convincing, particularly in view of the fact that the presence of insurance operates to overturn an absolute liability predicated upon principles of negotiable instruments law, giving, in effect, the responsible bank the benefit of insurance carried by someone else. For this reason, a number of courts have rejected the theory and permitted recovery.\(^{52}\)

**Election of Remedies Theory**

A few courts have denied the right of a compensated surety to subrogation on the premise that the insured, in collecting payment under its surety bond, has elected a remedy inconsistent with its right against the bank.\(^{53}\) The election of remedies theory is an extension of the familiar rule accepted in many jurisdictions that when payment has been made on a forged check, the depositor can pursue two remedies based on alternative rights: (1) a demand for the money can be made against the bank on the theory that the bank paid out its own money and not that of the depositor, or (2) a demand can be made against the forger on the theory that he has converted the depositor’s money in which case the depositor impliedly ratifies the action of the bank in making payment to the forger. The rights are said to be inconsistent and a successful pursuit of either one constitutes an irrevocable election of remedies.\(^{54}\) In the application of this theory to subrogation cases, the reasoning is that when a depositor recovers the loss under a fidelity bond, it constitutes an election to pursue his right against the forger, thereby waiving any action against the responsible bank.

The use of the theory in subrogation cases has been soundly criticized,\(^{55}\) and it no longer looms as a formidable barrier to subrogation as does the superior equity theory. The rejection of the election of remedies theory seems only logical since the surety is substituted to the position of its insured, and if an election of remedies is to be made by seeking

\(^{51}\) The cases denying subrogation listed in notes 37–42 supra are of this type with the exception of those cited in note 53 infra, which are based in whole or part upon the election of remedies theory.


\(^{54}\) See Annot., 144 A.L.R. 1440 (1943). The same result may be achieved under the Uniform Commercial Code. See UCC § 3-404, which provides that a forgery can be ratified.

\(^{55}\) The Supreme Court of Pennsylvania in Grubnau v. Centennial Nat’l Bank, 279 Pa. 501, 504–05, 124 Atl. 142, 143 (1924) said:
recovery from either the bank or the forger, the surety is the logical one to make it.\(^6\)

While there is considerable conflict, to say nothing of confusion, in the application of equitable principles to modern corporate suretyship, it is evident that there may be reasons far more fundamental than the superior equity doctrine behind the denial of subrogation against innocent third parties when a forgery has been caused by a dishonest employee. Quite often the true basis for, or substance of, a decision is not found alone in the explicit statements of a court but manifests itself equally clearly in the tone or style in which an opinion is written and the attitude in which the premises are held. With regard to the

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\[^6\] This presupposes, of course, that the insured has not already made an election prior to collecting from the surety. In Winn v. National Bank, 110 Ga. 133, 138 S.E.2d 89 (1964), the court held that simply bringing suit against the forger constitutes an election.
employer-employee relationship, there seems to exist a common belief that when a loss is caused by a dishonest employee, the employer, or his insurer, should absorb the loss since the employer is in a better position to prevent its occurrence than is some outside party, such as a bank.\(^{57}\) This latent reluctance to shift to others the employer's loss is largely unexpressed as a reason for limiting subrogation, but occasionally it has crept into the open and in some decisions the attitude of the court fairly oozes from its statements. To illustrate, in *Louisville Trust Co. v. Royal Indem. Co.*,\(^ {68}\) the Kentucky Court of Appeals stated:

Therefore, as between the employer and the bank, there is much to be said in favor of the position that the loss should fall on the employer who selects an unfaithful agent, and thus vouches for his integrity, rather than on the bank whose officers in many instances are called upon daily to examine and keep account of a large number of checks, a duty which, to say the least, operates as a severe strain on ordinary care.\(^ {69}\)

The tendency of law to raise a wet finger to the wind of public opinion finds expression also in check subrogation cases which have arisen under forgery bonds. In Missouri, for example, it has been held that the compensated surety defense can be asserted against a surety on a fidelity bond,\(^ {60}\) but not on a forgery bond.\(^ {61}\) There is no difference in the basic rights to which the surety is subrogated, that is, to the insured's collateral contract rights against third parties, when either bond is involved. However, the courts have, with remarkable uniformity, made a distinction without a difference, and the superior equity and election of remedies theories have been rejected when, under a forgery bond held either by the drawer or the drawee bank, the insurer has pursued subrogation against a collecting bank\(^ {62}\) or other indorser\(^ {63}\) on a guarantee of prior indorsements. The sole differentiating factor in these cases appears to be that a forgery bond is considered to be a contract of indemnity while a fidelity bond is treated as a contract of surety with the dishonest

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\(^{57}\) This opinion finds expression also in the provisions of the Uniform Commercial Code. UCC § 3-405(1)(c) adopts the expanded fictitious payee rule, which was previously in effect only in about one half of the States, with the result that now the employer-drawer will have to bear the loss in cases involving employees who misappropriate funds by causing checks to be issued in the names of payees not intended to have an interest in them.

\(^{58}\) 230 Ky. 482, 20 S.W.2d 71 (1929).

\(^{59}\) Id. at 484-85, 20 S.W.2d at 72. In American Alliance Ins. Co. v. Capitol Nat'l Bank, 75 Cal. App. 2d 787, 794, 171 P.2d 449, 453 (1946), the court stated: "He was the agent and employee of plaintiff, who, by implication at least, vouched for his honesty to the bank."


\(^{61}\) Borserine v. Maryland Cas. Co., 112 F.2d 409 (8th Cir. 1940) (Mo.).


\(^{63}\) New York Cas. Co. v. Sazenski, 240 Minn. 202, 60 N.W.2d 368 (1953).
employee as principal. There is, of course, no longer any reasonable ground for making such a distinction in view of the fact that modern fidelity bonds are as unmistakably contracts of insurance as are forgery bonds.

Effect of Bank’s Negligence

While numerous jurisdictions refuse to permit subrogation on collateral contract claims against innocent banks or other third parties on the theory that the equities of the paid surety are inferior or only equal to those of the bank, subrogation will lie where it can be established that the bank has been negligent, or has knowledge of, or has participated in, the wrongdoing. In such instances, the equities of the surety are deemed to be superior to those of the bank.

In Hartford Acc. & Indem. Co. v. Bank of America, a colluding employee gave samples of her employer’s genuine signature to a forger who then drew a check against the employer’s account at the Bank of America. The check was made payable to a fictitious payee, J. B. Cox Company, and the forger accomplished the fraud by depositing the check in, and subsequently withdrawing the funds from, an account which he opened at the Bank of America while representing himself as J. B. Cox. In opening the new account for the forger, the bank’s employees failed to obtain identification from him or to telephone the purported drawer to verify the check, despite instructions to this effect from officials of the bank and the fact that such was the custom and practice of the banking industry. The court held that this failure constituted negligence which facilitated the fraud and placed the bank in a position of fault which rendered the surety’s equity superior to that of the bank and justified subrogation.

Although the need to exercise extreme caution in handling checks payable to corporate or other business-form payees is evident to every banker and businessman, there seems to be an endless series of cases involving the cashing of such checks for unauthorized persons.


SUBROGATION ON FORGED CHECKS

rogation against banks paying or cashing checks under these circumstances is normally permitted in jurisdictions which otherwise recognize and give effect to the compensated surety defense. Paid sureties have recovered where a bank has collected checks payable to a union that were indorsed by the union’s financial secretary who had authority only to indorse for deposit;\(^68\) where a bank has cashed checks payable to a corporation upon the unauthorized indorsement of the payee’s name by its salesman;\(^69\) and where a bank has cashed checks payable to a warehouse commissioner when the checks were presented by a bookkeeper with a rubber stamp indorsement reciting, “For deposit in the Liberty National Bank . . . .”\(^70\) In the latter situation, the bank was held to have been grossly negligent and a “participant” in the wrongdoing.

What constitutes negligence or participation in the wrongdoing is, of course, a question of fact for determination by the jury or by the court if there is no trial by jury. Unfortunately, there is no crystal ball of the judicial world into which one can peer to view the outcome in a particular case. An unanticipated result was reached in *Liberty Mut. Ins. Co. v. Kleinman,*\(^71\) when the court upheld a jury finding of no negligence on the part of liquor store owners who cashed for a manager fifty-four checks payable to his employer without making inquiry as to his authority to indorse in the employer’s name. And in *Hartford Acc. & Indem. Co. v. First Nat’l Bank & Trust Co.,*\(^72\) the United States Court of Appeals, in recognizing the compensated surety defense applicable in Oklahoma, concluded that the equities of the surety were not superior to those of a bank in a decision which seems wholly unsupportable. The action was brought by the surety against a bank which had collected or cashed ten checks bearing forged indorsements. The checks had been made payable to fictitious payees by the drawer’s defaulting employee. The employee’s confederate opened an account in the defendant bank in the assumed name of Jennings and gave the name of a Kentucky bank as a reference. Two inquiries were made and even though the responses were to the effect that the Kentucky bank had no credit experience and no record in checking, the defendant bank failed to pursue the matter further. Even with such suspicious circumstances,

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\(^{68}\) National Sur. Corp. v. First Nat’l Bank, 278 Ky. 273, 128 S.W.2d 766 (1939).


\(^{72}\) 287 F.2d 69 (10th Cir. 1961) (Okla.).
the court held that no superior equity was shown to exist in favor of the surety.73

*Uncommitted Jurisdictions*

In jurisdictions where the issue of the applicability of the compensated surety defense in forgery cases has never been decided, analogous cases may be found which will serve to provide a basis for deciding if a subrogation action is advisable. The compensated surety defense is not an alien concept in fields other than forgery,74 and such cases can be useful in predicting the position the courts in a particular jurisdiction would take if a forgery case were presented.75

In Illinois, for example, where there is no case directly in point, it is believed that effect will be given to the compensated surety defense in a forgery subrogation suit against a bank. This belief is given substantial support by two cases. In *American Sur. Co. v. Morton*76 the court refused to permit subrogation against individuals who had guaranteed an insurance company against loss arising from an agent's misappropriation of premium collections. The court based its decision not only on superior equity theory cases,77 but also on an election of remedies case.78 And in *National Cas. Co. v. Caswell & Co.*79 a forgery case80 was cited with approval when the court held that a compensated surety was not entitled to recover its loss from an innocent but legally liable purchaser of a certificate of deposit sold by a defaulting trustee.81

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73 The case stands really as another example of the reluctance of courts to shift to banks losses caused by drawer's employees, even though the employer is not shown to have been negligent in the supervision of the employees.


75 In *General Ins. Co. of America v. Faulkner*, 259 N.C. 317, 130 S.E.2d 645 (1963), subrogation to a statutory right was permitted against the innocent parents of juveniles who committed acts of vandalism to the insured's property. The case was cited with approval in *Maryland Cas. Co. v. Bank of Charlotte*, 227 F. Supp. 649 (W.D.N.C. 1964), rev'd on other grounds, 340 F.2d 550 (4th Cir. 1965) (N.C.), where the court refused to recognize the compensated surety defense. The court of appeals found that since the bank acted in "bad faith," it was unnecessary to review the lower court's holding that the right to full subrogation exists in North Carolina.

For an unusual dictum, see *Unity Tel. Co. v. Design Serv. Co.*, 160 Me. 188, 197, 201 A.2d 177, 181-82 (1964), wherein the court stated: "While the finding of legal 'fault' in Design's conduct removes the applicability of the 'paid surety defense,'—were we inclined to consider it . . . . We adopt Pellecchia." The reference was to *Standard Acc. Ins. Co. v. Pellecchia*, 15 N.J. 162, 104 A.2d 288 (1954), one of the leading cases rejecting the compensated surety defense.

76 200 F. Supp. 82 (E.D. Ill. 1961), aff'd, 311 F.2d 222 (7th Cir. 1962) (Ill.).

77 United States Fid. & Guar. Co. v. First Nat'l Bank, 172 F.2d 258 (5th Cir. 1949) (Tex.); *American Sur. Co. v. Bank of California*, 133 F.2d 160 (9th Cir. 1943) (Ore.).

78 Ibid.


80 *New York Title & Mortgage Co. v. First Nat'l Bank*, 51 F.2d 485 (8th Cir. 1931) (Mo.).

81 In view, however, of the applicable provisions of the Uniform Fiduciary Obligations Act, the insured could not have recovered either, and the court's consideration of the superior equity doctrine was dictum.
A number of cases have arisen which involve the procurement by dishonest employees of company checks payable to payees that have applied the proceeds for the benefit of the employee and not the employer-drawer. Although the transfer of the checks did not entail forgery, the compensated surety defense was interposed with the result that subrogation by the fidelity bond carrier was denied against a bank in one case, while it was granted against a stock brokerage house and a bank in other cases.

The possibility of legal surprises in uncommitted jurisdictions cannot be underrated, of course, and perhaps the most reasonable approach would be for the surety and the bank to compromise and perhaps share the loss equally. Such a solution might be considered voluntary contributive subrogation where both parties, surety and bank, recognize a co-extensive obligation to the same obligee, the party wronged by the forgery, much in the fashion suggested by Professor Langmaid.

CIRCUMVENTING THE COMPENSATED SURETY DEFENSE

Evidencing the conviction that all legal improvement is not necessarily to be obtained through the loyal preservation of the past, the insurance companies began to work their way slowly through the obstacle course of cases approving of the compensated surety defense. In an effort to avoid decisions denying subrogation, contracts of assignment, loan receipts, and agreements to withhold claim were utilized. These devices have met with some notable measure of success.

Assignments

The taking of an assignment of an insured's right against a bank is the method most commonly employed by insurance companies in an attempt to obviate the application of equitable principles requiring a superior equity as a condition to subrogation to rights against third parties. The right of subrogation, being equitable in origin, is not dependent upon any express provision of the contract between insured and insurer. So instead of relying upon such an equitable right, insurance

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86 See note 16 supra. In Mathews v. Aiken 1 Comst. 595, 604-05 (N.Y. 1848), the court stated:

[T]he right of the surety to demand of the creditor whose debt he has paid, the securities he holds against the principal debtor and to stand in his shoes, does not depend at all upon any request or contract on the part of the debtor with the surety, but grows rather out of the relations existing between the surety and the creditor, and is founded
companies have upon payment of a forgery loss taken an assignment from the insured so that the cause of action against the bank is one at law, arising as it does from an assignment which is legal in nature, thereby making inapplicable any equitable considerations.

The use of assignments to circumvent the compensated surety defense has met with approval in many jurisdictions,\textsuperscript{7} while in others its efficacy has been denied.\textsuperscript{8} In general, the courts which allow recovery by the insurer have recognized a distinction between legal (equitable) subrogation and conventional (agreed) subrogation,\textsuperscript{8} while the other courts have adhered to the concept that all subrogation is purely equitable in nature.\textsuperscript{9} Where there is a firm and apparently irrevocable commitment to the paid surety defense, such as in California,\textsuperscript{10} the reluctance to per-


\textsuperscript{8} First Nat'l Bank v. American Sur. Co., 71 Ga. App. 112, 30 S.E.2d 402 (1944): While there are many cases dealing with the doctrine of subrogation, and some confusion and conflict in the decisions of the various state and federal courts, in this State an action based on conventional subrogation of the type presented by this case, clearly established by an agreement reduced to writing or otherwise shown, in which no equitable relief in aid of the claim is prayed, is an action at law, and is not controlled by the principles appertaining to an action in equity, and the conventional subrogees in this action did not have the burden of showing the superior equity as against the defendant in order to recover.

In Grubnau v. Centennial Nat'l Bank, 279 Pa. 501, 506-07, 124 Atl. 142, 144 (1924), concerning an assignment the court stated: "Nor is it a case of subrogation, wherein the equities of the bank may be said to exceed those of the insurer. Any person could have purchased the depositor's right against the bank, and there was no reason why the insurance company should not do so."

\textsuperscript{9} Meyers v. Bank of America Nat'l Trust & Sav. Ass'n, 11 Cal. 2d 92, 96-97, 77 P.2d 1084, 1086 (1938): Under these cases the conclusion seems inevitable that one who asserts a right of subrogation, whether by virtue of an assignment or otherwise, must first show a right in equity to be entitled to such subrogation, or substitution, and that where such right is clearly shown by the application of equitable principles, an assignment adds nothing to his right thereto. Otherwise stated, where by the application of equitable principles, a surety has been found not to be entitled to subrogation, an assignment will not confer upon him the right to be so substituted in an action at law upon the assignment. His rights must be measured by the application of equitable principles in the first instance, his recovery being dependable upon a right in equity, and not by virtue of an asserted legal right under an assignment.

\textsuperscript{10} In California it has been held that the defense cannot be circumvented by an assignment, Meyers v. Bank of America Nat'l Trust & Sav. Ass'n, supra note 90, a loan receipt, American Alliance Ins. Co. v. Capitol Nat'l Bank, 75 Cal. App. 2d 787, 171 P.2d 449 (Dist.
mit avoidance of the defense by a contract of assignment is understandable. And yet, it is unquestioned that the right possessed by the insured against the bank is legally assignable to anyone. In view of this fact, it is difficult to comprehend why a distinction is made in some jurisdictions to the effect that a paid surety must take the assignment subject to a defense which could not be interposed against any other assignee.

**Loan Receipts**

Only a few attempts have been made to avoid the compensated surety defense through the use of loan receipts. In a loan receipt transaction, the surety evades becoming a subrogee by ostensibly lending the amount due under the bond to its insured and obtaining a loan receipt reciting that repayment is due, without interest, only out of the proceeds of an action against the responsible bank. Suit is then instituted against the bank by the insurer at its expense and in the name of the insured.

Although loan receipts are well recognized as approved devices in other insurance transactions, in cases involving subrogation on forged checks two courts have treated such loans as the equivalent of payment and have allowed the compensated surety defense to be urged, while one other has given effect to the device, thereby precluding the applicability of the defense.

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92 The loan receipt was originated as a method of instituting suit in the insured's name so that no prejudice would be operative against the insurance company simply as a large corporate entity. It is also used commonly in cases of marine loss where insurance coverage is contingent upon the nonliability of the carrier. See Luckenbach v. W. S. McCahan Sugar Ref. Co., 248 U.S. 139 (1918).


The loan receipt transaction was a convenient device by which the impairment of Singletary's working capital was promptly restored without waiver of the issue of whether the loss was covered by the fidelity bond. This question will be resolved on the merits by the judgment herein. If, as between the parties to this action, the loss fell on Singletary, the paid surety will bear it. Otherwise, the surety incurred no liability, and the Bank can not justify complain that the parties to the indemnity contract shaped their transaction so as to preserve the surety's right to have the question of coverage decided by the court.
Agreements To withheld Claim

The most obvious and yet somewhat ingenious method of avoiding the consequences of the compensated surety defense is for the insured to refrain temporarily from making a claim for loss through forgery against his own surety while seeking recovery from the responsible bank or banks. In practice, this procedure is followed quite often because of the personal interest of insureds in maintaining a favorable loss experience. However, if the bank vigorously resists the insured's demands, the prospect of a delayed reimbursement pending the outcome of litigation does not loom as a desirable situation and, more often than not, an insurance claim is ultimately made.

The validity of the use of agreements to withhold claim has been tested in only two cases, and it is interesting to observe that the first successful application is found in Kentucky, the state which is said to have witnessed the birth of the compensated surety defense in subrogation cases against banks on forged checks. In Reynolds Metals Co. v. Liberty Nat'l Bank & Trust Co., the plaintiff sustained a loss of $17,171.80 as the result of forgeries committed by an employee. Reynolds' fidelity insurance carrier readily admitted its liability and willingness to pay the loss, but requested that Reynolds withhold demand for payment from the insurance company so that an action could be brought, at the carrier's instance and expense, to recover the loss from the drawee bank. The acknowledged reason for the agreement was that if the insurance company were to pay the loss and then, as subrogee to Reynolds, proceed against the bank, the compensated surety doctrine in Kentucky would preclude recovery.

In giving effect to the agreement by holding for Reynolds, the court stated:

As concerns the argument that the agreement between the insurance company and Reynolds was a mere subterfuge designed to evade the compensated surety doctrine, it is our opinion that the motive of the parties in making the agreement is not material. Reynolds, if it so chose, could have foregone any effort to collect from the insurance company, and proceeded immediately against the bank. Any private negotiations between Reynolds and its insurer were no concern of the bank, so long as the negotiations did not reach the point of transferring Reynolds' claim to the insurer.

The court rejected also the applicability of any doctrine of election of remedies and thereby refused to follow the lead of Hensley-Johnson Motors v. Citizens Nat'l Bank, which was the first case to consider the

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95 See note 47 supra and accompanying text.
96 294 S.W.2d 921 (Ky. 1956).
97 Id. at 923.
legal effect of an agreement to withhold claim. In *Hensley-Johnson*, the court denied subrogation with the questionable argument that the surety's agreement to pay the claim if Hensley-Johnson did not recover the loss from the bank was actually the same as reimbursement and that an election of remedies had been made. In applying the election of remedies theory, the court placed heavy reliance on *Liberty Mut. Ins. Co. v. First Nat'l Bank*,\(^9\) which had already been overruled\(^10\) when the California court rendered its decision.

Although there can be little or no reasonable legal objection to the use of agreements to withhold claim as a method of surmounting the hurdle of the compensated surety defense, it is difficult to visualize its widespread use. The reasons for this are strikingly apparent. To be able to utilize the device presupposes the concurrent existence of two conditions, namely, (1) a superior type of relationship between insurer and insured and (2) no immediate requirement of the insured for the money involved in the loss. Only in rare instances will both of these conditions exist simultaneously.

**ROLE OF INSURANCE COMPANIES**

The mass of compensated surety cases commanding the attention of courts and lawyers conclusively demonstrates the dissatisfaction of insurance companies with the denial of subrogation in cases involving forged checks. In view of this attitude, attacks on the compensated surety doctrine will, in increasingly frequent measure, press upon the courts for a palatable solution.\(^101\) However, it would be a disservice to truth and a thorough understanding of the problem not to discuss the role and responsibility of the insurance companies themselves in the development of the compensated surety defense. As it applies to actions against banks on forged checks, the defense has existed for sixty years.\(^102\) It would not

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\(^10\) 151 Tex. 12, 245 S.W.2d 237 (1951).
\(^101\) It has been said that the fact that all banks now have forgery insurance coverage will operate to eliminate the compensated surety defense. In Sandidge, "The Achilles Heel of the Compensated Surety Doctrine," 24 Ins. Counsel J. 259, 262 (1957), the author stated: Thus, it is clear that the Achilles heel that will ultimately spell the death of the compensated surety doctrine is the fact that the banks now carry insurance covering their liability for forgery or false checks erroneously charged against the account of the depositor. The realities of the situation have vanquished a doctrine that resulted from prejudice against insurance companies, and the arrow from Paris's bow that killed this doctrine was the insurance industry itself in making available to the banks coverage against loss from forged or raised checks or endorsements.

This position overlooks the fact that many of the banks which have urged the defense were insured in the first place, and that subrogation as an incident to modern corporate suretyship still is in a developmental stage.

\(^102\) The first case to apply the compensated surety defense to subrogation on forged checks against banks appears to be American Bonding Co. v. First Nat'l Bank, 27 Ky. L. Rep. 393, 85 S.W. 190 (Ct. App. 1905).
be unreasonable to assume that in many, if not most, of the thirty-nine cases cited in Table I, the defense of the banks was undertaken by their own forgery insurance carriers. And of the cases decided within the past thirty years, which number twenty-four, there can be little doubt that the vast majority of defendant banks were insured.\textsuperscript{103} It is disconcertingly evident then, that insurance companies have played an important, if not decisive, role in the perpetuation of the compensated surety defense.\textsuperscript{104}

It is not unthinkable either that the same insurance company could be discovered at once denying the validity or applicability of the defense in one case while asserting it in another. There is, of course, a natural tendency to place self-interest first and put on whichever legal shoe fits best, but this paradoxical approach stands as still another monument to the trivial genius of human nature.

It has been said that “Surety company attorneys have always regarded the ‘Compensated Surety Defense,’ and the legal propositions on which it is based, as unsound and illogical, and have vigorously resisted their application in the courts,”\textsuperscript{105} and yet if there is any validity at all to the huge wave of protest that has rolled over the compensated surety defense, then it remains for the insurance industry itself to convince its members to exercise restraint by ceasing to urge the defense.\textsuperscript{106} Failing in this, scant legal sympathy will be mustered for those economically dedicated parties who have been climbing up and down both sides of the fence.

**CONCLUSION**

The right of subrogation, as a development of equity under common law, had to endure a gestation period some sixteen or seventeen centuries longer than it did under Roman law. Yet if the law changes with glacial slowness, it does change. And in view of the comparative infancy of corporate suretyship, the fact that the courts have failed to give general

\textsuperscript{103} Reference to this situation was made in Standard Acc. Ins. Co. v. Pellecchia, 15 N.J. 162, 190, 104 A.2d 288, 303 (1954), when the court said:

It would seem that the cases denying subrogation to a surety of its insured's contractual right against a third party are unrealistic in ignoring the fact that the third party itself is generally insured by another surety or casualty company against losses . . . In states which follow the criticized rule the surety or insurer of the third party . . . would go free of obligation.

\textsuperscript{104} It must be noted, however, that since the bond premiums for banks are loss-rated, and many carry deductible provisions, banks have a material interest in the outcome of forgery suits and can insist that the surety urge whatever legal defenses are available.


\textsuperscript{106} There are numerous cases in which the compensated surety defense has not been urged. E.g., First Farmers & Merchants Nat'l Bank v. Columbia Cas. Co., 226 F.2d 474 (5th Cir. 1955) (Ala.); Fidelity & Deposit Co. v. Fort Worth Nat'l Bank, 65 S.W.2d 276 (Tex. Comm'n App. 1933); Fidelity & Cas. Co. v. Flanenscheck, 200 Wis. 304, 227 N.W. 387 (1930).
SUBROGATION ON FORGED CHECKS

recognition to the unfettered right of a paid surety to subrogation to collateral contract rights should not be disquieting. While it is difficult to point to any single case as sounding the emancipation proclamation or serving as a paradigm, the undeniable trend of modern decisions involving subrogation on forged checks is to grant a paid surety the right to recover from an innocent but legally liable bank. In today's judicial climate, where the courts have come to assume an uncommonly responsive role, the development of this facet of suretyship should not have to suffer the protracted maturation so characteristic of past changes in the law of suretyship. This is not to say, however, that decisions of the future will proceed toward uniformity in the lockstep of togetherness. The compensated surety defense has an aura of respectability that is buttressed by the technical verity of the superior equity theory. But therein also lies its vulnerability. The defense will stand only so long as the birthright of subrogation continues to be regarded as existing in equity. How much longer this will continue is a matter of pure conjecture, but when courts are willing to allow the defense to be circumvented by assignments, loan receipts, and agreements to withhold claim, they in reality are seizing upon these devices only as convenient methods of shattering the fossilized forms which surround a right founded in and at the same time restricted unnecessarily by equity.

The fact that all banks now are insured against forgery makes suit by a surety against a bank essentially a contest between sureties wherein one paid surety denies the right of another surety to subrogation simply because it too is a paid surety. While not supplying a technical argument to refute the superior equity theory, it would seem a curious result if not an attack upon common sense to continue a rule which plays havoc with well-established principles of negotiable instruments law solely to achieve a different distribution of loss between two sureties.

Although the case for full subrogation has recruited considerable judicial support, it does not merit legislative attention. None of the provisions of the Uniform Commercial Code either aid or hinder a surety in pursuing subrogation, but, as is pointed out by Professor Farnsworth,

107 Standard Acc. Ins. Co. v. Pellecchia, 15 N.J. 162, 104 A.2d 288 (1954), is considered to be the leading case denying the validity of the compensated surety defense in matters of forgery.

108 See Table I infra and cases cited.

109 Professor Langmaid suggests contribution by both sureties, the contractual surety and the quasi-surety (a bank in this instance), as a solution to the problem. See Langmaid, supra note 85.

110 For an analysis of the common policy arguments against the defense, see Comment, "The Right of a Paid Surety to Subrogation," 44 Marq. L. Rev. 194, 200-02 (1960).

the Code's adoption of the expanded fictitious payee rule\textsuperscript{112} eliminates the problem involved in many of the hard cases which contributed materially to the growth of the compensated surety defense in matters of forgery.

**USE OF TABLE I**

The problem of recourse for subrogated sureties has proved sufficiently troublesome to produce a confusing cluster of cases. Table I is designed to demonstrate the application of the compensated surety defense in jurisdictions which have decided the issue as it applies to actions by insurers on forged checks\textsuperscript{118} and to show whether the defense can be circumvented by one device or another in those jurisdictions that allow the defense to be interposed.

The case which most clearly manifests the certain need for a collection of applicable decisions is *Fidelity & Cas. Co. v. National Bank*,\textsuperscript{114} in which the surety on a county official's bond was denied subrogation against a drawee bank which had honored forged drafts totaling $111,514.36. In citing several cases holding that the equities of a compensated surety are not superior to those of an innocent drawee bank, the court stated:

>[S]uffice it to say that we find no case where both parties are innocent of either participation or negligence and have no notice of the fraud perpetrated that a recovery has been allowed against the depository by the surety who claims to be subrogated to the rights of the principal.\textsuperscript{115}

The purpose of Table I is to furnish a ready reference to such unfound cases. An examination of the noted cases will reveal that although the majority were once aligned against permitting a paid surety subrogation on checks against nonnegligent banks, persuasive legal argument and the use of such devices as assignments, loan receipts, and agreements to withhold claim have swung the balance in favor now of the insurer.

\begin{itemize}
\item \textsuperscript{112} UCC § 3-405. See note 57 supra.
\item \textsuperscript{113} The author has attempted to include all jurisdictions which have decided the specific issue. However, such an undertaking usually falls short of the mark.
\item \textsuperscript{114} 383 P.2d 497 (Okla. 1963).
\item \textsuperscript{115} Id. at 500.
\end{itemize}
### TABLE I
APPLICATION OF COMPENSATED SURETY DEFENSE

<table>
<thead>
<tr>
<th>Jurisdictions Which Have Decided Issue</th>
<th>Defense Assertible</th>
<th>Circumvention Permitted By</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Assignment</td>
<td>Loan Receipt</td>
</tr>
<tr>
<td>California</td>
<td>Yes(^1)</td>
<td>No(^1)</td>
</tr>
<tr>
<td>District of Columbia</td>
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<tr>
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</tr>
<tr>
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</tr>
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<td>Texas</td>
<td>No(^29)</td>
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</table>

5. American Sur. Co. v. Lewis State Bank, 58 F.2d 559 (5th Cir. 1932) (Fla.). Subrogation was by assignment. The court did not decide if equitable principles would preclude subrogation in the absence of an assignment.
9. Kansas City Title & Trust Co. v. Fourth Nat'l Bank, 135 Kan. 414, 10 P.2d 896 (1932). Subrogation was by assignment. The court did not decide if equitable principles would preclude subrogation in the absence of an assignment.
Subrogation was by assignment. The court did not decide if equitable principles would preclude subrogation in the absence of an assignment.

15 New York Cas. Co. v. Sazenski, 240 Minn. 202, 60 N.W.2d 368 (1953). The court distinguished subrogation under a depositor's forgery bond, extending coverage to the drawee bank also, from that involving a fidelity bond. See Northern Trust Co. v. Consolidated Elevator Co., 142 Minn. 132, 171 N.W. 265 (1919), where effect was given to the superior equity doctrine in denying subrogation to a contract right against the operator of a grain elevator.


18 Borserine v. Maryland Cas. Co., 112 F.2d 409 (8th Cir. 1940). (Mo.) (action by a surety of a depositary bank against a prior indorser).


20 Royal Indem. Co. v. Poplar Bluff Trust Co., 223 Mo. App. 908, 20 S.W.2d 971 (1929). Contra, United States Fid. & Guar. Co. v. Fidelity Nat'l Bank & Trust Co., supra note 19, where the surety did not take an assignment until a year after payment of the loss.


25 American Sur. Co. v. Bank of California, 133 F.2d 160 (9th Cir. 1943) (Ore.).

26 Grubnau v. Centennial Nat'l Bank, 279 Pa. 501, 124 Atl. 142 (1924). Subrogation was by assignment. The court did not decide if equitable principles would preclude subrogation in the absence of an assignment.

