Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

When NJ Banks Are Liable For 3rd-Party Fiduciary Breach

Law360, New York (January 29, 2013, 8:24 AM ET) -- Banks, broker/dealers and other financial institutions often are the subject of claims by noncustomer investors, businesses, and estate and trust beneficiaries asserting that the institution is responsible for defalcations involving checks committed by persons running investment schemes, employees of account holders with responsibility for company accounts, attorneys, trustees or executors.

The most common situations in which such claims arise involve corporate employees with responsibilities for corporate accounts, such as controllers and their assistants, or bookkeepers in smaller entities. In most cases, the bank or other institution owes no duty to third parties and enjoys a general rule of nonliability for claims arising out of a breach of another's fiduciary duty.

However, banks and financial institutions should be aware of certain potential exceptions to the nonliability rule that may apply when the bank or institution acted "knowingly," in "bad faith," or where the nature of the transaction suggests the likelihood of misappropriation. Exceptions to the general rule of nonliability can be found in New Jersey's version of the Uniform Fiduciaries Act and in Article 3 of New Jersey's version of the Uniform Commercial Code.

Potential Liability Under New Jersey's Uniform Fiduciaries Law

The general purpose of the Uniform Fiduciaries Act (UFA) is to insulate banks and others dealing with fiduciaries from third-party claims even if the bank, financial institution, or other generally protected person or entity is negligent.

In jurisdictions that have adopted the UFA, the statute may provide a complete defense. But many states have not adopted the UFA and in those that have, there are textual variations that should be reviewed in specific cases. New Jersey has adopted the UFA with certain modifications as the Uniform Fiduciaries Law (UFL), N.J.S.A. 3B:14-52 to -61. Although the UFL's general aim is to protect banks and other financial institutions from third-parties' claims arising out of alleged fiduciary breaches, the New Jersey statute carves out some instances in which that protection will not apply.

An understanding of when and how those exceptions apply first requires an explanation of some of the UFL's definitions and general provisions. The UFL defines "fiduciary" broadly to include not only appointed capacities such as trustees, but also partners and officers or other employees of a corporation acting in a fiduciary capacity. N.J.S.A. 3B:14-53(b). "Banks" are defined generally as any state and federal savings and loan association. N.J.S.A. 3B:14-53(a). Certain provisions of the UFL apply only to banks, so broker/dealers or other financial institutions that receive deposits may not be covered by those provisions.

An exception applicable to all recipients of checks — i.e., banks and other financial institutions alike — may be summarized as applying if a fiduciary draws a check payable to the fiduciary personally and the recipient either has actual knowledge of the fiduciary breach or takes the instrument with knowledge of facts that doing so amounts to bad faith. N.J.S.A. 3B:14-55. The UFL expressly states that "[a] thing is done 'in good faith' ... when it is in fact done honestly, whether it be done negligently or not." N.J.S.A. 3B:14-53(e). The statute does not expressly define "bad faith," but the Supreme Court of New Jersey has provided a definition for purposes of the UFL:

[B]ad faith denotes a reckless disregard or purposeful obliviousness of the known facts suggesting impropriety by the fiduciary. It is not established by negligent or careless conduct or by vague suspicion. Likewise, actual knowledge of and complicity in the fiduciary's misdeeds is not required. However, where facts suggesting fiduciary misconduct are compelling and obvious, it is bad faith to remain passive and not inquire further because such inaction amounts to a deliberate desire to evade knowledge.

N.J. Title Ins. Co. v. Caputo, 163 N.J. 143, 155-56 (2000).

The court further held that, because of the fact-sensitive nature of the conduct typically at issue, "[t]he test for good or bad faith is a subjective one to be determined by the trier of fact unless only one inference from the evidence is possible." Id. at 156. When the plaintiff must construct a claim of bad faith from isolated knowledge by various employees of discrete facts, bad faith is unlikely to be found. Id. at 150.

An exception applicable only to banks is triggered if a deposit is made in a fiduciary account at the bank, and the fiduciary then draws on that account to pay or secure a personal obligation of the fiduciary to the drawee bank. N.J.S.A. 3B:14-56. In that case, if the payment is a breach of fiduciary duty, the bank is liable without the requirement of proving actual knowledge or bad faith. Ibid.

A second bank-only exception exists if a check payable to the fiduciary or his principal is deposited to a nonfiduciary account, which gives the bank notice of a breach of fiduciary duty. N.J.S.A. 3B:14-58(b). That exception is unique to the New Jersey version of the UFA.

Accordingly, banks and other financial institutions should be aware of the UFL's various exceptions to nonliability. Under certain circumstances, the UFA does not protect such institutions from third-party claims arising out of the acceptance of a check issued or deposited in violation of a fiduciary duty.

Potential Liability Under Article 3 of New Jersey's Uniform Commercial Code

Another potential avenue of liability in the fiduciary check context is found in New Jersey's Uniform Commercial Code (UCC). If a financial institution accepts a check issued under circumstances that put the institution on notice that the check was issued in violation of the fiduciary duty, then the institution faces potential liability under Article 3 of the UCC for claims to the check or its proceeds asserted by the fiduciary's beneficiaries.

Section 3-307 of the UCC dictates when a financial institution will be deemed on "notice" of a breach of fiduciary duty. That provision begins by broadly defining "fiduciary" as "an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument," and "represented person" as "the principal, beneficiary, partnership, corporation, or other person to whom the [fiduciary duty] is owed." N.J.S.A. 12A:3-307(a).

The statute then establishes the four rules governing the "notice" determination that apply when "an instrument is taken from a fiduciary for payment or collection or for value, the taker has knowledge of the fiduciary status of the fiduciary, and the represented person makes a claim to the instrument or its proceeds" alleging that the issuance of the instrument "is a breach of fiduciary duty." N.J.S.A. 12A:3-307(b). The first rule is that "[n]otice of breach of fiduciary duty by the fiduciary is notice of the claim of the represented person." N.J.S.A. 12A:3-307(b)(1).

The three remaining rules then set forth the circumstances that will determine whether the taker of the instrument "has notice of the breach of fiduciary duty."

If the instrument is "payable to the represented person or the fiduciary as such," then the taker is deemed on "notice of the breach of fiduciary duty" if the instrument is taken in payment of "a debt known by the taker" to be the fiduciary's personal debt, "taken in a transaction known by the taker to be for the personal benefit of the fiduciary," or deposited to an account other than one belonging to the fiduciary as such or to the represented person. N.J.S.A. 12A:3-307(b)(2).

If the fiduciary as such or the represented person issues the instrument and it is "payable to the fiduciary personally," then the taker will not be deemed on "notice of the breach of fiduciary duty," absent actual knowledge of the breach. N.J.S.A. 12A:3-307(b)(3).

Lastly, if the taker is the payee of an instrument issued by the fiduciary as such or the represented person, then the taker "has notice of the breach of fiduciary duty" if the instrument is taken in payment of "a debt known by the taker to be the personal debt of the fiduciary," "taken in a transaction known by the taker to be for the personal benefit of the fiduciary," or deposited to an account other than one belonging to the fiduciary as such or to the represented person. N.J.S.A. 12A:3-307(b)(4).

Section 3-306 of the UCC, in turn, establishes the claim that may be asserted by an aggrieved beneficiary against the financial institution that accepted the check despite being on "notice" pursuant to section 3-307. "A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds." N.J.S.A. 12A:3-306.

The UCC's official commentary explains how the interplay of the provisions creates an affirmative basis for liability, although the viability of such a claim has not been authoritatively resolved. "Section 3-307 applies to cases in which a represented person is asserting a claim because a breach of fiduciary duty resulted in a misapplication of the proceeds of an instrument. The claim of the represented person is a claim described in section 3-306" and the defendant will not be entitled to assert a holder-in-due-course defense. N.J.S.A. 12A:3-307 (Official Comments 2).

Other provisions of the UCC likewise indicate that sections 3-306 and 3-307 should be interpreted as giving rise to a claim. As stated in one of the UCC's "General Provisions," which are applicable to the entire statute, "[a]ny right or obligation declared by [the UCC] is enforceable by action unless the provision declaring it specifies a different and limited effect." N.J.S.A. 12A:1-106(2). The official commentary further clarifies that the rights described in the UCC are "enforceable by court action, even though no remedy may be expressly provided." N.J.S.A. 12A:1-106 (Official Comments 2).

Similarly, the UCC's treatment of "payment" in section 3-602 expressly identifies section 3-306 as providing an independent "claim" that could affect such matters as a bank's obligation to honor a check submitted for payment. That provision initially states that "an instrument is paid" when payment is made by a party obligated to pay it and to a party entitled to enforce it, "even though payment is made with knowledge of a claim to the instrument under 12A:3-306 by another person." N.J.S.A. 12A:3-602(a).

However, the statute then cautions that one's payment obligation "is not discharged" if, for example, "a claim to the instrument under 12A:3-306 is enforceable against the party receiving payment and payment is made with knowledge by the payor that payment is prohibited by" court order. N.J.S.A. 12A:3-602(b).

In other words, section 3-602 of the UCC specifically contemplates that a person may have "a claim to the instrument under" section 3-306 that is "enforceable against a party receiving payment," and that the extent of the payor's awareness of that specific claim might affect its obligation to pay the instrument.

An issue might exist regarding whether the UCC claim would be subsumed by the general common law principle that banks and broker/dealers owe no duty to third-party noncustomers. See Frederick v. Maxwell, 416 N.J. Super. 594 (App. Div. 2010), certif. denied, 205 N.J. 317 (2011). However, the principles espoused in Frederick have not been extended beyond the common law negligence context, and as such banks and financial institutions should not presume that they would enjoy immunity from statutory claims arising out of the acceptance of checks issued in violation of a fiduciary duty.

Decisions in other jurisdictions appearing to recognize a UCC claim also appear to limit it to the uncommon circumstance when, as with bad faith under the UFL, knowledge of all of the necessary facts is held by an employee or a small group of employees working together, and bar its application in the normal circumstance where the employee receiving a fiduciary check has no knowledge of the other facts required to meet the standard of section 3-307.

Conclusion

Financial institutions such as banks and broker/dealers therefore should be aware of UFL and UCC-based exceptions to nonliability that may apply when they accept checks issued in violation of a fiduciary duty owed to third-parties.

--By Steven A. Beckelman and Gary R. Tulp, McCarter & English LLP

Steven Beckelman is a partner in McCarter & English's Newark office and a member of the firm's business & financial services litigation practice group. Gary Tulp is an associate in McCarter & English's Newark office and the firm's product liability practice group.