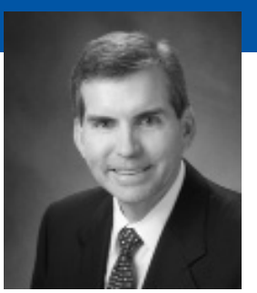
Can the Bank be Liable for a Loss of Trust Account Money Resulting from a Phishing Scam?

Avoiding Liability



By Jeffrey P. Lewis

Jeffrey P. Lewis is a member in the Philadelphia office of the law firm of Eckert Seamans Cherin & Mellott LLC. He serves on the PBA Professional Liability Committee.

In the July 15 issue of the *Pennsylvania Bar News* I wrote on *Stark & Knoll Co., L.P.A. v. Proassurance Casualty Co.,* 2013 WL 1411229 (U.S.D.Ct., N.D. Ohio), a case where a law firm successfully argued that its professional liability policy covered a loss caused by a phishing scam. That scam involved a lawyer who was fraudulently induced to transfer money out of his firm's escrow account, which was purportedly funded by a check previously deposited into that account that turned out to be bad. The law firm in that case prevailed based upon an ambiguity in the policy language that was in its favor. But that holding is not necessarily an indication that there is coverage for such schemes in every instance because carriers use many different policy forms. But a law firm in Illinois that was the victim of such a scam and incurred a loss (after all, the law firm must replenish the escrow account with its own funds) recently tried a different means to be made whole — it sued the bank that maintained its trust account.

In *Dixon, Laukitis and Downing, P.C. v. Busey Bank*, 2013 IL App (3d) 120832, 2013 Ill. App. LEXIS 516, plaintiff law firm deposited a check for $350,000 from one of its clients into the firm's trust account. The check by all appearances looked bona fide — it was purportedly drawn from an account of an insurance company in a reputable Canadian bank; it was even marked, "contains a true security watermark — hold at an angle to view." Without waiting for the check to clear (which, in addition to being stupid, is an ethical violation), the law firm transferred $210,000 from the escrow account to the client who had provided the check and later transferred another $60,000 to that client. Thereafter the $350,000 check was returned to the bank uncollected, and on that same day the bank notified the law firm that the check was dishonored and charged back the $350,000 deficit to the trust account.

The law firm sued the bank. In its complaint it contended that the bank had "breached its duty by failing to inquire as to the circumstances of how [the law firm] acquired the check; to recognize the check as counterfeit and inform [the law firm]; to advise [the law firm] that funds should not be withdrawn until final payment, given the nature of the check and the account; and to notify [the law firm] at the 'earliest time it knew or should have known that the check would not be paid by the drawee bank.' "

In response the bank filed a motion to dismiss and an affidavit in support given by a bank officer. In the affidavit the bank officer attested that "[t]here was nothing on the face of this check that gave any indication that it may not be genuine or that it may be dishonored." Moreover, the bank noted in its motion that the check met all requirements for a negotiable instrument stated in Article 3-104 of the Uniform Commercial Code (UCC). As an alternative basis to deny liability the bank also cited a provision in an agreement between the bank and the law firm wherein the law firm as the account holder "agree(s) to be jointly and severally (individually) liable for any account shortage resulting from charges or overdrafts."

After an evidentiary hearing the trial court granted the motion for reasons stated verbally from the bench. A written order was thereafter entered granting the bank's motion "for all the reasons stated by the Court in its verbal Ruling from the Bench," but the appellate record does not include a transcription of that verbal ruling. The law firm appealed to the Appellate Court of Illinois, an intermediate appellate court, which affirmed.

The court noted that although Article 4 of the UCC "governs the relationship between a bank and its customer," "[T]he principles of law and equity supplement the UCC unless they are displaced by a particular provision in the UCC." It noted that the bank's duty under Article 4 is to "exercise ordinary care" but that "action or non-action approved by this Article … is the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent … with a general banking usage not disapproved by this Article is prima facie the exercise of ordinary care." By this means provisions of Article 4 "displace common law negligence principles." As a result "UCC compliance is non[-]negligent as a matter of law." Therefore, in the court's view, so long as the bank processed the check in a manner consistent with the deposit and collections requirements under Article 4, it is presumed irrefutably to have acted consistent with its "general duty to exercise ordinary care." The court noted that even before the days of the UCC there was "no duty under common law to inspect a check for genuineness or to remind customers that they bear the risk of loss before a deposited check is finally settled."

The court noted that the UCC requirements may be altered by an agreement between the bank and the account holder, which is a binding contract. But in the account holder agreement here the risk of loss language tracks the risk of loss language contained in the UCC. Moreover, that agreement does not obligate the bank to conduct an investigation of the check's genuineness. Therefore, in the court's view, the law firm cannot state a claim against the bank when it had assumed the risk of loss both under the UCC and under the agreement when it transferred money out of the escrow account before the check cleared.

The court rejected the law firm's argument that the Article 4-202 standard of ordinary care only applies to issues involving timeliness of the actions that the bank is required to take "and not to whether they were performed in accordance with the ordinary care." Because "the UCC provides a comprehensive plan for the processing of checks," "[it] displaces common law duties for a collecting bank" (that is, the bank that has accepted the check for deposit from another bank).

The court also affirmed the order dismissing the complaint by application of what Illinois refers to as the *Moorman* doctrine, known under Pennsylvania law as the economic loss doctrine. Under that doctrine, "a plaintiff cannot recover for solely economic loss under a tort theory of negligence." The court acknowledged the exception to the rule for service providers such as lawyers and accountants but stated that it does not apply to bankers.

This case merely underscores the obvious premise that ethical considerations and also sound business practices demand that checks deposited in escrow accounts cannot be relied upon for transfers out of the account until they have cleared. Even if insurance coverage is available, such as was the case in *Stark & Knoll* previously reported in this column, that does not cure the ethical impropriety of such action, and recovery may be delayed by prolonged litigation if the carrier denies coverage.