

ORAL ARGUMENT – 11/05/03

02-0946

SOUTHWEST BANK V. INFORMATION SUPPORT CONCEPTS

WILSON: This case involves the application of the proportionate responsibility statute to a claim for conversion under the UCC §3.420. The claim arose out of a series of checks that were stolen by an employee of the plaintiff over a period of 22 months, were deposited into the employee's bank account at my client's Southwest Bank. Most of the funds were withdrawn. The employee is now in federal prison.

The employer sued the bank for conversion of the checks seeking approximately \$320,000 for the face amount of the checks. We sought to assert the availability of the proportionate responsibility statute as a defense to this, and also decided to bring in the thief and a few others as additional defendants. The TC said that the proportionate responsibility statute was not available to us as a defense for a claim under §3.420, and the CA affirmed saying that the proportionate responsibility statute set forth in ch. 33 of the Civ. Prac. & Rem. Code does not apply to a UCC §3.420 claim for conversion.

In the CA opinion there was some kind of a discrete legislative fault scheme under the UCC and, therefore, the attempt by the legislature to adopt the proportionate responsibility statute does not apply to a claim brought under article 3 or 4 of the Tex. Bus. Com. Code. And it specifically deals with §3.420.

Now we think the CA is clearly erroneous in that respect. And I think it's very clear why. First of all, the legislature in 1995 spent a great deal of time and a great deal of effort to change law in the area of tort claims. The statute that they adopted, which is ch. 33 of the Tex. Civ. Prac. & Rem. Code, states specifically that it applies to any cause of action based in tort. It also specifically states that the trier of fact as to each cause or claim asserted shall determine the percentage of responsibility allocated in whole numbers for the following persons with respect to each person's causing or contributing to cause in any way the harm for which recovery is sought. Whether by negligent act or omission, by any defective or unreasonably dangerous product, or by any other conduct or activity that violates applicable legal standards...

O'NEILL: But doesn't your argument undercut the entire UCC's scheme? If you allow the thief to be submitted proportionately, I can't imagine a situation where 100% of fault wouldn't be apportioned to the thief. And therefore the employer who the UCC protects is without a remedy.

WILSON: Actually I think I can conceive of a jury coming back and actually allocating some of the loss to the bank, and some of the loss to the thief, and maybe some of the loss to the employer too. But I don't think it does.

If you look at 1 under §1.103 of the Bus. Com. Code, the code specifically says unless displaced by a particular provision of this type. And there is nothing in article 3 or 4 that

says you can't bring in the thief. There's nothing in article 3 or 4 that says you can't allocate responsibility to third parties. It just isn't addressed. But article 1.103 specifically says that unless displaced by the particular provisions of this title, then article 2, etc are supplemented by that extra law.

In addition, if you look at 3.404, which is really not before the court, because that involves a situation where there were in fact endorsements and usually those are endorsements by an individual who has control - a bookkeeper or financial officer or somebody like that. The way the Bus. Com. Code allocates responsibility it says in para. D of that section, if a person paying the instrument or taking it for value or for collection fails to exercise ordinary care and pay for taking the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to loss.

OWEN: It seems like the legislature did specifically address proportionate responsibility in 3.404, 3.405 and 3.406. And just because they didn't think of this case or the universe is that a reason for us to now oppose a completely proportionate responsibility statute on top of this?

WILSON: I think the UCC opens it up to do that because of the way this 3.404 reads.

OWEN: Well how do we pick and choose which sections of the UCC we apply for proportionate responsibility to only where the legislature hasn't spoken?

WILSON: You apply proportionate responsibility to tort claims. Conversion claims. You're not going to apply them to warranty claims.

OWEN: But these sections do cover "tort claims", so which controls? If we apply it across the board, the UCC tort claims, does the proportionate responsibility statute control notwithstanding what 3.405 and 3.406 say?

WILSON: Again, I don't agree that there is necessarily conflict between those. But it does control it. Proportionately responsibility does control. Because what happened when the legislature adopted the tort reform in 1995, they changed essentially the entire fabric upon which tort claims are dealt with. For years and years and years, centuries joint and several liability was the rule. Obviously the UCC provisions were written just under the assumption well joint and several liability that is the framework we're dealing with and we're going to draft statutes that assume that's the framework. Well the framework changed. That's no longer the framework in this state. The framework in this state is proportionate responsibility and you can bring in the responsible parties to allocate the...

OWEN: We had two statutes, both of which specifically addressed proportionate responsibility. The UCC does address it in some circumstances. Are you saying that we - it seems to me we can't just say we're going to have to say one governs over the other.

WILSON: Again, I don't think there's an inconsistency if you look at 3.404. 3.404 says specifically the liability in this case, say the bank, is they're responsible to the extent the failure to exercise ordinary good care contributed to the loss. Now if that's the standard, you can see a situation where a bank could say I contribute the loss. And the jury could say 30%, 40%.

OWEN: Why don't we just apply 3.404 to this case?

WILSON: Because 3.404 does not apply to this case.

OWEN: That's my point. The legislature said it applies in these cases, but didn't say all cases in the UCC. And we would be going behind the legislature saying well, now we've decided that you didn't really mean what you said. _____ apply in all cases even though you chose not to apply it in all cases.

WILSON: Except the legislature did do that. They said it applies to all causes of action based in tort. And they also said specifically when you look at the definition of what allocation is they say duty created by law. What else is 3.404? or 3.405? or 3.406? or 3.420? That is a duty created by law and you have to allocate under the regime that this legislature has adopted to the third party, one of the responsible third party and allocate the percentage of liability among those parties. I think it's clear what the legislature intended.

O'NEILL: One of the reasons behind the UCC is uniformity in these transactions. Has any other state in the country gone with your interpretation? Any other state that has proportionate responsibility statutes?

WILSON: I checked Monday and there were no cases that I could find where this issue had come up.

There are all kinds of variances going on here in the way that business and commerce is adopted in this state verses the way it's adopted in other states. As we pointed out in the supplement to our brief, there are literally scores of differences that have been adopted by the various states to comply with the way that state sees its public policy. The way this state sees its public policy is we are going to allocate any tort claim to the parties who cause the loss regardless of their solvency.

OWEN: What about the two sections of the UCC that seem to say pretty strongly that you should not imply repeal by another statute?

WILSON: 1.104, I think, is what you're talking about. That says this title is treated as a general body intended as a unified coverage of its subject matter. There is no question that's what it says. But again, the legislative intent clearly in this case was to apply in a tort situation, which this is clearly a tort situation, a proportionate responsibility scheme. And that applies to every tort. There is no way one can say the legislature didn't mean to imply every tort.

Let's look at 3.420. The first sentence says the law applicable to _____ personal property applies to instruments. No question that if I or a thief steals cattle from an owner, sells the cattle to Mr. Smith, Mr. Smith slaughters the cattle and eat its. There is no question that that is a conversion and there's no question that the owner can sue Mr. Smith. And there's no question that Mr. Smith can say, wait a minute. The thief is responsible. Partially. Maybe totally. Maybe the owner is responsible partially. But I'm not the only one that should take the hit in this situation. If that's what 3.420 says, then why doesn't that scenario under the proportionate responsibility apply to instruments? Because that's exactly what 3.420 says. It does apply to instruments.

We've got to focus I think again on what the legislature was attempting to do here. And what they were attempting to do was solve a major problem which has been going on and change the public policy of this state, and perhaps eventually change the public policy of every state. But what we're doing here is we're saying if you are involved in causing harm, regardless of your solvency, you are going to bear some responsibility. And just because my client happen to have deep pockets, that doesn't mean any more that they are responsible and bear the entire loss.

That used to be the law. No question about it. It didn't matter whether Rasco, the thief, was in this lawsuit or not back in the old days when all we had was a contribution claim. We don't have a contribution claim anymore. We have the right to say jury, Mrs. Rasco caused some of this harm, maybe 80% of it, maybe 50%, maybe we were negligent too. We probably were. Maybe we should have been more careful. If this case is remanded, I think the jury is probably going to allocate some loss to the bank. I don't know what percentage, but I think they are going to allocate some.

PHILLIPS: Are independent bankers worried about public trust and confidence in the banking system if they know that if their account ends up short in this type of circumstance they are going to have to go through a trial process and hope the jury finds the bank more liable than the insolvent thief?

WILSON: The plaintiff didn't have a bank account at Southwest. It was the thief who had the bank account. So their account didn't really come up short. If you look at the proportionate responsibility statute, and if you look at the public policy in this state, I think what you're telling people who are in this situation is you shouldn't hire people who have already been charged with committing this same crime, who you should have known had committed this crime because the name of the prior employer that she stole from was listed on her employment application. You should have opened your bank statements to see what's going on. The plaintiff didn't do that in this case. You should supervise your employees. You should check and see what's going on with your account receivable. This went on for 22 months.

If you're going to talk about fairness and what a person's business should expect, they should expect to take care of business first and be responsible for the problems that they

cause.

Again, I think the purpose of this legislation - proportionate responsibility, makes absolutely clear what the legislature wanted to do. They want to allocate loss based upon fault, not upon the ability to respond to a claim.

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RESPONDENT

KOBS: We are asking the court today to either affirm the CA's decision, which affirmed the TC's decision, or to dismiss the petition as improvidently granted. The argument that the 95 amendments, the passage of the proportionate responsibility act, ch.33 applies to UCC is not a new argument. We've cited a case to the court from the San Antonio CA where this issue was raised last year in connection with UCC warranty claims, which the UCC sets out and defines. And the San Antonio court in that case also held that the proportionate responsibility statute did not apply. And the basis for its holding is, it said in its opinion, that the plaintiffs in that case who sought the application for proportionate responsibility to that case, had not supplied them with a single SC case or any UCC case or UCC provision that would justify extending proportional responsibility to the UCC. We believe that court was correct, and the Ft. Worth court was correct in failing to extend proportionate responsibility that far.

Our argument as we set forth in our brief is really three fold. First of all, we don't believe that the plain language of ch. 33 makes application to the UCC. Based on tort is the applicability section of ch. 33. This is not based on tort.

Now a conversion claim is your classic common law tort, intentional tort action. But the UCC section that my client sought relief at the TC level on is a statutory cause of action. The cases that we've cited in the brief indicate that to the extent the UCC has been adopted in specific areas and it's in conflict with old common law causes of action, that the UCC controls. And it's important in this case for a couple of reasons. First, the damages are limited in this case from what a common law conversion would be. In other words 3.420 limits the damages to the face amount of the instrument. It used to be the value. Now it's the amount as evidenced by the instrument. There's no consequential damages. There's no special damages. And in this case there are no exemplary damages. So a common law conversion is different than a UCC conversion. It applies specifically to this type of action. I think the court's aware of this from their earlier questions. But this is different from 3.404, 3.405 and 3.406, because these are missing endorsements. This is not a faithless employee case. This is not a situation where there was a failure to identify the person. There were forged endorsements or forged signatures. This is a case where there were no signatures. And that's important because when you look at the comments to 3.420 verses 3.405, for example, the commentators to the UCC spend a great deal of time talking about who's in the best position to catch this type of conduct.

In the case now that the legislature has passed 3.405, where there's a

fraudulent or forged endorsement by an employee who's in a managerial position at an employer, the commentators indicate that the employer would be in the best position to detect that type of fraud that was going on. A managerial employee who is taking the checks and forging a company's name on them in order to negotiate them. Thus, there is some allocation set forth in the UCC in those types of situations.

In the comment to 3.402, the UCC drafters indicate that when a check is negotiated to the bank with a missing endorsement, in those types of cases, which is our case, that it is the depository bank that's in the best position to catch that. And that is why the depository bank in essence has the type of strict liability under the UCC.

HECHT: And you think that is irrespective of any complicity of the employer in the conduct?

KOBS: Yes. And I think that's important in this case because as we know from the UCC, claims such as contributory negligence are not permitted as a defense to 3.420 conversion claims.

HECHT: But even if the employer actually knew it was happening, and just didn't do anything, for whatever reason for awhile that still would not prevent recovery?

KOBS: It's my position that no it wouldn't. But we haven't addressed that in this case because there's no evidence that the employer knew. The evidence was that this lady was the mail opener and she opened some of the checks, and they were all small checks as they came in or opened the mail, and that they never got to the employer that they would know about it.

What was alleged that they should have known - this is a should have known case, was that she had embezzled money or somehow defrauded her prior employer, and that a sufficient background check would have revealed that.

HECHT: It just seems like it goes too far. Although, I think it's part of your position that if the employer were actively complicit in the activity it could nevertheless recover?

KOBS: And we haven't had to address that. And fortunately this court doesn't have to address that. That would be a difficult issue to prove. In this case there is no evidence of that. But what's important is, I think to note, that the defendant Southwest Bank in this case filed an affirmative defense of contributory negligence, which was struck by the TC, which they don't complain of, and they sought to bring in three responsible third parties. All employees of Information Support Concepts, my client, and only complained here of the TC's refusal with respect to the thief.

The court should remember they also sought to bring in other employees at the company in order to have their fault compared as well. So they don't argue before this court that

these other employees of my client should have been responsible third parties. But if their argument is accepted, then it would make sense that those people then should - if one person's a responsible third party, then all should be responsible third parties.

HECHT: Do you think the bank has a cause of action against them independently?

KOBS: I think the bank clearly has a cause of action against the thief, who they are calling the thief - Kelly Rasco, that they have a cause of action for breach of transfer...

HECHT: The person is in prison I take it?

KOBS: That's what I've been told. Under the UCC they clearly have a right of action against her, because she's presented an instrument and she's given certain transfer warranties that it's properly endorsed. It was not. They have claims against her.

J. O'Neill asked whether the argument of the petitioners undercuts the UCC? And I think the response was interesting, because the petitioners say that if it goes to the jury, then in all likelihood the jury would find some responsibility on the part of the thief, and the bank, and the employer. And again, that would undercut §3.420, which doesn't permit that type of contributory negligence analysis.

If the petitioner's argument is to be applied across the board to the UCC, that would potentially create tremendous change in the UCC law. It would affect UCC uniformity.

J. Owen asked how far should we go in applying the proportionate responsibility statute in the way that petitioner wants? And my question would be, if it applies to art. 3, does it apply to art. 9 to secure transactions when we have a cause of action for wrongful disposition of collateral? Are we going to examine whether there were other people that were responsible for that? Would it apply to ch. 2, sales? The old things that we learned in law school when gifts arrive that are damaged, or nonconforming, are we going to reject, accept, are we going to cover, or are we going to start looking for responsible third parties to add as defendants in the litigation? A freight company or something like that.

What petitioner's argument would do for ____ in due course under the UCC is something that the court should consider. In other words if we're going to take the proportionate responsibility statute and we're going to apply it to any part of the UCC, then the court has to make the decision how far are we prepared to go in that? To date there are no cases that have applied it in the manner the petitioner seeks. And in the legislative history that the petitioners cite there's no reference to the UCC as something that's going to be affected.

O'NEILL: And how many courts have rejected your opposing counsel's argument? I know New York has. Have there been others?

KOBS: There have been others. I believe it's cited in one of the briefs, but there is an ALR Law Review annotation. I believe it's 101 ALR and I don't recall the page number that deals with these issues in other states. In Texas I'm aware of two. This case from the CA, and then the San Antonio case that dealt with UCC warranties.

HECHT: But the legislature was aware at some point that ch. 33 could disturb other statutory schemes. So they excluded worker's comp. for example.

KOBS: Yes. They excluded worker's comp. They initially didn't include the DTPA, then they included the DTPA. If the petitioner's argument is correct that it applies to any cause of action that sounds in tort, then clearly the DTPA would have been included by implication as petitioners argue the UCC is. But obviously it wasn't because the legislature came in and added §H, which has now been moved under H.B. 4 to a new section of the proportional responsibility statute, which requires that it be applied to DTPA cases. If they had intended that to be done in the UCC context, there would have been a §I is our argument, and they would not have done it by implication. And TEX. BUS. COM. CODE §1.104 that says that the UCC is a uniformed body of law shall not be repealed by implication or implied repeal we think is important in this case. Because especially what the statute sets as the UCC. If it was the legislature's intent in 1995 to apply proportional responsibility either across the board or to selected sections of the UCC, we believe that the legislature would have made that clear.

It's more problematic now because H.B. 4 has certainly expanded the potential of proportional responsibility, and responsible third parties in the future now allowing defendants to add people whose identities are unknown and who do not have to be joined but whose responsibility will be considered by the trier of fact.

So an expansion of the proportional responsibility statute to the UCC will not only bring in a situation such as the one that petitioners argue in this case, but could potentially have UCC commercial transactions filled with potentially responsible parties who are not even a part of the litigation and in some instances whose identities are not even known.

HECHT: So even though that issue is not before us it's consistent with your position that those changes in HB 4 would not affect the UCC either?

KOBS: That's correct. My position that the changes in HB 4 won't affect the UCC and my concern that if proportional responsibility does apply to the UCC, then the changes in HB 4 will make that application even more drastic than it was before HB 4. I would point out that if the legislature were set on increasing proportional responsibility to apply to the UCC, then HB 4 was the perfect avenue to do that and the legislature did not change the applicability portions of the proportional responsibility by the HB 4 amendments.

OWEN: Where is the comment you said that deals with unendorsed instruments?

KOBS: It would be in §3.420, and I believe it's about Comment 3. It's cited in the CA's opinion. The CA noted that 3.420 intended to apply to this type of case without proportional responsibility because the depository bank was in the best position to know.

I want to address the issues raised in the amicus brief before the court. The brief obviously addresses, and in fact we concur with the applicability of 3.405 and 3.406 as loss allocation sections of the UCC.

HECHT: Does that show that the assessment of who is in the best position to catch the malfeasance is shifting, that as time passes and the nature of banking changes that maybe there is a different reception of who is in the best position to stop it?

KOBS: I think 3.405 does do that. That was adopted in 1995, effective Jan. 1, 1996 and was actually Texas's codification of a 1990 UCC revision. Those aren't new statutes although they are newer to Texas than they are to some of the other states that have adopted the UCC. And clearly there would have to be, and common sense would tell us, that there would have to be a shift in and recognition in modern day banking practices to these types of large commercial transactions.

If you look at, and they are not technically in the record, but the amici have attached them, the internet newspaper articles and surveys. If the court looks at those, I think that what you will see in the other materials that have been supplied is that there is more automation going on. Banks have been protected to a great degree. For example in the fraudulent endorsements, the banks now share responsibility with the other people.

But in this type of case where there's an absolute missing endorsement there is a check that's delivered and there is no endorsement, no faked, fraud, nothing except for deposit only written on the back of the check, that in those instances the bank is not protected. Despite modern day banking practices or automation or anything else in those instances the bank should not honor that check, and when they do and when they pass that check up stream and they collect the funds and distribute them to their depositor, when the check has not been endorsed, then the bank incurs that section 3.420 liability. All of the automation notwithstanding.

The articles that the amici attached talk about rise in bank fraud claims. The article goes on though to show first that the actual losses have not increased because the banks have become more adept at catching these types of things. And good banks catch instruments like were deposited in this case. And then it begins to talk about the different types of bank fraud that have caused the losses, and it ranks them. And this type of bank fraud - a missing endorsement bank fraud, is not even among the ones that the article talks about. There are other fake identities and things like that. So this at least by the materials submitted by the amici is not an issue that other banks are dealing with, or are suffering large losses over them because I think the truth is that other banks are simply catching these things in the way that Southwest Bank did not.

Finally just to remind the court, there is a conditional cross petition on review.

In the event that the court determines that this is a situation where this is a tort, or this sounds(?) in a common law tort proportional responsibility does apply. We've asked the court to remand also the issue of exemplary damages. And there was evidence at the summary judgment hearing that Southwest Bank was aware that this was going on, that they had improper rules in place, that they specifically allowed this type of conduct in this case, and they did it willfully and they did it knowingly. And we believe that's an issue that should go to the jury.

With respect to exemplary damages, which are not recoverable under 3.420, but if this court determines that this is some type of common law claim where we're subject to proportional responsibility, then we would like that issue remanded so that we can present the additional damages that we believe that we are entitled to. That's a conditional cross-point. What we're asking the court to do is either affirm the judgment of the CA and dismiss for improvident granting.

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REBUTTAL

WILSON: I would like to simply go back to where we started here, and that is this. The legislature has decided that any tort claim case that...

O'NEILL: What about the argument that this is a statutory kind of tort claim because the remedies are different?

WILSON: The legislature said any duty imposed by law, is what section...

O'NEILL: You would acknowledge that the UCC conversion looks different from the common law conversion claim. And under common law you can recover incidental consequential damages, etc., but you can't under the UCC. So why is this not a unique statutorily created claim?

WILSON: I think the legislature in proportionate responsibility said a claim based in tort. This is a claim based in tort. That's the UCC. They codified common law under the Uniformed Negotiable Instruments Act, _____ all of this and they took some claim. Obviously there are contract claims that are incorporated into the UCC and what we do in certain contract claims, what we do in certain tort claims, and how we handle them.

OWEN: The proportionate responsibility statute is older than the now proportionate responsibility provisions of the UCC. And we sometimes held that subsequent acts trump the previous acts. And I guess you could say they were both amended in 1995, but the legislature we presume at the time it was amending the proportionate responsibility act in 1995, and then first enacting proportionate responsibility in the UCC knew what it was doing. So why would it need proportionate responsibility in the UCC in the 1995 if the amendments to 1995 and the preceding proportionate responsibility already took care of all of this?

WILSON: I don't think the legislature thought about it. But again, that's a rule of interpretation statute on how you interpret a statute. All in the rule is what did the legislature intend to do here? It is clear. When you've got legislation that is introduced by the Gov. of Texas to the legislature it's pretty clear that they are really focusing on tort reform and they want that to be as broad as possible.

OWEN: At the same time they also did separate proportionate responsibility that covers some things in the UCC and not other. So how do we deal with that given that they are contemporaneous?

WILSON: They took a uniform law, adopted, and created the reformed act in late 80's, or early 90's, and they made some slight modifications based on the State Bar of Texas recommendation. And then they adopted it. But I don't think you could say that if we've got to fit proportionate responsibility together with the UCC, that we would say well just because the UCC happened to be in ch. 127, and tort reform was in ch. 53, or 74, that automatically it trumps tort reform.

I like to talk about article 3.420, comment 3. It says former section 3.419, which was the old former UCC provision that was conversion instruments said it drew criticism because depository banks had certain defenses that were available to it there. And one of the defenses was, well to the extent it didn't have any funds on hand anymore, then it wasn't liable as long as it had acted in good faith in a personal and reasonable manner. Basically what the old rule did is it pretty much forced the plaintiff to sue the drawee bank. Who may be out of state, or might be anywhere, or they may have been several checks stolen.

Obviously what they are doing in the amendment to 3.420 is they are saying you can go directly against the depository bank. And it also goes on to say the _____ is ultimately liable in the case with a forged endorsement check because of the warranty to the payor bank. Now that statement should have about a zillion caveats to it. One, it's only the drawee bank that has a warranty cause of action. A drawee bank that has a defense under 3.404 or 3.405 that doesn't assert that - I mean it pays to a claimant under a conversion claim, is going to have a great of defense in the depository bank when they get sued under the warranty. That's under 4.208.

In addition if there is a suit brought by the payee of the check against the drawee bank, the drawee bank has to send a notice within 30 days to the depository bank, otherwise, there could be additional defenses raised. So they are going to send that right away.

So what's going to happen as a practical matter is you are never really going to see 4.208 come into play. Because what's going to happen is the bank is going to go to the drawee bank and say, fine. We'll indemnify and hold you harmless and we will defend the conversion cause of action. And we will be back exactly where we would be in this case, which is saying okay thief. You are in the lawsuit. Okay employer or employer's agent, you are responsible. And we allocate the percentages.

