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Commercial Paper: Depository Bank Liable to Drawer for Payment over Forged Indorsement

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RECENT CASES

COMMERCIAL PAPER: DEPOSITARY BANK LIABLE TO DRAWER FOR PAYMENT OVER FORGED INDORSEMENT

Underpinning & Foundation Constructors, Inc. v. Chase Manhattan Bank, N.A.[1]

Walker, an employee in the accounting department of Underpinning and Foundation Constructors, Inc., used various schemes to embezzle approximately one million dollars during the course of an eighteen month period. One particularly profitable device used by Walker was to submit false invoices from firms with which Underpinning did considerable business. After obtaining signatures on the respective checks Walker forged the indorsements of the named payees by using rubber stamps similar to those used by each respective payee. These stamps contained restrictive indorsements, such as "for deposit only," which required that the checks be deposited only in the account of the named payee. Walker presented these checks at various banks and either cashed or deposited them in savings accounts other than the accounts of the named payees—a clear violation of the restrictive indorsements. The banks put these checks through the normal collection process by presenting them to the drawee bank, which accepted and paid the checks. The drawee bank then debited Underpinning's account for the amount of the checks.

Upon discovering the embezzlement scheme Underpinning filed an action against each of the depositary banks which had accepted the checks in violation of the restrictive indorsements. Bank of New York, one of the defendants in the suit, filed a pre-answer motion to dismiss on the theory that the drawer of a check may never sue a depositary bank but instead is limited to any claims it might have against the drawee bank. Indeed, this had been the rule in New York prior to the adoption of the Uniform Commercial Code.[2] The New York Court of Appeals disagreed with the bank's contention and held that the drawer of a check may sue a depositary bank which accepts a check in violation of a restrictive indorsement where the

1. 46 N.Y.2d 459, 386 N.E.2d 1319, 414 N.Y.S.2d 298 (1979).

2. Trojan Pub. Corp. v. Manufacturer's Trust Co., 298 N.Y. 771, 83 N.E.2d 465 (1948) (memorandum) (conversion and money had and received).

indorsement, although forged, is nonetheless "effective."[3] Liability of the depositary banks was based on the theories of conversion or money had and received. By its decision the court recognized an important, although limited exception to the general rule that a drawer has no cause of action against a depositary bank.

Prior to adoption of the Code, courts were split on the issue of whether to permit a direct action by a drawer against a depositary bank, although a slight majority allowed such a cause of action.[4] Pre-Code cases were successfully brought under several substantive theories,[5] two of which were relied upon in *Underpinning*. Recovery for conversion is based on the premise that when the drawee bank wrongfully debits the drawer's account and pays that amount to the depositary bank, the depositary bank has wrongfully appropriated funds belonging to the drawer.[6] Money had and received is an equitable action based on the view that when a depositary bank accepts checks over forged indorsements, the bank does not acquire title to the checks but holds the proceeds for the payee or rightful owner who may recover for money had and received.[7] Despite the success of actions brought under either of these two theories, several states have rejected not only these, but other theories of recovery as well.[8]

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3. N.Y. U.C.C. § 3-405(1) (McKinney 1964) states in part: "[A]n indorsement by any person in the name of a named payee is effective if . . . (c) an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest." The New York statute is identical to U.C.C. § 3-405(1)(c). Hereinafter, citations will be made only to the 1978 Official Text of the Uniform Commercial Code.

4. 10 AM. JUR. 2d *Banks* § 629 (1963); 9 C.J.S. *Banks and Banking* § 254 (1938). The pre-Code position in Missouri is unclear. In First Nat'l Bank v. Produce Exch. Bank, 338 Mo. 91, 89 S.W.2d 33 (1935), it was held that a collecting bank which accepted cashier's checks bearing forged indorsements could be liable to the issuing bank. Since the case involved cashier's checks, however, the drawer was also the drawee bank and the court did not state whether the drawer would have a cause of action if it had not also been the drawee-payor bank. No theory of recovery was discussed.

5. Washington Mechanics' Sav. Bank v. District Title Ins. Co., 65 F.2d 827 (D.C. Cir. 1933) (dictum) (conversion and money had and received); Home Indemn. Co. v. State Bank, 233 Iowa 103, 8 N.W.2d 757 (1943) (title had not passed to the collecting bank, therefore the drawer had a cause of action for conversion of the checks and their proceeds); Railroad Bldg. Loan & Sav. Ass'n v. Bankers Mortgage Co., 142 Kan. 564, 51 P.2d 61 (1935) (dictum) (conversion and money had and received); Greenville Nat'l Exch. Bank v. Nussbaum, 154 S.W.2d 672 (Tex. Civ. App. 1941) (collecting bank which accepts a check bearing a forged indorsement acquires no title and holds the proceeds for the drawer, who may sue for money had and received).

6. Comment, *Drawer v. Collecting Bank for Payment of Checks on Forged Indorsements—Direct Suit Under the Uniform Commercial Code,* 45 TEMP. L.Q. 102 n.5 (1971).

7. *Id.* at n.6.

8. *See, e.g.,* California Mill Supply Corp. v. Bank of America Nat'l Trust & Sav. Ass'n, 36 Cal. 2d 334, 223 P.2d 849 (1950) (conversion) (court acknowledged split of authority but stated in general language that arguments *against* direct action represented the sounder view); Metropolitan Life Ins. Co. v. San Francisco Bank, 58 Cal. App. 2d 528, 136 P.2d 853 (1943) (conversion; warranty) (no cause of action for conversion because the checks were non-negotiable, had

The Uniform Commercial Code does not expressly provide for a direct action by a drawer against a depositary bank, a factor which has contributed to inconsistent court decisions. The first judicial application of the Code to this issue appeared in the seminal case of *Stone & Webster Engineering Corp. v. First National Bank.*[9] There the court held that the drawer of a check had no cause of action against a depositary bank which accepted a check bearing a forged indorsement. The money had and received theory of recovery was found to be inapplicable because the depositary bank had no money in its hands which belonged to the drawer. Furthermore, the drawer had no right in the proceeds of its own check, payable to the payee. Recovery was likewise denied under the theory of conversion because the Code provides that conversion occurs when a check is *paid* over a forged indorsement and only a payor bank can *pay* on an instrument.[10] This limitation necessarily excludes depositary banks.[11]

The principal reason the court in *Stone & Webster* would deny a drawer a direct cause of action against a depositary bank in a case where the drawee bank is liable to the drawer and the depositary bank is liable to the drawee bank stems from the various defenses provided by the Code.[12] The first defense is found in section 3-406 which precludes a drawer, who by his negligence substantially contributes to the forgery, from asserting the forgery against a drawee bank.[13] A second defense, which prevents a drawer from recovering payment on a forged instrument from the drawee bank unless the drawee bank is notified of the forgery within three years, appears in subsection (4) of section 4-406. This subsection imposes a duty on the drawer to review promptly bank statements and cancelled checks.

In addition to the defenses provided a drawee bank, the Code confers a defense on the depositary bank when sued by the drawee bank. Subsection (5) of section 4-406 provides that the drawee bank is precluded from asserting a claim against a depositary bank based on a forged indorsement if the drawee bank has a valid defense against the drawer and waives or fails upon request to assert it. The court in *Stone & Webster* recognized

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been made out to fictitious payees, and therefore were of no value); First Nat'l Bank v. North Jersey Trust Co., 18 N.J. Misc. 449, 14 A.2d 765 (Sup. Ct. 1940) (conversion) (drawer was not a payor and therefore had no right to immediate possession of the check). The theories of warranty, assignment of warranty, implied contract, and negligence are discussed in notes 27-30 and accompanying text *infra*. *See also* Railroad Bldg. Loan & Sav. Ass'n v. Bankers Mortgage Co., 142 Kan. 564, 51 P.2d 61 (1935) (direct action supported in dictum under conversion or money had and received, but no direct action on a warranty theory).

9. 345 Mass. 1, 184 N.E.2d 358 (1962).

10. *Id.* at 5-6, 184 N.E.2d at 361.

11. *Id.* A "payor bank" is defined in U.C.C. § 4-105(b) as "a bank by which an item is payable as drawn or accepted."

12. 345 Mass. at 8-10, 184 N.E.2d at 363.

13. *See generally* Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 348 F. Supp. 969 (W.D. Mo. 1972); Twellman v. Lindell Trust Co., 534 S.W.2d 83 (Mo. App., St. L. 1976); Mordy, *Forged and Altered Instruments Under the Uniform Commercial Code*, 24 J. Mo. BAR 424, 428-29 (1968).

that, assuming all the drawee bank's defenses were available to the depositary bank in a suit brought by the drawer, the depositary bank would confront practical problems in successfully asserting these defenses. The drawee bank is generally in a better position to know the drawer's business practices, which would be essential in determining whether a defense under sections 3-406 or 4-406 is available. Furthermore, the drawee bank probably would not share this information voluntarily because the drawer is its customer and the depositary bank is often a competitor. As stated in *Stone & Webster,* "The possibilities of such a result would tend to compel resort to litigation in every case involving a forgery of commercial paper."[14] The court found the practical problems involved in asserting applicable defenses to outweigh any positive aspect of allowing a direct action.

The court in *Underpinning* distinguished the typical forged indorsement situation where the indorsement is wholly inoperative[15] from that in which the indorsement, although forged, is effective.[16] In the former, the funds paid to the forger are the property of the drawee bank since the bank is not authorized to charge the drawer's account for the amount of the check. It follows, therefore, that the depositary bank's disposition of those funds does not constitute conversion of the drawer's property.[17] When the indorsement is effective, on the other hand, the drawee bank is authorized to debit the drawer's account. In this situation the drawer has an interest in the proceeds of the check.[18] Since the indorsement in such a case is effective, the eventual debit to the drawer's account is authorized and the

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14. 345 Mass. at 10, 184 N.E.2d at 363. *But see* International Indus., Inc. v. Island State Bank, 348 F. Supp. 886 (S.D. Tex. 1971) (money had and received; assignment of warranty) (pre-Code cases in Texas had allowed a direct action for money had and received and the Code contained no provision which would change this result; issue of defenses not discussed); Commercial Credit Corp. v. Citizens Nat'l Bank, 150 W. Va. 196, 144 S.E.2d 784 (1965) (money had and received) (avoidance of circuity sufficient reason to allow a direct action; disagrees with *Stone & Webster* argument that the depositary bank would have difficulty asserting certain defenses).

15. U.C.C. § 3-404(1) provides:

> Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any person who in good faith pays the instrument or takes it for value.

U.C.C. § 1-201(43) defines unauthorized indorsement as "one made without actual, implied, or apparent authority and *includes a forgery.*" (Emphasis added.)

16. *See* note 3 *supra;* U.C.C. § 3-405, Comment 4. *See generally* Twellman v. Lindell Trust Co., 534 S.W.2d 83 (Mo. App., St. L. 1976); Mordy, *supra* note 13, at 426-28.

17. 46 N.Y.2d at 465, 386 N.E.2d at 1321, 414 N.Y.S.2d at 300. Similarly, since the funds belong to the drawee bank and not the drawer, the depositary bank has not had and received any money of the drawer. The court also noted that, because the drawer is not a holder and could not present the check for payment, the drawer has no interest in the physical check. Therefore, there can be no liability for conversion of the check itself. *See* W. BRITTON, BILLS AND NOTES (2d ed. 1961); 6 A. MICHIE, BANKS AND BANKING ch. 10, §§ 87-88 (1975).

18. 46 N.Y.2d at 466, 386 N.E.2d at 1322, 414 N.Y.S.2d at 301.

depositary bank cannot be liable in conversion for paying over the effective, albeit forged, indorsement. For these reasons the court in *Underpinning* held that the drawer may maintain a direct action against the depositary bank "only in those comparatively rare instances in which the depositary bank has acted wrongfully and yet the drawee has acted properly."[19]

The Uniform Commercial Code offers support for liability of a depositary bank where it disregards a restrictive indorsement irrespective of whether the indorsement has been forged. Prior to adoption of the Code each bank in the collection process could be liable for violation of a restrictive indorsement.[20] The Code changed this by limiting the duty to act consistently with the restrictive indorsement to the first taker of the check.[21] The rationale is that the first taker has the best opportunity to insure that the restriction is satisfied.[22] Applied to *Underpinning*, this means that the drawee bank acted properly in honoring the check, while the depositary bank was responsible for violating the restrictive indorsement.

By allowing a direct action against the depositary bank, the *Underpinning* court observed the mandate of section 1-102 which provides that the Code "shall be liberally construed and applied to promote its underlying purposes and policies." One underlying purpose of Article 3 is the allocation of loss to the party with the greatest power and best opportunity to prevent such a loss.[23] At times this may place liability on the drawer as a matter of law.[24] Presumably this would have been the result in *Underpinning* had it not been for the restrictive nature of the forged indorsements. Since the forged indorsement was made "effective" by operation of the Code, the drawer typically would not have a cause of action against *any* of the banks involved. But in *Underpinning* the court held that "the failure to [pay a check in accordance with a restrictive indorsement] serves as a basis of liability independent of any liability which might be created by payment over a forged indorsement alone."[25]

Decisions under the Code which allow a direct cause of action by the drawer against a depositary bank generally have relied on theories other

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19. *Id.*

20. Soma v. Handrulis, 277 N.Y. 223, 14 N.E.2d 46 (1938).

21. U.C.C. § 3-206(2) provides: "An intermediary bank, or a payor bank which is not the depositary bank, is neither given notice nor otherwise affected by a restrictive indorsement of any person except the bank's immediate transferor or the person presenting for payment." *See* U.C.C. § 3-206, Comment 3. *See also* V.A.M.S. § 400.3-206, Missouri Code Comment (1965); Comment, *Restrictive Indorsements Under the Uniform Commercial Code*, 24 U. PITT. L. REV. 616, 627 (1963).

22. U.C.C. § 3-206, Comment 3.

23. White, *Some Petty Complaints About Article Three*, 65 MICH. L. REV. 1315, 1323 (1967).

24. *Id. See also* Mordy, *supra* note 13, at 426.

25. 46 N.Y.2d at 469, 386 N.E.2d at 1323, 414 N.Y.S.2d at 303.

than conversion or money had and received.[26] Some courts have allowed a direct cause of action on a warranty theory by holding that the drawer is a third-party beneficiary of the warranty of prior indorsements which runs from the depositary bank to subsequent holders in due course.[27] A direct action also has been upheld where the drawer is the assignee of the drawee bank's warranty claim.[28] Still another successful theory has been that of an implied contract in which a depositary bank has an implied obligation to pay to the true owner the money received and erroneously paid over the forged indorsement.[29] A more recent theory is that a depositary bank is negligent if it fails to follow reasonable commercial standards in ascertaining the genuineness of indorsements.[30]

Two procedural techniques have been suggested as alternatives to allowing a direct suit by a drawer against a depositary bank. The first is "vouching-in," a procedure authorized by section 3-803 which allows the drawee to notify the depositary bank to join and defend the suit brought by the drawer. The depositary bank, however, is not compelled to become part of the lawsuit and if it chooses not to join, the only effect is that it is bound by any common determinations of fact in the drawer's suit against

26. In fact, several post-Code decisions have held that a drawer may not sue a depositary bank on the theories of conversion or money had and received. *See, e.g.,* Central Cadillac, Inc. v. Stern Haskell, Inc., 356 F. Supp. 1280 (S.D.N.Y. 1972) (conversion) (the absence of a specific Code provision dictates following prior New York law in denying a direct action); Allied Concord Fin. Corp. v. Bank of America, 275 Cal. App. 2d 1, 80 Cal. Rptr. 622 (1969) (no conversion because the money paid over the forged indorsement does not belong to the drawer; direct action upheld, however, on a warranty theory); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 358 A.2d 859 (Passaic County Ct. 1976) (elements of conversion lacking because the drawer had no right to immediate possession of the check).

27. Allied Concord Fin. Corp. v. Bank of America, 275 Cal. App. 2d 1, 80 Cal. Rptr. 622 (1969) (importance of reducing circuity of actions stressed). In Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978), and Insurance Co. v. Atlas Supply Co., 121 Ga. App. 1, 172 S.E.2d 632 (1970), the courts allowed a direct cause of action by the drawer using the rationale that a drawer is an "other payor," and thus is entitled to claim the benefit of § 4-207 warranties. *But see* Central Cadillac, Inc. v. Stern Haskell, Inc., 356 F. Supp. 1280 (S.D.N.Y. 1972); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 358 A.2d 859 (Passaic County Ct. 1976). These two cases held that the drawer was not a "payor bank or other payor" for purposes of § 4-207.

28. International Indus., Inc. v. Island State Bank, 348 F. Supp. 886 (S.D. Tex. 1971); Commonwealth v. National Bank & Trust Co., 90 Dauph. 71, 46 Pa. D. & C.2d 141 (1968).

29. Columbian Peanut Co. v. Frosteg, 472 F.2d 476 (5th Cir.), *cert. denied,* 414 U.S. 824 (1973); Commercial Ins. Co. v. First Sec. Bank, 15 Utah 2d 193, 389 P.2d 742 (1964) (pre-Code decision). *See also* Comment, *supra* note 6, at 103 n.7.

30. Prudential Ins. Co. v. Marine Nat'l Exch. Bank, 315 F. Supp. 520 (E.D. Wis. 1970); Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978). *But see* Chartered Bank v. American Trust Co., 48 Misc. 2d 314, 264 N.Y.S.2d 656 (Sup. Ct. 1965) (absent a defect on the face of the instrument, the drawer must seek recovery from the drawee).

the drawee bank.[31] A second alternative is to allow the drawee bank to implead the depositary bank where local rules of procedure allow such third-party practice.[32] A drawback of both alternatives is that they leave unresolved the problem of circuitous lawsuits since all three parties are still involved in the action.

Several policy reasons have been advanced by the courts for allowing a drawer to sue a depositary bank.[33] One policy already mentioned is the avoidance of circuity of actions: judicial economy discourages two lawsuits where one suit would sufficiently dispose of all issues and disputes. Another policy reason for allowing a direct action is to foster the banking relationship between the drawer and the drawee bank. Some courts have applied these policy considerations to reach what they considered to be the most equitable result, with little concern for the legal principles involved. As indicated above, the courts allowing a direct cause of action under the Code have not been able to agree on any particular substantive theory. Some pre-Code decisions allowed a direct action without even discussing a substantive theory.[34]

The opposite approach is taken by authorities who stress the importance of a sound substantive basis in the Code. At least one commentator believes that Article 3 was intended to bar a direct suit by a drawer against a depositary bank, despite the circuity of actions which results.[35] The absence of a specific authorization to recover and the circular pattern of liability established in the Code lend support to this strict approach.[36]

In *Underpinning,* the Court of Appeals of New York was able to bridge the gap between the result-oriented and the substantive-minded groups. The opinion first reinforces the general rule with a full explanation of why, in the typical situation, a drawer may not sue a depositary bank which wrongfully accepts checks bearing forged indorsements. The court then created an exception to this general rule by utilizing Code provisions to impose a special duty on the first bank in the collection process to comply with the terms of a restrictive indorsement. The result was to uphold public policy considerations while maintaining a firm substantive basis in the Code.

Underpinning may hold strong precedential value in Missouri and

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31. *See* Bank of St. Helens v. Clayton Bank, 502 S.W.2d 449 (Mo. App., St. L. 1973).

32. H. BAILEY, BRADY ON BANK CHECKS 111 (Supp. 1971).

33. McDonnell, *The Rapid Decline of Privity in the Modern Law of Commercial Paper,* 30 BUS. LAW. 203, 223-25 (1974).

34. *See, e.g.,* First Nat'l Bank v. Guaranty Life Ins. Co., 45 Ga. App. 289, 164 S.E. 212 (1932); Gustin-Bacon Mfg. Co. v. First Nat'l Bank, 306 Ill. 179, 137 N.E. 793 (1922); Sidles Co. v. Pioneer Valley Sav. Bank, 233 Iowa 1057, 8 N.W.2d 794 (1943).

35. McDonnell, *supra* note 33, at 206-07 & n.21.

36. *Id. See also* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 15-4, at 500-01 (1972).