UNIFORM COMMERCIAL CODE SECTION 3-419 AND THE BATTLE TO PRESERVE A PAYEE'S RIGHT TO SUE DIRECTLY A DEPOSITARY OR COLLECTING BANK THAT PAYS ON A FORGED INDORSEMENT

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Consider the plight of Paul, the owner of a modest electronics repair business. *Paul's Repair* was the payee named on a series of checks that a number of Paul's customers had drawn on their various banks over a period of several months. Without Paul's knowledge, Bob, Paul's bookkeeper, forged Paul's indorsement on these checks and deposited them into his personal checking account at First State Bank. First State collected on these checks and credited Bob's account. Bob then withdrew from that account the full amount of the credit. Upon completion of that withdrawal, Bob abruptly left town, leaving no forwarding address.

Six months later, during his annual audit, Paul discovered Bob's wrongdoing. Paul immediately assessed his chances for recovering the stolen money. He knew that he could sue Bob for his wrongful act, but Bob was nowhere to be found. Paul also knew that he could request new checks from his customers. They balked at drawing new checks, however, since their accounts had already been debited. Furthermore, Paul's customers were too numerous and too scattered to make the task manageable.

Paul then considered the various banks that had paid on the fraudulently indorsed checks. He knew that he could sue separately each of the various drawee banks upon which the checks had been drawn, since those banks were clearly liable to him for

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breach of warranties of presentment. But just as with the customers who had drawn the checks on those banks, the drawee banks were too many and too scattered to make Paul's actions against them feasible.

Paul decided to sue First State as the depositary bank that had accepted the fraudulently indorsed checks from Bob. Paul reasoned that First State was a single, easily identifiable and reachable party that undoubtedly had the funds to compensate him for his loss.

Prior to the enactment of section 3-419 of the Uniform Commercial Code, Paul would clearly have been afforded an opportunity to recover against the depositary bank that had paid over the forged indorsement. Much to the chagrin of Paul and other such payees, however, the protection provided to payees by section 3-419 has not, over the years, proven clear. In construing section 3-419, some courts have gone to great lengths to insure that payees such as Paul have a cause of action against depositary and collecting banks. In other jurisdictions, judicial interpretation of section 3-419 has severely curtailed the payee's power to sue directly depositary and collecting banks.

This article will focus on the payee's ability to sue a depositary or collecting bank that pays over a forged indorsement. Part I will explore the early English common law history behind the payee's cause of action. Part II will consider the status of that cause under the American common law, and Part III will track the cause under the Negotiable Instruments Law. Part IV will take a brief look at the legislative history behind the enactment of section 3-419. Part V will examine the leading cases that, in construing the text of section 3-419, have led to the massive confusion surrounding it. Part VI will analyze proposed section 3-420, a revision of section 3-419 that the National Conference of Commissioners on Uniform State Laws has prepared, approved, and recommended for adoption in all the states. Finally, the article will conclude in Part VII with an alternative revision which is designed to protect the rights of the payee without unduly burdening collecting and depositary banks.

I. *Liability Under English Common Law For Payment Over Forged Indorsements*

The practice of indorsing[1] bills of exchange[2] to third parties became known in England some time during the seventeenth century and was well-accepted by the turn of the eighteenth century.[3] While this practice helped establish the negotiability of bills in England,[4] the practice also provided a new avenue of op-

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[1] The word "indorse" means to write or to place on the back (sur dos) of something. *See* 5 THE OXFORD ENGLISH DICTIONARY 233 (2d ed. 1989); 8 W. HOLDSWORTH, A HISTORY OF THE ENGLISH LAW § 2, at 141 (2d ed., 3d impression 1937). A payee who indorses a negotiable instrument thus writes on the back of that instrument further orders concerning the payment of the instrument. HOLDSWORTH, *supra*, § 2, at 141.

[2] The classic four-party bill of exchange included the following players: the "purchaser," who entrusted a sum of money to the "drawer," who drew on the "drawee" in favor of the "payee." J. HOLDEN, THE HISTORY OF NEGOTIABLE INSTRUMENTS IN ENGLISH LAW 28 (1955). The bill of exchange was used by merchants on the Continent perhaps as early as the thirteenth century. *Id.* at 1, 21; 8 HOLDSWORTH, *supra* note 1, § 2, at 116. Bills of exchange may have, from time to time, found their way into English circles during the fourteenth century. HOLDEN, *supra* at 21; 8 HOLDSWORTH, *supra* note 1, at 116. These bills, however, apparently were not regularly used by English traders until some time in the fifteenth century. HOLDEN *supra*, at 21-23; 8 HOLDSWORTH, *supra* note 1, § 2, at 136-137.

[3] Holden claimed that the earliest example of an indorsed bill was dated 6 August 1519 and was drawn in Naples or Florence. HOLDEN, *supra* note 2, at 44-45 n.8 (citing R. DE ROOVER, L'EVOLUTION DE LA LETTRE DE CHANGE, VIV-XVIII SIECLES 100; 151 (1953)).

See also Kessler, *Forged Indorsements*, 47 YALE L.J. 863, 864 (1938). Early examples were also quoted in Goodwin v. Robarts, 10 L.R. 337 (Ex. 1875) (cited in HOLDEN, *supra* note 2, at 44-45 n.8). In his opinion, Cockburn, C.J., referred to a recently published German work by one Hartmann, which claimed that the Neopolitan Pragmatica of 1607 contained the first reference to indorsements. *Goodwin*, 347-48. Marius, who published his "Advice Concerning Bills of Exchange" in 1651, did discuss the method and effect of indorsements. MARIUS, ADVICE CONCERNING BILLS OF EXCHANGE 10, 30 (cited in HOLDEN, *supra* note 2, at 44-45). *See also* Kessler, *supra*, at 864-65. The practice of indorsing evidently became commonplace on the Continent by the end of the seventeenth century and in England by at least the beginning decades of the eighteenth century. *Goodwin* at 347 (cited in HOLDEN, *supra* note 2, at 44-45 n.8). *See also* 8 HOLDSWORTH, *supra* note 1, § 2, at 142-43, 155; Kessler, *supra*, at 864-65.

[4] In its classic form, the negotiable instrument came to possess three vital trading characteristics: 1) it could be transferred; 2) it could be sued upon by the person presently holding it; and 3) it could provide a bona fide purchaser with greater rights than had been possessed by the transferor. HOLDEN, *supra* note 2, at 4; 8 HOLDSWORTH, *supra* note 1, § 2, at 140. Such an instrument was described by Blackburn, J., in Crouch v. The Cre'dit Foncier of England, 8 L.R. 374, 381 (Q.B. 1873), in the following terms:

> [I]n the notes to Miller v. Race, 1 Smith L.C., 13th ed., p. 524, where all

portunities for English forgers.[5] The contemporaneous rise[6] of the check[7] likewise added to the opportunities available for those

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the authorities are collected, the very learned author says: 'It may therefore be laid down as a safe rule that where an instrument is by the custom of trade transferable, like cash, by delivery, and is also capable of being sued upon by a person holding it pro tempore, then it is entitled to the name of a negotiable instrument, and the property in it passes to a bona fide transferee for value, though the transfer may not have taken place in market overt.'

Crouch, 8 L.R. at 381 (quoted in HOLDEN, *supra* note 2, at 4 n.1). Indorsement thus furthered negotiability by assisting in the free transfer of an instrument. 8 HOLDSWORTH, *supra* note 1, § 2, at 140-141.

[5] *Cf.* Kessler, *supra* note 3, at 865.

[6] On the Continent, from as early as the turn of the fourteenth century, the Venetian campsores operated as bankers by borrowing money from certain individuals in order to lend to others at a higher interest rate. 8 HOLDSWORTH, *supra* note 1, § 3, at 178. While England lagged far behind the Continent in the development of a true banking system, from at least the sixteenth century, England had individuals who acted as money-lenders by lending their own surplus capital. HOLDEN, *supra* note 2, at 205. At the beginning of the seventeenth century, wealthy English merchants deposited their gold in the Tower of London for safekeeping. As the first half of that century progressed, the merchants began to turn first to scriveners, and later to goldsmiths, for the deposit of their excess capital. *Id.* at 205-06.

Soon after they became accustomed to depositing sums with the goldsmiths, merchants also began to look to goldsmiths for assistance in paying third parties. Initially, the depositor probably wrote a letter, addressed to the goldsmith, requesting the goldsmith to pay a sum certain to the depositor's creditor. The creditor would take that letter to the goldsmith and would receive payment. *Id.*

These letters were eventually reduced to a standard form, which directed the goldsmith to pay a certain sum to the named creditor or his order. *Id.* at 207. Holden points to these standardized, handwritten letters as the origin of the modern check. See *id.* at 210, for three early examples, dated 1659, 1665 and 1675. These handwritten checks continued to be the norm until the latter part of the eighteenth century when the printed check was introduced. Farnsworth, *Insurance Against Check Forgery*, 60 COLUM. L. REV. 284 n.2 (1960).

[7] When they were first used, the request letters sent to goldsmiths were called by various names, including "bills," "notes" and "drawn notes." The word "check" was apparently first used during the eighteenth century. HOLDEN, *supra* note 2, at 208-09. According to the Oxford English Dictionary, "cheque" derived from "the name of the counterfoil of an Exchequer or other bill, the purpose of which was to check forgery or alteration." OXFORD ENGLISH DICTIONARY (2d ed. 1989) (quoted in HOLDEN, *supra*, note 2, at 209). *See also* 8 HOLDSWORTH, *supra* note 1, at 190 n.2. An early use of the word can be found in the statute 5 Anne ch. 13 (1706), which provided that the Bank of England should "have the Use and Custody of the one Part and all and every the Cheques, Indents, or Counterfoyles of all such Exchequer Bills, which shall from time to time be Issued at the Receipt of Her Majesties Exchequer." (quoted in HOLDEN, *supra* note 2, at 209 n.1). Although the English first spelled the word "check," during the first half of the eighteenth century they initially spelled it "cheque" with its analogies to the Exchequer. *Id.* at 209.

who would forge indorsements.[8] As a result, during the eighteenth century, the English common law courts[9] were presented with cases brought by the victims of forged indorsements.[10]

By the middle of the nineteenth century, the English courts were asked to determine the question of who should bear the loss when a bill or check was paid over a forged indorsement. In *Robarts v. Tucker*,[11] an insurance company sued its bank for debiting the company's account with the amount of a bill bearing a forged indorsement. Parke, B., acknowledged that the bank had

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8 Farnsworth points to James Townsend Saward, an early nineteenth century English barrister, as the head of the first organized ring of check forgers. Saward, a.k.a. Jim the Penman, ran his forgery ring for some thirty years until his conviction in 1857. Farnsworth, *supra* note 6, at 284 n.2.

9 During the latter half of the fifteenth and the first half of the sixteenth centuries, the mercantile courts, with their law merchant, took cognizance of controversies that grew out of bills of exchange. HOLDEN, *supra* note 2, at 23-27. Due to the development of the ubiquitous action of assumpsit and the absorption of the law merchant into the common law, by the middle of the seventeenth century the common law courts had successfully wrested from the mercantile courts jurisdiction over litigation concerning bills of exchange. *Id.* at 27-34; 8 HOLDSWORTH, *supra* note 1, § 2 at 151-53, 159.

10 Apparently, the first reported case concerning the effect of a forged indorsement was decided in France in 1755. Kessler, *supra* note 3, at 865.

Early English cases included Cheap v. Harley, 100 Eng. Rep. 491 (*Circa* 1786) (cited in HOLDEN, *supra* note 2, at 124). The defendants in that case, who maintained accounts with banking houses in both England and America, drew a bill in America on their English bank. The bill was lost and eventually came into the hands of a third person, who forged the payees' indorsement. The forger then presented the check to the defendants' English bank, where the forger received payment for the full face value of the bill. Buller, J., held that the payees could recover the amount of the bill from the defendants. *Id.*

For another early English case dealing with a forged indorsement, see Price v. Neal, 97 Eng. Rep. 871 (K.B. 1762), where a drawee tried unsuccessfully to recover from an innocent indorsee for value of sums that the drawee had paid over a forged indorsement. *See also* Smith v. Shepperd, Hil. T. 16 Geo. III (1776) (cited in CHITTY, BILLS OF EXCHANGE 126 n.4 (1st ed. 1799), cited in Kessler, *supra* note 3, at 866 n.22); Johnson v. Windle, 132 Eng. Rep. 396 (1836).

11 117 Eng. Rep. 994 (Ex. 1851) (cited and discussed in HOLDEN, *supra* note 2, at 222-23 n.4). In that case, the local agent of an insurance company drew a bill on the company for £5,000, made payable to a person in settlement of a claim. The agent handed the bill to a representative of the payee. Instead of turning the bill over to the payee, the representative forged the payee's indorsement and negotiated the bill for value. The holder then presented the bill to the insurance company, which accepted it payable at the company's bankers. The bill was subsequently paid and debited to the insurance company's account. When the forgery was discovered, the insurance company sued its bankers, claiming that the bank was not entitled to debit the company's account with the amount of the bill. *Robarts*, 117 Eng. Rep. at 994.

acted in good faith.[12] Parke nevertheless maintained that when a customer accepts a bill payable at his bank, the customer thereby orders his bank to pay the bill to the named payee.[13] The bank in the case at bar, however, failed to follow its customer's order when it paid over the forgery of the payee's indorsement.[14] Parke held, therefore, that the bank was not entitled to debit the insurance company's account.[15]

Bankers publicly vented their fears concerning the losses that the *Robarts v. Tucker* decision would ultimately allocate to banks.[16] In response to this public venting, Parliament added Section 19 to the provisions of the Stamp Act of 1853.[17] This section provided drawee banks with the authority to pay any draft or order drawn on that bank that, when presented for payment, purported to be indorsed by the person to whom it had been drawn payable.[18]

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12 *Id.* at 1001.

13 *Id.* at 580.

14 *Id.*

15 *Id.* at 1002. The decision in this case was thus consistent with Continental law, at least as it had existed through the beginning of the eighteenth century. *See* Kessler, *supra* note 3, at 865-66.

16 HOLDEN, *supra* note 2, at 223. One banker lamented, "[I]t seems shocking to think that a banker should have to lose £5,000 for paying a genuine acceptance." 13 THE BANKERS' MAGAZINE 640 (quoted in HOLDEN, *supra* note 2, at 223 n.2).

Apparently, Continental bankers had begun to raise these same concerns as early as the middle of the eighteenth century. Kessler, *supra* note 3, at 868.

17 HOLDEN, *supra* note 2, at 223. Holden suggests that, in introducing section 19, the Chancellor of the Exchequer was partially attempting to allay fears expressed in a July 1853 letter that a banker had written to *The Economist*. 11 THE ECONOMIST 754, cited in Holden, *supra*, note 2, at 223 n.3. The editor of *The Bankers' Magazine*, who had likewise drawn attention to the potential effect of the decision in *Robarts*, apparently also claimed responsibility for forcing the insertion of section 19. 13 THE BANKERS' MAGAZINE 698, cited and discussed in HOLDEN, *supra* note 2, at 223 n.3.

18 Section 19 provided:

> any draft or order drawn upon a banker for a sum of money payable to order or on demand which shall, when presented for payment, purport to be endorsed by the person to whom the same shall be drawn payable, shall be a sufficient authority to such banker to pay the amount of such draft or order to the bearer thereof; and it shall not be incumbent on such banker to prove that such endorsement, or any subsequent endorsement, was made by or under the direction or authority of the person to whom the said draft or order was or is payable either by the drawer or any endorser thereof.

Quoted in HOLDEN, *supra* note 2, at 223 n.4.

Section 19 found a parallel in Article 145 of the French Commercial Code of

When it enacted the Bills of Exchange Act of 1882,[19] Parliament again addressed the question of drawee liability for payment over a forged indorsement. Section 60[20] of that Act absolved from liability a banker who, "in good faith and in the ordinary course of business," paid a bill, payable to order or on demand, that bore a forged indorsement.[21]

By the middle of the nineteenth century, the English common law had recognized the right of the payee to sue a bank that had paid over a forged indorsement. In response, however, to the strong lobbying of the banking community during the latter part of the nineteenth century, the English Parliament had acted to limit the payee's ability to recover by granting immunity to a drawee bank that had in good faith and in the ordinary course of business paid over a forged indorsement.

II. American Common Law

During the latter half of the nineteenth century, the American common law appears to have picked up exactly where the English common law had been before the bankers began to inter-

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1807, which created a presumption discharging a person who paid a bill at its maturity unless he had been given notice not to pay. Kessler, *supra* note 3, at 869 (citing to NOUGIER, DES LETTRES DE CHANGE nn. 333-39 (4th ed. 1875)).

19 Bill of Exchange Act of 1882 (England).

20 Section 60 provided:

> [W]hen a bill payable to order on demand is drawn on a banker, and the banker on whom it is drawn pays the bill in good faith and in the ordinary course of business, it is not incumbent on the banker to show that the indorsement of the payee or any subsequent indorsement was made by or under the authority of the person whose indorsement it purports to be, and the banker is deemed to have paid the bill in due course, although such indorsement has been forged or made without authority.

Bills of Exchange Act of 1882 (45 & 46 Vict. ch. 61, § 60), quoted in 5 HALSBURY'S STATUTES, *Bills of Exchange* at 382-83.

Although section 60 of the Bills of Exchange Act did not expressly repeal section 19 of the Stamp Act of 1853, in 1937 the English Court of Appeals held that section 60 impliedly repealed section 19. Carpenters' Co. v. British Mutual Banking Co., 3 All E.R. 811 (C.A. 1937).

21 Section 80 of the Bills of Exchange Act extended similar protection to a drawee bank that, "in good faith and without negligence" and according to the terms of the cross, paid over a forged indorsement. Holden suggested that section 80 may have been intended to reenact section 9 of the Crossed Cheques Act of 1876, which likewise protected a drawee that paid over a forced indorsement if the drawee paid in good faith, without negligence, and in accordance with the cross. HOLDEN, *supra* note 2, at 229, 237.

fere. Thus, at the close of the nineteenth century, the American common law, which had not yet been subjected to banker lobbying, generally favored the right of the payee to recover against a bank that had paid over a forged indorsement.[22]

A. *Payee's Recovery in Conversion*

By at least the second half of the nineteenth century, the primary source of the payee's right to recover could be found in the tort action of conversion.[23] In order to maintain a cause of action for conversion of a negotiable instrument, the payee was required to show: (1) that he had standing to sue; (2) that he had title, possession, or a right to possession to the instrument; and (3) that the depositary or collecting bank had converted the instrument by exercising dominion and control over it in a manner contrary to the payee's interest.[24] Once the payee had shown standing and made his *prima facie* case, the bank was usually held strictly liable for the face value of the instrument.[25]

1. Payee's standing to sue

As with any common law action, a payee who desired to maintain an action for conversion against a collecting or depositary bank was required to show that he had standing to sue. In

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22 Jones v. Commonwealth Bank & Trust Co., 71 Pa. D. & C. 2d 143, 19 U.C.C. Rep. Serv. (Callahan) 1194 (Pa. Ct. C.P. 1976). For a collection of early common law cases construing the payees' right to sue a collecting bank that paid over a forged indorsement, see Annotation, *Right of Check Against One Who Cashes it on a Forged or Unauthorized Indorseement and Procures its Payment by Drawee*, 31 A.L.R. 1068 (1924). Note that while some of the cases cited in this section were technically governed by the provisions of the Negotiable Instruments Law, these cases make no reference to that uniform law and instead rest upon common law principles. See Murray, *Under the Spreading Analogy of Article 2 of the Uniform Commercial Code*, 39 FORDHAM L. REV. 447, 448 (1971) for a general discussion of where courts have even ignored the provisions of the NIL. These cases have therefore been included in this section rather than in the section that explores the NIL. See *infra* text accompanying notes 100-133 for a discussion of cases that rested expressly upon NIL sections.

23 *See* Comment, *Depositary Bank Liability Under § 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676, 676-77, 682-83 (1974). Conversion was also the theory of choice in nineteenth century England. *Cf.* A.L. Underwood, Ltd. v. Bank of Liverpool and Matrins, [1924] All. E.R. 230 (C.A.).

24 *See* Comment, *supra* note 23.

25 *See id.*

Pickle v. People's Nat'l Bank,[26] a payee brought a bill in equity[27] against a collecting bank for conversion of a check, the proceeds of which the payee claimed to have never received.[28] In granting judgment for the payee, the Supreme Court of Tennessee admitted that, for want of privity, a payee of a check could not sue a bank that had negligently paid a check unless the bank had accepted the check.[29] The court did maintain that a bank would accept a check if it assented to pay that check.[30] Such assent would then bring the payee into privity with the bank.[31] With privity thus established, the payee could then sue the bank if it paid contrary to the directions on the face of the check.[32]

2. Elements of payee's *prima facie* case

Once privity was established, the common law required the payee to plead and prove certain elements in order to make a *prima facie* case for common law conversion.

First, the payee was required to show title to, possession of or a right to possession of the check under litigation.[33]

The fact that the payee had not been able to gain possession was not necessarily fatal to the payee's cause of action. For example, in the *Crisp v. State Bank of Rolla*,[34] decision, a woman, who had never received possession of an estate check made payable to her, brought an action for conversion against a bank that had paid cash to her second husband over an apparent forgery of her indorsement.[35] The Supreme Court of North Dakota recognized the traditional possession requirement.[36] The court then reasoned that a payee who had never gained actual possession of a check that was intercepted and was cashed on a fraudulent indorsement could nevertheless ratify the delivery to the thief with-

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26 88 Tenn. 380, 12 S.W. 919 (1890).

27 *Id.* at 382, 12 S.W. at 919. The case was thus not actually based in conversion. Nevertheless, the principles discussed by the court in reaching a decision for the payee do support the traditional common law action for conversion.

28 *Id.*

29 *Id.* at 387, 12 S.E. at 920.

30 *Id.*

31 *Id.*

32 *Id.* at 387, 12 S.W. at 920-21.

33 *See* Graves v. American Exch. Bank, 17 N.Y. 205 (1858).

34 32 N.D. 263, 155 N.W. 78 (1915).

35 *Id.* at 264-65, 155 N.W. at 78-79.

36 *Id.* at 268, 155 N.W. at 79-80.

out ratifying the fraudulent indorsement.[37] By ratifying the delivery, the payee would thereby make the thief her agent for the purpose of possession.[38] With possession established, the true payee could then maintain a cause of action in conversion.[39]

Second, the payee had to show that the bank had converted the payee's check by exercising dominion and control over it in a manner that ran contrary to the interests of the payee.[40] The courts uniformly found collection over a forged indorsement to be such an exercise of dominion and control. In *People v. Bank of North Am.*,[41] for example, the State of New York brought an action for conversion of ten drafts, made payable to the state, which had been cashed by a bank over indorsements forged by a clerk in the state treasurer's office.[42] The court held that the bank had indeed converted the drafts in question, since it took the drafts with forged indorsements from persons in wrongful possession of them, collected upon them, and then surrendered them to the drawees. This was done in contravention to the payee's legal rights in the drafts.[43]

3. Defenses to payee's *prima facie* case

If the payee succeeded in making a *prima facie* case for conversion, the common law generally held the defendant collecting or depositary bank strictly liable to the plaintiff payee. Thus, a collecting bank was not permitted to defend on the ground that it had acted in good faith, without negligence and according to the custom of the banking business.[44] In *Moler v. State Bank*,[45] a collecting bank attempted to avoid liability in conversion by claiming that it had acted without negligence when it cashed for a son

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37 *Id.* at 269-70, 155 N.W. at 79-80.

38 *Id.* at 269-70, 155 N.W. at 79.

39 *Id.; see also* Pickle v. People's Nat'l Bank, 88 Tenn. 380, 12 S.W. 919 (1890).

40 *See* People v Bank of North Am., 75 N.Y. 547 (1879).

41 75 N.Y. 547 (1879).

42 *Id.* at 553.

43 *Id.; see also* Meyer v. Charles Rosenheim & Co., 115 Ky. 409, 73 S.W. 1129 (Ct. App. 1903); Good Roads Mach. Co. v. Broadway Bank, 267 S.W. 40 (Mo. Ct. App. 1924); Crisp v. State Bank of Rolla, 32 N.D. 263, 155 N.W. 78 (1915).

44 For a collection of cases discussing the defenses available under common law, see Annotation, *Payor's Negligence Facilitating Forging of Indorsement as Precluding Recovery from Bank Paying Check*, 87 A.L.R.2d 638 (1963).

45 176 Minn. 449, 223 N.W. 780 (1929).

an interest-bearing certificate made payable to his mother.[46] On appeal, the Supreme Court of Minnesota expressly found that the collecting bank had not been negligent in cashing the certificate.[47] The court further found that the bank had acted in good faith[48] and had exercised reasonable business prudence.[49] Nevertheless, the bank did participate in acts that constituted a conversion of the plaintiff's certificate.[50] The supreme court, therefore, held the bank to be liable to the plaintiff payee.[51]

Similarly, the "real" nature of an action for conversion prevented a collecting bank from raising as an affirmative defense the negligence of the payee. In *People v. Bank of North Am.*,[52] the defendant bank argued that the state was barred from recovering because, *inter alia*,[53] it had been negligent in providing the clerk

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46 *Id.* at 452, 233 N.W. at 781.

47 *Id.* The court judged the collecting bank's conduct from the standpoint it occupied at the time the transaction in question took place. According to the court, no suspicious circumstances presented themselves: Schweppe was a local businessman of good repute, he regularly banked at State Bank, State Bank knew that his mother-in-law was then living with him, and State Bank knew that she had previously authorized him to cash pension checks for her. Given this set of facts, the court could find no basis for imposing a duty of further inquiry by State Bank. *Id.* at 452-53, 223 N.W. at 782.

48 *Id.* at 454, 233 N.W. at 782. The court found that the drawer/drawee bank had also acted in good faith. *Id.*

49 *Id.* The court acknowledged the rule requiring a bank to know the signature of its customer. The court maintained, such is not the case for the signature of a payee on a cashier's check. The court argued that the bank could not conduct "business if it made impertinent inquiries of businessmen" since "most honest men" would be offended by an inquiry into the genuineness of such an indorsement. *Id.* at 452, 223 N.W. at 782. According to the *Moler* court, the making of such inquiries would not be "the conduct of an ordinary, reasonable, or prudent banker or businessman." *Id.* at 452-54, 223 N.W. at 782. For an examination of the effect under section 3-419(3) of adherence to reasonable commercial standards, see *infra* text accompanying notes 399-464.

50 *Id.* at 455, 233 N.W. at 782. This was true because the forged indorsement prevented the bank from gaining title to the certificate.

51 *Id.* In affirming the decision reached below, the supreme court confirmed that, due to the warranties of presentment made by State Bank as the collecting bank, State Bank would be primarily liable and First State would secondarily be liable to Moler. *Id.* at 455, 223 N.W. at 783; *see also* California Stucco Co. v. Marine Nat'l Bank, 148 Wash. 341, 268 P. 891 (1928).

52 75 N.Y. 547 (1879).

53 *Id.* at 560. The bank also claimed unsuccessfully that Phelps had actual, implied, or apparent authority to indorse the checks and that the State was estopped from denying Phelps' authority to indorse. *Id.* at 562. For a discussion of the estoppel claim, see *infra* text accompanying notes 56-59.

with the opportunity to fraudulently indorse the drafts. According to the court, however, the bank was not entitled to raise the state's possible contributory negligence in this action for conversion.[54] As the court explained, one cannot be deprived of his property by an unauthorized transfer simply because he did not use ordinary care to prevent such a transfer.[55]

Even though contributory negligence was not traditionally allowed as an affirmative defense to an action for conversion, some courts did allow the payee's negligence to be raised through the vehicle of estoppel. In *People v. Bank of North Am.*,[56] the defendant bank had argued that the State should be estopped from denying the clerk's authority to indorse the drafts under litigation. The court recognized that, under the appropriate circumstances, a collecting bank might be able to claim the payee was estopped from denying actions that led to the making of a forged indorsement.[57] According to the court, an estoppel *in pais* could arise only when one person, by words or conduct, induced another to act in reliance on the words or conduct.[58] The court found in the instant case, however, that the collecting bank had relied on the forged indorsements, not on anything that the State treasurer had said or done.[59]

Although defendant banks were left largely without an available defense during the nineteenth century, one affirmative defense did develop for brokers who were sued for conversion of negotiable instruments that they had handled. In *Pratt v. Higginson*,[60] the owner of several bonds brought an action for conversion against a broker's firm that sold the bonds after receiving them through an intermediary broker, from the thief who had stolen them.[61] The court noted that the brokers had, without no-

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54 75 N.Y. at 562.

55 *Id.* at 558. For a discussion of the availability of contributory negligence as an affirmative defense to an action for conversion brought under section 3-419(1)(c), see *infra* text accompanying notes 465-484. For a discussion of this defense under the provisions of the redraft of Article 3, see *infra* text accompanying notes 540-543.

56 75 N.Y. 547, 559 (1879).

57 *Id.* at 559-60.

58 *Id.* at 560.

59 *Id.* at 561; *see also* Brown v. People's Nat'l Bank, 170 Mich. 416, 136 N.W. 506 (1912).

60 230 Mass. 256, 119 N.E. 661 (1918).

61 *Id.* at 256, 119 N.E. at 662.

tice of any infirmity of title or of any other circumstances that should have put them on inquiry notice, sold the bonds and accounted for the proceeds to the apparent owner.[62] The question thus became: whether under those circumstances the brokers should, nevertheless, be held responsible for damages in conversion.[63] The court acknowledged that the brokers would have been liable if the instruments in question had been non-negotiable documents.[64] In that case, the true owner's title would not then have been divested by a sale, even if the purchaser had paid value and had taken in good faith.[65] The court did note the "well-recognized" exception that existed for negotiable securities.[66] Under this rule, an action for conversion could not be maintained by the owner from whom the negotiable instruments were stolen where the seller, in good faith and without notice, received them as an agent in exchange, without gross negligence from a party to the theft and where the seller paid the proceeds to the principal without receiving any benefit for himself.[67] According to the court, however, the true test was not whether the seller received compensation, but whether the transaction was conducted without knowledge that the bearer lacked title or that

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62 *Id.* at 257, 119 N.E. at 662.

63 *Id.*

64 *Id.* at 257, 119 N.E. at 662.

65 *Id.*

66 *Id.* For a collection of early cases that discuss the broker exemption, see Annotation, *Liability to True Owner of Broker or Other Agent Who Sells Negotiable Securities Which Have Been Stolen*, 73 A.L.R. 1342 (1931); see also RESTATEMENT (SECOND) OF TORTS § 233(4) (1965), which describes the broker exception in the following terms:

> The statement in Subsection (1) [which provides that an agent or servant of a third person will generally be liable for conversion for disposing of an item to one not entitled to its immediate possession] is not applicable to an agent or servant who disposes of current money, or a document negotiable by common law or by statute, pursuant to a transaction by which the transferee becomes a holder in due course of such money or document, unless the agent or servant knows or has reason to know that his principal or master does not have authority so to dispose of it.

As the comments to section 233 explain, this rule is designed to enhance the marketability of the easy exchange of credits. RESTATEMENT (SECOND) OF TORTS § 233 comment 3 (1965).

67 *Pratt*, 230 Mass. at 257, 119 N.E. at 662. In support of this rule, the *Pratt* court cited to Spooner v. Holmes, 120 Mass. 503, 3 Am. Rep. 491 (1869); O'Herron v. Gray, 258 Mass. 573, 47 N.E. 429 (1897). *Pratt*, 230 Mass. at 257, 119 N.E. at 662.

any other circumstances existed that would put a reasonable man on inquiry notice.[68] Because the brokers in the instant case had no such knowledge, the court entered judgment in their favor.[69]

4. Measure of damages

A payee who was successful in making a case of conversion against a bank that paid over a forged indorsement was, *prima facie*, entitled to recover as damages the face value of the converted instrument.[70] The payee's recovery could, however, be limited under the doctrine of mitigation. In *People v. Bank of North Am.*,[71] the court acknowledged that the mitigation limitation is available in an action for conversion, where, for example, the instrument under litigation was returned to the payee. According to the *North Am.* court, however, before a bank can assert the mitigation doctrine to this situation, it must show that the payee accepted the return of the instrument or resumed dominion and control over it.[72]

So, by the end of the nineteenth century, a payee could recover in conversion against a bank that had paid over a forged indorsement. Except in the case of brokers, liability in conversion was virtually strict, and, absent a showing of mitigation, the payee was entitled to recover the face value of the instrument converted.

B. *Money Had and Received*

As noted above, the traditional common law theory available to the payee was conversion. Many courts, however, also gave the payee the option of electing to sue the collecting or depositary bank in contract for money had and received.[73] In *Allen v. M.*

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68 *Id.*

69 *Id.* at 258-59, 119 N.E. at 663.

70 Good Roads Mach. Co. v. Broadway Bank, 267 S.W. 40 (Mo. Ct. App. 1924).

71 75 N.Y. 547.

72 *Id.* at 564. In the *Bank of North Am.* case, the court ultimately denied the bank's claim of mitigation on the ground that the state had taken the drafts back only to use them as evidence at trial and not to reassert them as negotiable instruments. *Id.*

73 *See, e.g.*, Atlanta & St. B. Ry. v. Barnes, 96 F.2d 18 (5th Cir. 1938); Buena Vista Oil Co. v. Park Bank, 39 Cal. App. 710, 180 P. 12 (Cal. Dist. Ct. App. 1919); E. Moch Co. v. Security Bank, 176 App. Div. 842, 163 N.Y.S. 277 (N.Y. App. Div. 1917). At that time, however, a small minority of courts maintained that the com-

Mendelsohn & Son,[74] a payee brought an action for money had and received against a business[75] that had accepted, paid over, and then collected upon a check bearing the payee's forged indorsement.[76] In upholding the payee's right to sue in assumpsit, the Alabama Supreme Court explained that, where one person has money that by equity and right belongs to another, the person entitled to the money may recover it in an action for money had and received.[77]

1. Payee's standing to sue for money had and received

In order to successfully elect a suit for money had and received, the payee was required to show some sort of connection with the defendant bank. In the normal case of payment over a forged indorsement, the payee and the collecting bank were strangers.[78] Hence, the traditional privity of contract required for the maintenance of a contractually based action did not exist between the payee and the bank. In an effort to preserve the payee's right to sue in contract, the courts discovered an alternative means for creating the required privity. In *United States Portland Cement Co. v. United States Nat'l Bank*,[79] the Colorado Supreme Court considered an action for money had and received brought by a cement company as the payee of a check that had been cashed by a collecting bank over a forgery of the cement company's indorsement.[80] The payee had no relationship with the

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mon law did not give the payee the option to sue for money had and received. *See* Tibby Bros. Glass Co. v. Farmers' & Mechanics' Bank, 220 Pa. 1, 69 A. 280 (1908), *overruled in*, Lindsley v. First Nat'l Bank, 325 Pa. 393, 395-96, 190 A. 876, 878 (1937). *See also* Comment, *Depositary Bank Liability Under § 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676, 677-78, 683-84 (1974).

The right to waive the tort action and to elect to sue in assumpsit was recognized by the English common law as early as 1677. Arris & Arris v. Stukely, 86 Eng. Rep. 1060 (Ex. 1677). *See also* 89 Eng. Rep. 354, 358 (K.B. 1678).

74 207 Ala. 527, 93 So. 416 (1922).

75 *Id.* at 527, 93 So. at 416-17. Although the defendant in this case was a merchandiser rather than a bank, the rationale the court gave was generally applicable at that time to all actions in assumpsit for money had and received, including those brought against depositary or collecting banks. *See id.*

76 *Id.*

77 *Id.* According to the *Allen* court, the owner may recover unless there has been a contractual alteration of the general liability. *Id.*

78 *See, e.g., id.*

79 61 Colo. 334, 157 P. 202 (1916).

80 *Id.* at 336, 157 P. at 202-03.

defendant bank. The Colorado Court nevertheless upheld the payee's right to bring an action for money had and received on the ground that the payee could choose to ratify the collecting bank's acceptance and collection of the check.[81] This ratification became the requisite connection between the payee and the bank.[82]

2. Elements of payee's *prima facie* case for money had and received

A payee who gained standing to sue in contract by ratifying the bank's acceptance and collection was then required to make a *prima facie* case for money had and received. This was done by showing that the payee had title, possession, or a right to possession in a negotiable instrument or the money equivalent thereof. The payee who could show clear title to the instrument in question could easily satisfy this first element. In *Merchants' Bank v. Nat'l Capital Press, Inc.*,[83] a business brought an action for money had and received against a bank that had cashed checks, which were made payable to and actually received by the business, over unauthorized indorsements made by the business' bookkeeper.[84] The Court of Appeals for the District of Columbia maintained that the checks were clearly the property of the business when they were presented to the bank, since the payee's title to those checks could not be defeated by the forged indorsement.[85]

A more difficult task faced the payee who had not succeeded in gaining possession of the checks upon which his indorsement was ultimately forged.[86] This task did not, however, prove to be insurmountable. In *Allen v. M. Mendelsohn & Son*,[87] a payee attempted to recover in contract for payment over a check made

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81 *Id.* This ratification did not, however, extend to the bank's payment to a person other than the payee. *Id.* at 338-39, 157 P. at 204.

82 As the court explained in *Allen*, 207 Ala. 527, 93 So. 416, 417 (1922), "the law itself creates the privity and the promise" required for the maintenance of an action in assumpsit for money had and received. 207 Ala. at 527, 93 So. at 417.

83 288 F. 265 (D.C. Cir. 1923).

84 *Id.* at 265-66.

85 *Id.* at 266.

86 For a discussion of the problems that such a payee faced if he elected to sue in conversion, see *supra* text accompanying notes 33-43.

87 207 Ala. 527, 93 So. 416.

payable to, but never received by the payee.[88] The question was whether the fact that the check failed to reach the hands of the payee was fatal to the payee's recovery.[89] In answering this question in the negative, the court explained that, in electing to ratify the bank's acceptance and collection of the check, the payee had in effect elected to ratify the delivery of the check to the wrongdoer.[90] With the ratification of that delivery, the payee thus gained a right to possession of the check.[91]

The payee who could satisfy the possessory element of money had and received was then required to demonstrate that in paying over a forged indorsement on an instrument, the bank had and received money to the payee's benefit. This element was explored in *United States Portland Cement Co. v. United States Nat'l Bank*,[92] in which the court considered the contractual liability of a bank that had cashed a check over the forged indorsement of the cement company payee. The court reviewed the effect of the payee's election to sue in contract by electing to ratify certain portions of the bank's actions.[93] According to the court, when a payee elected to ratify a bank's acceptance of a check bearing a forged indorsement, the payee also elected to ratify any subsequent collection that the bank may have made on the check.[94] Upon the successful completion of the ratified collection process, the bank would then hold the proceeds collected on the check for the benefit of the payee.[95] The payee would therefore be entitled to recover those proceeds in an action for money had and received.[96]

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88 *Id.*

89 *Id.* at 528, 93 So. at 417.

90 *Id.*

91 *Id.*; *but see* Burson v. Huntington, 21 Mich. 415 (1870) (holding that a payee could not maintain an action in assumpsit absent delivery of the instrument in question).

92 61 Colo. 334, 157 P. 202 (1916).

93 *Id.* at 338-39, 157 P. at 203.

94 *Id.* 338-39, 157 P. at 204.

95 *Id.*

96 *Id.* at 339, 157 P. at 204. A few courts, however, further required the payee to show that the bank was unjustly enriched as a result of the transaction in question. As the Supreme Court of Minnesota explained in Erickson v. Borchardt, 177 Minn. 381, 225 N.W. 145 (1929), "[t]he purpose of the action for money had and received is to compel the restitution of ill-gotten gains." *See also* Soderlin v. Marquette Nat'l Bank, 214 Minn. 408, 8 N.W.2d 331 (1943). Perhaps this sentiment helped lay the

3. Damages

A payee who showed he had standing to sue in contract and who succeeded in making his *prima facie* case for money had and received was then entitled to receive damages for his loss. As a basic principle, the payee was entitled to recover the amount of money that the collecting bank had actually had and received to the payee's benefit.[97] This amount was generally found to be the face value of the checks in question.[98]

So, by the end of the first few decades of the twentieth century, the common law had clearly confirmed and defined the payee's right to recover, either in tort for conversion or in contract for money had and received,[99] against the bank that had paid over the payee's forged indorsement.

III. Negotiable Instruments Law

When the Negotiable Instruments Law[100] (hereinafter "NIL") appeared on the American scene at the beginning of the twentieth century,[101] it did not contain an express codification of the payee's common law right to recover in tort or in contract from a collecting or depositary bank that had paid over the

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groundwork for the "proceeds remaining" language in section 3-419(3). See *infra* text accompanying notes 311-398.

97 *See* Merchants' Bank v. National Capital Press, Inc., 53 App. D.C. 59, 288 F. 265 (D.C. Cir. 1923).

98 *See* United States Portland Cement Co. v. United States Nat'l Bank, 61 Colo. 334, 157 P. 202 (1916).

99 Several cases also offered a third option for recovery: a suit in equity for an accounting, based upon a constructive trust imposed upon the bank. *See* Atlanta & St. A.B. Ry. v. Barnes, 96 F.2d 18 (5th Cir. 1938); National Union Bank v. Miller Rubber Co., 148 Md. 449, 129 A. 688 (1925).

100 According to the court in First Nat'l Bank v. Goldberg, 340 Pa. 337, 343, 17 A.2d 377, 380 (1941), "[t]he purpose of the Negotiable Instruments Law is to enhance the marketability of such securities and to allow bankers, brokers and people generally to trade them with confidence."

101 The Negotiable Instruments Law ("NIL") was promulgated in 1896 by the National Conference of Commissioners on Uniform State Laws. Schnader, *A Short History of the Preparation and Enactment of the Uniform Commercial Code*, 22 U. MIAMI L. REV. 1 (1967). By 1940, the NIL had been adopted by all of the states and other American jurisdictions. *Id.* By that time, the NIL had already become outdated, due to wholesale "judicial amendments" and changing commercial patents. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 1, at 3 (1980). Thus, by 1940, the National Conference was considering a major revision of the NIL. This revision was ultimately subsumed into the promulgation of Articles 3 and 4 of the Uniform Commercial Code. *Id.* at 3-6.

payee's forged indorsement. In apparent satisfaction with the existing common law scheme, the courts strove to construe the provisions of NIL in a manner that would preserve the payee's right to sue either in conversion or for money had and received.

A. *Conversion*

1. Source of cause of action

In their search for a source within the Negotiable Instruments Law to sustain a payee's action in conversion, courts came to rely primarily on section 23 of NIL.[102] This section provided that an unauthorized or forged indorsement would be inoperative and ineffective in transferring title to an instrument unless the person whose name was signed was precluded from denying the signature's authority.[103] Section 23 was expressly referred to in *Harry H. White Lumber Co. v. Crocker-Citizens Nat'l Bank*.[104] In that case, a lumber materials supplier sued a bank that cashed, for a roofing subcontractor, a check that had been made payable to both the supplier and the subcontractor and upon which the subcontractor had forged the supplier's indorsement.[105] The California Court of Appeals noted that, under section 23, a

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102 N.I.L. § 23.

103 The full text of section 23 read as follows:

> When a signature is forged or made without authority of the person whose signature it purports to be, it is wholly inoperative, and no right to retain the instrument, or to give a discharge therefor, or to enforce payment thereof against any party thereto, can be acquired through or under such signature, unless the party against whom it is sought to enforce such right is precluded from setting up the forgery for want of authority.

(quoted in Harry H. White Lumber Co. v. Crocker-Citizens Nat'l Bank, 253 Cal. App. 2d 368, 372, 61 Cal. Rptr. 381, 384 (1967).

Section 23 was the predecessor of UNIFORM COMMERCIAL CODE § 3-404 (1987 Official Text with Comments) ("U.C.C." or "Code"), which provides:

> (1) 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.
>
> (2) Any unauthorized signature may be ratified for all purposes of this Article. Such ratification does not of itself affect any rights of the person ratifying against the actual signer.

104 253 Cal. App. 2d 368, 61 Cal. Rptr. 381.

105 *Id.* at 370-71, 61 Cal. Rptr. at 382-83.

forged indorsement was wholly inoperative.[106] Because such an indorsement had no effect, it could not be used to transfer title to another party, including a collecting or depositary bank. The *White Lumber* court reasoned, under NIL,[107] that a collecting bank would be liable in conversion,[108] to a payee if the bank paid over the forged indorsement of that payee.[109]

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106 *Id.* The court construed section 23 in conjunction with the provisions of NIL section 41, which provided that:

> Where an instrument is payable to the order of two or more payees or indorsees who are not partners, all must indorse, unless the one indorsing has authority to indorse for the others.

(quoted in *White*, 253 Cal. App. at 373, 61 Cal. Rptr. at 384).

107 *Id.*; *see also* Fabricon Products v. United California Bank, 264 Cal. App. 2d 113, 70 Cal. Rptr. 50 (1968); Teas v. Third Nat'l Bank & Trust Co., 125 N.J. Eq. 224, 4 A.2d 64 (N.J. 1939); *cf.* Hoffman v. First Nat'l Bank, 299 Ill. App. 290, 20 N.E.2d 121 (1939).

Previously sections 33 and 44 of the Negotiable Instruments Law were also cited as sources of the payee's right to use in conversion. In Wilton Manors Nat'l Bank v. Adobe Brick and Supply Co., 232 So. 2d 29 (Fla. Dist. Ct. App. 1970), a materials supplier sued a collecting bank that had accepted for deposit into a plastering company's account a check that was made payable to both the supplier and the plasterer but that was indorsed by the plasterer only.

At the outset, the Florida Fourth District Court of Appeals noted that, although the Uniform Commercial Code was in effect at the time this appeal was heard, all of the pertinent transactions had occurred prior to the Code's January 1, 1967 effective date. The appellate court therefore determined that the case was governed by the *Florida Negotiable Instruments Law*, F.S.A. § 674.01 et seq. (1965). Under sections 33 and 44 of the NIL (F.S.A. §§ 674.33 and 674.44, respectively), a negotiable instrument payable to the order of several named payees could be transferred without the indorsement of all of the payees only where the indorsing payee had authority to indorse for the others. In this case, however, the plasterer did not have authority to indorse for the supplier. Hence, when the collecting bank took the check without the supplier's indorsement, the bank did not acquire good title to it. When the collecting bank then made the proceeds available to the plasterer, the bank thus deprived the supplier of its interest in the check. As a result, the collecting bank was liable in conversion to the supplier for the value of its interest in the check. 232 So. 2d at 30-32.

108 The *White* court also acknowledged that the joint payee in this situation could elect to sue in contract for money had and received. *White*, 253 Cal. App. at 375-76, 61 Cal. Rptr. at 385-86. For a discussion of this election under the NIL, see *infra* text accompanying notes 121-126.

109 *White*, 253 Cal. App. 2d at 375-76, 61 Cal. Rptr. at 385-86. In keeping with one line of common law thinking (see *supra* text accompanying notes 33-39), some courts refused to allow a payee to sue in conversion in the absence of actual possession on the part of the payee. In People ex rel. Nelson v. Kaspar Am. State Bank, 364 Ill. 121, 4 N.E.2d 14 (1936), an engineer brought an action for conversion against a bank that had accepted and negotiated over a forged indorsement a check that had been made payable to the engineer, but that the engineer had never received. On appeal, the bank argued that, because the engineer had never gained

2. Defenses available

As had been the case with decisions reached under the aegis of the common law, cases determined under the rubric of NIL tended to frown upon the use of contributory negligence as an affirmative defense to a payee's action for conversion.[110] In *Crahe v. Mercantile Trust & Sav. Bank*,[111] a joint payee sued a drawee bank[112] for paying on a check that lacked the joint payee's indorsement.[113]

In determining that the provisions of NIL would not permit a collecting bank to raise the contributory negligence of the payee, the court cited approvingly to the traditional common law prohibition of this defense in actions upon commercial paper.[114]

Courts construing NIL, however, held that it maintained the common law broker exception.[115] In *Gruntal v. National Surety Co.*,[116] the New York Court of Appeals considered the liability of a stockbrokerage firm that had innocently procured a sale of stolen bonds.[117] The court explained that a broker who accepted negotiable bonds or securities on behalf of his customer served

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possession of the check, an action in conversion would not lie. In holding that the payee's claim was indeed barred by lack of possession, the Supreme Court of Illinois pointed to NIL section 16, which provides that a negotiable instrument is not effective until delivered. *See also* Slattery & Co. v. Nat'l City Bank, 114 Misc. 48, 186 N.Y.S. 679 (1920).

110 For a collection of cases that discuss the defenses available under the NIL, see Annotation, *supra* note 44.

111 295 Ill. 375, 129 N.E. 120 (1920).

112 *Id.* at 376, 129 N.E. at 120. Although this action was maintained against the drawee rather than the depositary or collecting bank, its holding on the availability of contributory negligence as an affirmative defense spoke to all payee actions in conversion under the NIL, without regard to the type of bank named as defendant. *Id.*

113 *Id.*

114 *Id.* at 379-80, 121 N.E. at 121-22. In support of this proposition, the court cited to Shepard & Morse Lumber Co. v. Eldridge, 171 Mass. 516, 51 N.E. 9 (1898). See also *supra* text accompanying notes 52-55.

Estoppel, however, apparently was available. *See* Crahe, 295 Ill. at 379-80, 121 N.E. at 121-22; *see also* Slattery & Company v. Nat'l City Bank, 114 Misc. Rep. 48, 186 N.Y.S. 679 (Municipal Court 1920); *infra* text accompanying notes 127-133 (discussing availability under NIL § 23 of the affirmative defense of estoppel).

115 *See supra* text accompanying notes 60-67; *see also* Comment, *Depositary Bank Liability Under 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676, 680-82 (1974).

116 254 N.Y. 468, 173 N.E. 682 (1930).

117 *Id.* at 470-71, 173 N.E. at 682-83.

merely as a conduit between the seller and the purchaser.[118] Further, since negotiable bonds and securities had passed freely upon delivery, the broker who dealt with them would not have the benefit of the warning that indorsements could provide to those dealing with other negotiable instruments.[119] The court found that public policy would not be served by imposing liability in conversion on a bond or securities broker who was merely acting as an agent for his customer.[120]

B. *Money Had and Received*

1. Source of cause of action.

Courts likewise found that section 23 of NIL supported the payee's action in assumpsit for money had and received. In *Mackey-Woodard, Inc. v. Citizens Bank*,[121] a corporation sued a bank that had accepted for deposit into the personal account of the corporation's president a check made payable to the corporation.[122] In determining whether the plaintiff corporation was entitled to the protection of Kansas' three-year statute of limitations for contractual actions, the Supreme Court of Kansas noted that section 23 negated attempts to transfer title to a negotiable instrument through a forged or inoperative indorsement.[123] In the case at bar, the defendant collecting bank did not acquire title to the check in question because the unauthorized indorsement made by the corporation's president was a nullity.[124] The collecting bank was therefore in wrongful possession of the check and,

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118 *Id.* at 474, 173 N.E. at 684. The court did not find significant the fact that a broker generally received a commission for serving as such a conduit. *Id.* at 470, 173 N.E. at 684. See *supra* note 67 for a discussion of the effect at common law of a broker's commission on the availability of the broker's exemption.

119 *Gruntal*, 254 N.Y. at 475, 173 N.E. at 684.

120 *Id.*; *see also* First Nat'l Bank v. Goldberg, 340 Pa. 337, 17 A.2d 377 (1941), in which a bank brought an action for conversion against a securities broker who had innocently dealt with bearer bonds that had previously been stolen from the plaintiff bank. In absolving the defendant, the Supreme Court of Pennsylvania explained that the very purpose of the Negotiable Instruments Law would be defeated if liability were to be imposed upon an innocent broker who mistakenly but in good faith dealt with stolen bonds in ordinary market channels. *Id.*

121 197 Kan. 536, 419 P.2d 847 (1966).

122 *Id.* at 539, 419 P.2d at 850.

123 *Id.* at 542, 419 P.2d at 852.

124 U.C.C. § 3-419.

as a result, held it in equity and good conscience for the payee.[125] The payee could then, at its option, ratify the collection by the bank and proceed against the bank in assumpsit for money had and received.[126]

2. Defenses available

In permitting the payee to sue under section 23 of NIL in contract for money had and received, however, the courts also had to consider the estoppel defense that section 23 expressly recognized.[127] In *Lindsley v. First National Bank of Philadelphia*,[128] a partnership brought an action for money had and received against a bank that had accepted for deposit into a personal account checks made payable to the partnership.[129] On appeal, the court first noted that section 23 did indeed authorize the payee to elect an action in contract against the collecting bank that had

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125 Echoing the common law approach, the *Mackey-Woodard* court explained that the bank's holding of the check for the payee creates a privity between the collecting bank and the payee. *Id.* at 543, 411 P.2d at 853; *see also supra*, text accompanying notes 29-32.

126 *Id.*; *see also* Lindsley v. First Nat'l Bank, 325 Pa. 393, 190 A. 876 (1937); Schaap v. State Nat'l Bank, 137 Ark. 251, 208 S.W. 309 (1918) (confirming the payee's right to ratify the collection and thereby elect to sue for money had and received).

At least one court was asked to consider whether, in the face of NIL section 210, a payee could maintain an action for money had and received. In Independent Oil Men's Ass'n v. Fort Dearborn Nat'l Bank, 311 Ill. 278, 142 N.E. 458 (1924), the Illinois Supreme Court was presented with an action for money had and received brought by an association against a bank that had accepted for deposit checks that bore the association's unauthorized indorsement. On appeal, the bank argued that the payee's action was barred under NIL section 210, which provided that "[a] check of itself does not operate as an assignment of any part of the funds to the credit of the drawer with the bank, and the bank is not liable to the holder, unless and until it accepts or certifies the check." *Id.* at 280, 142 N.E. at 459 (quoting NIL, ILL. REV. STAT. ch. 98, § 210 (Smith-Hurd Rev. 1972)). The court agreed that, under section 210, the payee in possession of a check could not, prior to acceptance of the check, sue a bank that refused to pay the check on demand. Further, if a check was paid over a forged indorsement there would not be a legally binding acceptance of and collection on the check. A payee who elected to sue in contract would do so by ratifying both the acceptance and the collection of the check. The court thus reasoned that section 210 was not a barrier to the payee's action in assumpsit. *Id.* at 280-81, 142 N.E. at 459.

127 See *supra*, text accompanying notes 56-59 for a discussion of this defense under the common law.

128 325 Pa. 393, 190 A. 876 (1937).

129 *Id.*

paid over its forged indorsement.[130] The *Lindsley* court then acknowledged that section 23 qualified the payee's right to recover by stating that no right should pass by indorsement "unless the party against whom it is sought to enforce such right is precluded from setting up the forgery or want of authority."[131] Although the *Lindsley* court ultimately found that the facts of that case did not justify such a preclusion,[132] the court did recognize that, under section 23, a collecting bank could raise the affirmative defense of estoppel against a payee suing in contract for money had and received.[133]

During the first half of the twentieth century, then, both the American common law and the Negotiable Instruments Law confirmed and preserved the payee's traditional right to maintain an action in either conversion or money had and received against a depositary or collecting bank that paid over a forged indorsement. This structure, which allocated the risk of loss to the bank, made both legal and practical sense. First, as the party that usually dealt directly with the wrongdoer, the bank was in the best position to avoid the loss before it occurred. Second, a bank's wealth rendered it better able to absorb losses than most individual and many institutional payees. Finally, direct suit promoted judicial efficiency and convenience.

IV. Legislative History

It was against the backdrop created by the common law and the Negotiable Instruments Law that, in the late 1940s, the drafters of the Uniform Commercial Code evaluated the right of a payee to sue a collecting or depositary bank that had paid over a

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130 *Id.*, 190 A. at 878. In so holding, the court expressly overruled *Tibby*. *Id.* at 398, 190 A. at 879.

131 *Id.* at 397, 190 A. at 878 (quoting NIL § 23).

132 *Id.* at 399-400, 190 A. at 880. In so holding, the court explained that it could find no evidence that, at the time that the forgeries in question occurred, the payee owed a duty to the collecting bank. Absent such a duty, the court could find no breach that would support a claim of negligence on the part of the payee. *Id.*

133 *Id.* at 399, 190 A. at 880 The *Lindsley* court did not expressly address the application of the estoppel defense to an action for conversion brought under the aegis of section 23. There is nothing in the *Lindsley* opinion, however, that suggests that estoppel would not be equally applicable to an action for conversion under section 23. *See also* Coffin v. Fidelity-Philadelphia Trust Co., 374 Pa. 378, 97 A.2d 857 (1953).

forged indorsement. The drafters approached the issue in a piecemeal fashion. Conversion of checks first appeared in the Code in the context of a drawee who dishonors an instrument and then intentionally fails to return it to the holder on demand.[134] No attempt was made at that time to enlarge upon the types of acts that would constitute conversion under the Code.

The Code's first apparent attempt to expand the list of actionable conversions can be found in tentative draft number 4.[135] Section 512 of that draft provided that "[a]n instrument is converted when . . . it is paid on a forged indorsement."[136] In addressing the status of payment over a forged indorsement, the drafters formally recognized the common law rule that such a payment did not constitute an acceptance.[137] The drafters, however, also cited with approval the common law rule that such a payment did constitute an exercise of dominion and control rising to the level of conversion.[138]

From that point forward, payment over a forged indorse-

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134 *See* U.C.C. § 82 (Draft No. 2, October 1946). According to the comments that accompanied this draft, section 82 was intended to replace the original section 137, which had not addressed the question of drawee liability for refusing to return a bill on demand. The drafters therefore included the definition of conversion in section 82 in recognition of the holder's need for immediate recourse in the face of destruction or withholding of the bill.

In a refrain that became a familiar tag to later drafts of the code, the comments to section 82 confirmed that liability for conversion should be equal to the value of the instrument. And, in what may have been an attempt to dispel any beliefs that privity would still be required, the comments further suggested that a holder should not be required to first sue the maker or drawer before recovery could be had against the drawee.

Section 82 became section 83 in Tentative Draft no. 2, dated April 25, 1947. Again, the only type of conversion named was failure of the drawee to return a bill on demand. In addition to the points discussed above, the comments to section 83 analogized to previous case law concerning maker liability for conversion. These comments further recognized that, upon conversion by the drawee, the holder could elect to sue either on the instrument for money had and received or in tort for conversion. As the comments noted, such an election would be important primarily in regard to the running of the statute of limitations.

135 U.C.C. § 512 (Draft No. 4, February 20, 1948). *See* KELLY, UNIFORM COMMERCIAL CODE DRAFTS at 45-110 (1984) [hereinafter KELLY].

136 The comments accompanying this section explain that "[t]his section now covers in addition the right of a party whose indorsement is forged against the party who pays and takes up the instrument under the forged indorsement." *Notes and Comments to Tentative Draft No. 4 — Article III*, at 33.

137 U.C.C. § 512 comments (Tentative Draft No. 4, February 20, 1948).

138 *Id.*

ment was consistently included by the Code drafters in the categories of acts that would constitute conversion. Even though the drafters decided to recognize officially that conversion would lie for payment over a forged indorsement, they immediately began to chip away at the cause of action. The April 1948 draft included a new section stating "[a] representative who in good faith has dealt with an instrument or its proceeds is not liable for conversion even though his principal was not the owner of the instrument."[139] The comments to the Code suggest that this section was originally added to recognize the line of cases that absolved from liability for conversion a broker who sold a negotiable instrument for and turned over the proceeds to his principal.[140]

Beginning in March 1950, the sections defining conversion and representative liability were merged.[141] In addition, the scope of the representative's immunity was redefined in two ways. First, a representative was expressly defined to include a depositary bank;[142] second, the liability was limited to proceeds remaining in the representative's hands.[143]

The comments to this version of representative liability indicate that this language was again merely intended to affirm the existing rule on broker liability.[144] Other sources suggest that this new language was added in an attempt to appease the banking community by expanding the traditional broker rule to ab-

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139 U.C.C. § 427 (Proposed Revision of Tentative Draft No. 2, April 1948). In exempting a bank that acted in good faith, the drafters seemed to have had an eye toward the definition of good faith in Article 2, which is "honesty in fact." U.C.C. § 2-103.

140 U.C.C. § 3-427 comment (Draft, May 1949). *See also* McDonnell, *The Rapid Decline of Privity in the Modern Law of Commercial Paper*, 30 BUS. LAW. 203 (1974) [hereinafter McDonnell].

141 U.C.C. § 3-419 (Draft, March 1, 1950) in KELLY, *supra* note 135, vol. IX, at 308.

142 *Id.*

143 *Id.* The full text of this version of the section reads: "A representative, including a depositary bank, who has in good faith dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands." *Id.*

144 U.C.C. § 3-419 comment 5 (Proposed Final Draft, Spring 1950), in KELLY, *supra* note 135, vol. X, at 398. See *supra* text accompanying notes 60-67 and 115-120 for a discussion of the broker exception under the common law and NIL, respectively.

solve depositary banks.[145]

The definition of representative liability was further refined in the spring of 1951, such that "representative" was expressly expanded to include not only a depositary bank but also a collect-

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[145] McDonnell, *supra* note 140, at 220 n.80 (citing to correspondence of Soia Mentschikoff and Milbank, Tweed, Hope & Hadley). According to J.B. McDonnell, the Code drafters eventually decided to move away from the narrow broker's rule toward a broader rule that was to work in tandem with the negligence provisions of U.C.C. section 3-406. *Id.* See also *infra* text accompanying notes 452-485 for a discussion of the relationship that has actually developed between sections 3-406 and 3-419(3). *See also* WHITE & SUMMERS, *supra* note 101, § 15-4 at 593; MCDONNELL, *Bank Liability for Fraudulent Checks: the Clash of the Utilitarian and Paternalistic Creeds Under the Uniform Commercial Code*, 73 GEO. L.J. 1399, 1402, 1413 (1985); Note, *Cooper v. Union Bank: California Protects the True Owner Against a Forged Indorsement Despite Uniform Commercial Code Section 3-419(3)*, 25 HASTINGS L.J. 715, 724-25 (1974) [hereinafter *California Protects the True Owner*].

Although the drafters did not in their comments make reference to English law, it is possible that they were also influenced by certain statutory changes in banker liability that occurred earlier, and were continuing to occur in the English law of banking. During the nineteenth century, the English Parliament introduced a series of statutes culminating in section 60 of the Bills of Exchange Act of 1882. This Act absolved from liability a banker who "in good faith and in the ordinary course of business," paid a bill, payable to order or on demand, that bore a forged indorsement. See *supra* text accompanying notes 16-21 for a discussion of this development. *See also* Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334, 353 (1952) for a similar suggestion as to the interrelationship between the Bills of Exchange Act and the U.C.C.

In keeping with its traditional pro-bank bias, and perhaps with an eye toward the changes with which the drafters of the U.C.C. were then experimenting, Parliament extended protection to collecting banks through the vehicle of section 4 of the Cheques Act of 1957. See Taxation Comm'rs v. English, Scottish and Australian Bank, Ltd., [1920] L.R. 683, as cited in 5 HALSBURY'S STATUTES, *Bills of Exchange* at 402 (4th ed. 1985). The courts that have construed this "ordinary course of business" standard have tended to reach results very similar to the American courts that have construed the "reasonable commercial standards" language in section 3-419(3). *See* 3 HALSBURY'S LAWS OF ENGLAND, *Banking* § 103 at 79 (4th ed. 1973). This position conforms with the Continental system, which similarly absolves a transferee that holds an instrument in good faith and without gross negligence. *See California Protects True Owners*, *supra*, at 717.

The drafters of the Uniform Commercial Code surely must have been aware of both the above-described changes in the English law of banking and the existing Continental scheme. Similarly, the drafters of section 4 of the English Cheques Act of 1957 were clearly familiar with the Continental system and must certainly have been aware of the large-scale revision of American commercial law that was underway during the late 1940's and the 1950's. It is possible that the drafters of the Uniform Commercial Code and the Parliamentarian drafters responsible for the Cheques Act of 1957 consulted, and perhaps even borrowed from, each other's codification and revision activities.

ing bank.[146] To be exempt from liability, such a representative was required to deal with an instrument in good faith and "in accordance with the reasonable commercial standards applicable to the business of such representative."[147] Despite the inclusion of this additional language, the comments to section 3-419 again indicate that the section on representative liability was intended to do no more than to mirror the existing rule on broker liability.[148] It clearly extended protection to collecting banks, which were not covered under the original broker rule.[149] In addition, this rule moved even further beyond the common law by adopting a standard of liability tied to commercial standards.[150] The definition of representative liability underwent one final revision in 1955, when language was added to that section making it subject to other Code provisions concerning restrictive indorsements.[151]

When the code was eventually presented in its official form in 1962, section 3-419 ultimately read as follows:

> Section 3-419. Conversion of Instrument; Innocent Representative.
>
> (1) An instrument is converted when

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146 U.C.C. § 3-419(3) (Proposed Final Draft No. 2, Spring 1951), in KELLY, *supra* note 135, vol. XII, at 142.

147 *Id.*

148 *See, e.g.*, U.C.C. § 3-419 comment 5 (Official Draft 1952), in KELLY, *supra* note 135, vol. XIV, at 387. The language of this comment is virtually identical to the language used in comment 5 to the current edition of the code.

Although the Official Comments to the Code ignore the changes made by the text of section 3-419(3), comments that accompany the various versions of section 3-419(3) adopted by several states are more honest about the effect of this section on common law rules. *See, e.g.*, ILL. ANN. STAT. ch. 26 § 3-419 Illinois Code Comment (Smith-Hurd 1972) at 328, where subsection (3) is described as changing the rule of prior Illinois law, which had held a collecting bank liable for payment over a forged indorsement despite that the bank had no proceeds remaining.

149 See *supra* text accompanying notes 60-68 and 115-120.

150 As discussed *supra* note 145, the "good faith" and "reasonable standards of the business" language of section 3-419(3) finds a certain parallel in the "good faith," "ordinary course of business," and "without negligence," language of section 60 of the Bills of Exchange Act of 1882 and section 4 of the Cheques Act of 1957.

151 U.C.C. § 3-419(3) (Supplement No. 1 to the 1952 Official Draft, January 1955). The referenced Code provisions concerning restrictive indorsement include sections 3-205 (definition of restrictive indorsement) and 3-206 (effect of restrictive indorsement).

(a) a drawee to whom it is delivered for acceptance refuses to return it on demand; or

(b) any person to whom it is delivered for payment refuses on demand either to pay or to return it; or

(c) it is paid on a forged indorsement.

(2) In an action against a drawee under subsection (1) the measure of the drawee's liability is the face amount of the instrument. In any other action under subsection (1) the measure of liability is presumed to be the face amount of the instrument.

(3) Subject to the provisions of this Act concerning restrictive indorsements, a representative, including a depositary or collecting bank, who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.

(4) An intermediary bank or payor bank which is not a depositary bank is not liable in conversion solely by reason of the fact that proceeds of an item indorsed restrictively (Sections 3-205 and 3-206) are not paid or applied consistently with the restrictive indorsement of an indorser other than its immediate transferor.[152]

In agreeing to this final version of section 3-419, the drafters ostensibly intended to reflect the existing common law rules concerning conversion and broker liability. In yielding to pressure from the banking industry, the drafters apparently settled, knowingly or not, for language that could seriously curtail the liability of a collecting or depositary bank that pays over a forged indorsement.

V. Interpretation of Section 3-419

Shortly after the adoption of the Uniform Commercial Code, the courts were faced with the unhappy task of interpreting the murky text of section 3-419,[153] with its checkered legislative past

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[152] The final draft of section 3-419 appeared in 1962. U.C.C. § 3-419 (Official Draft, Uniform Commercial Code, 1962), in KELLY, *supra* note 135, vol. XXIII, at 98-101.

[153] When referring to section 3-419, White and Summers describe it as "a haphazard (critics might even say half-ass) codification of conversion liability." WHITE & SUMMERS, *supra* note 101, § 15-4 at 585.

and express language that conflicts with long-standing American legal tradition.[154] From the very start, the courts struggled with the complexity of this task. Surprisingly, despite the express language of the statute, the courts have come to construe section 3-419 in a manner that, for the most part, preserves the payee's traditional right to bring an action, in tort or in contract, against a depositary or collecting bank that pays over a forged indorsement.

Although the courts have not always been consistent in their view of section 3-419,[155] certain basic guidelines concerning the operation of this section can nevertheless be identified.

A. *Payee's Prima Facie Case*

1. Payee's standing to sue under section 3-419(1)(c)

Section 3-419(1)(c) expressly authorizes suit against a drawee bank.[156] This section does not, however, expressly authorize a payee to sue directly a depositary[157] or collecting[158] bank that pays on a forged indorsement. Nevertheless, the courts uniformly have followed the common law's lead on this question and have acknowledged that section 3-419 impliedly, if not expressly, permits a payee to proceed directly against the collecting or depositary bank[159] that first dealt with the

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154 *See supra* text accompanying notes 22-133.

155 According to White and Summers, "the courts have taken up section 3-419(3), and what they have done to it shouldn't happen to a dog." WHITE & SUMMERS, *supra* note 101, § 15-4 at 591.

156 Section 3-419(1) provides:

> (1) An instrument is converted when
>
> (a) a drawee to whom it is delivered for acceptance refuses to return it on demand; or
>
> . . .
>
> (c) it is paid on a forged indorsement.

157 Under section 4-105(a), a depositary bank is defined as "the first bank to which an item is transferred for collection even though it is also the payor bank."

158 Section 4-105(d) defines a collecting bank as "any bank handling the item for collection except a payor bank."

159 Section 3-419(1) does not expressly address the liability of a depositary or collecting bank. Courts and commentators, however, have routinely implied that such a bank is a proper defendant under that section. *See* Bullitt County Bank v. Publishers Printing Co., 684 S.W.2d 289 (Ky. Ct. App. 1984); Hinchey, *An Analysis of Bank Defenses to Check Forgery and Alteration Claims under Uniform Commercial Code Articles 3 and 4: Claimants' Negligence and Failure to Give Notice*, 10 PEPPERDINE L. REV. 1, 3, 5 (1982). *See also* Dugan, *Stolen Checks—The Payee's Predicament*, 53 B.U.L. REV.

wrongdoer.[160]

2. Elements of cause of action

In keeping with common law tradition, courts generally have recognized that section 3-419 authorizes a payee to sue a depositary or collecting bank either in tort for conversion or in contract for money had and received.[161]

955, 965-70, where the author suggested that, although the direct cause of action is recognized under section 3-419(3), it is actually founded on principles outside the Code, presumably in pre-Code common law.

160 *See, e.g.*, Harry H. White Lumber Co. v. Crocker-Citizens Nat'l Bank, 253 Cal. App. 2d 368, 61 Cal. Rptr. 381 (Cal. Ct. App. 1967); Continental Casualty Co. v. Huron Valley Nat'l Bank, 85 Mich. App. 319, 271 N.W.2d 218 (1978); Grieshaber v. Michigan Nat'l Bank, 18 U.C.C. Rep. Serv. (Callaghan) 1248 (Mich. C.P. 1976).

An interesting analysis of the payee's standing to sue under section 3-419 is found in Lincoln Nat'l Bank & Trust Co. v. Bank of Commerce, 764 F.2d 392 (5th Cir. 1985). Where the collecting bank which cashed stolen checks claimed that Louisiana law precluded the payee, and thus the payee's subrogees, from suing a collecting bank. The court noted that, in contrast to the common law, pre-Code Louisiana civil law did indeed preclude a payee from suing a depositary or collecting bank that paid over a forged indorsement. *Id.* at 395 (citing Smith v. Louisiana Bank & Trust Co., 272 So. 2d 678 (La. 1973)). The court was convinced that section 3-419(1), which Louisiana adopted in 1975, provides the payee with a cause of action against the depositary and collecting banks that still retain proceeds or that fail to meet reasonable commercial standards. According to the court, this was true despite the fact that, in adopting section 3-419, the Louisiana legislature deleted the phrase "in conversion or otherwise" from section 3-419(1). This deletion, the court explained, was made solely to reflect the fact that the civil law does not recognize conversion. Ultimately, the court confirmed both the payee's right to sue directly and the bank's right to raise the affirmative defense of good faith and reasonableness. *Id.* at 395-99. *See also* Top Crop Seed & Supply Co. v. Bank of Southwest Louisiana, 457 So. 2d 273 (La. App. 1984).

161 *See, e.g.*, National Sur. Corp. v. Citizens State Bank, 41 Colo. App. 580, 593 P.2d 362 (1979), *aff'd*, 199 Colo. 497, 612 P.2d 70 (1980). In that case, certain employees of Dayco Corporation forged indorsements on checks payable to Dayco and then deposited the checks into their personal accounts at Citizens State Bank. National Surety Corporation indemnified Dayco for part of the loss and thereby became subrogated to Dayco's rights concerning the forgeries. Dayco sued Citizens State Bank in conversion, for money had and received, and for breach of warranty. The trial court dismissed all three counts for failure to state a claim, and the plaintiffs appealed.

On appeal, the Colorado Supreme Court considered the bank's claim that section 3-419(3) abolished the payee's right to sue in either conversion or for money had and received. According to the Colorado court, section 3-419(3) clearly was not intended to abolish the payee's right to sue for conversion of checks paid over a forged indorsement. The court maintained that section 3-419(3) was simply intended to establish an affirmative defense for a collecting or depositary bank that was sued for paying over a forged indorsement. the court also noted that section 3-

a. *Action for conversion.*

As had previously been true under both the common law and the Negotiable Instruments Law, under section 3-419, a payee choosing to sue in conversion must meet his initial burden of proof[162] by showing:

(1) Title to, possession of or right to possession of a check;
(2) The payee's forged, unauthorized or missing indorsement on the check; and
(3) The depositary or collecting bank's unauthorized payment of the check.[163]

(1) Title to, possession of or a right to possession of a check

As discussed above,[164] at common law, a payee could recover in conversion if he showed title to, possession of or a right to possession of an instrument that was paid over a forged indorsement.[165] Relying on the traditional rules applicable to negotiable instruments, some courts have held that section 3-

419(3) speaks of liability in conversion or otherwise. *Id.* at 383, 593 P.2d at 365. The latter phrase has meaning only if the drafters anticipated the continued viability of a cause of action other than conversion. Money had and received is clearly such an action. The *Citizens* court was therefore convinced that the payee could sue the bank either *ex delictu* for conversion or *ex contractu* for money had and received. *Id.*; *see also* Crockford v. Merchants Nat'l Bank, 132 Misc. 2d 959, 505 N.Y.S.2d 525 (1986); Knesz v. Central Jersey Bank and Trust Co., 97 N.J. 1, 477 A.2d 806 (1983); Lawrence, *Misconceptions about Article 3 of the Uniform Commercial Code: A Suggested Methodology and Proposed Revisions*, 62 N.C.L. REV. 115, 137, 138 (1983); *but see* D & G Equip. Co. v. First Nat'l Bank, 764 F.2d 950 (3d Cir. 1985) (where the court, applying Pennsylvania law, suggested that section 3-419 was intended to replace, not to supplement, the available common law forms of action).

162 *See* Top Crop Seed & Supply Co. v. Bank of Southwest La., 457 So. 2d 279 (La. 1984). In that case, a seed company brought an action for conversion against a bank that cashed for the company's vice president checks made payable to Top Crop and that bore an unauthorized corporate indorsement made by the vice president. The Louisiana Court of Appeals held that the seed company had stated a cause of action against the collecting bank under section 3-419(1). *Id.*

For a like summary of the proof required to meet the plaintiff payee's initial burden of proof, *see* Yeager and Sullivan, Inc. v. Farmers Bank, 162 Ind. App. 15, 317 N.E.2d 792 (1974).

163 For cases that summarize the elements of the payee's *prima facie* case for conversion under section 3-419(1), *see* Burks Drywall, Inc. v. Washington Bank & Trust Co., 110 Ill. App. 3d 569, 442 N.E.2d 648 (1982); Yeager and Sullivan, Inc. v. Farmers Bank, 162 Ind. App. 15, 317 N.E.2d 792 (Ind. Ct. App. 1974).

164 See *supra* text accompanying notes 33-39.

165 For a discussion of the meaning of "forgery" within the context of section 3-419(1), see *infra* text accompanying notes 192-220.

419(1)(c) requires the payee to allege and prove actual possession of the checks in question. In *City Nat'l Bank of Miami, N.A. v. Wernick*,[166] for example, a woman claimed that, as the named payee on certain checks, she had a right to possess those checks and therefore had a right to sue for conversion of the checks.[167] The *Wernick* court maintained that delivery of a negotiable instrument is indispensable to its effectiveness.[168] The payee thus acquires no rights prior to delivery.[169] The *Wernick* court determined that absent such rights, a payee cannot maintain an action for conversion.[170]

A similar position was taken by a federal court applying Louisiana law in *Lincoln Nat'l Bank & Trust Co. v. Bank of Commerce*.[171] The Court of Appeals for the Fifth Circuit examined the rights of the subrogees of a payee whose indorsement had been forged on checks that the payee had never received, and indeed, for many years had not even known about.[172] The *Lincoln* court believed that the Louisiana courts would deny recovery in this situation.[173] As the *Lincoln* court explained, to allow a payee to sue under section 3-419 as the true owner of a check when he never had possession of that check would directly conflict with the well-established rule that a payee does not become a holder of an instrument until he gains possession thereof.[174] The *Lincoln* court further explained that the permission of such an action would recognize in the payee rights where he previously had none apart

166 368 So. 2d 934 (Fla. Dist. Ct. App. 1979), *cert. denied*, 378 So. 2d 350 (Fla. 1979).

167 *Id.* at 935-36.

168 *Id.* at 936.

169 *Id.*

170 *Id.* It must be noted that in *Wernick*, the check never left the possession of the maker. Thus, the holding in this case may be restricted to those cases where the maker does not part with possession. *But see* Winn v. First Bank, 581 S.W.2d 21 (Ky. App. 1978), where a mother drew a check payable to one of her son's creditors and then delivered the check to her son. On appeal, the Kentucky Court of Appeals upheld the trial court's grant of summary judgment in favor of Citizens. According to the appellate court, absent physical delivery, a payee does not have standing to sue, because he does not have a substantial interest in the check under litigation. *Id.* at 22-23.

171 764 F.2d 392 (5th Cir. 1985).

172 *Id.* at 393-95.

173 *Id.* at 397.

174 *Id.*

from the underlying obligation represented by the check.[175]

As a general rule, however, most courts have permitted a payee to sue where he can at least show constructive possession of the check under litigation. In *Humberto Decorators, Inc. v. Plaza Nat'l Bank*,[176] a collecting bank paid over a cashier's check that had been delivered to the payee's debtor.[177] The court noted that the drawer of that check had intended to transfer title to the payee creating an enforceable obligation when the bank surrendered control of the check to the debtor as agent for the payee.[178] Thus, once the check had been constructively delivered to the payee through the debtor, the ownership rights in the check vested in the payee. The payee therefore had standing to sue.[179]

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[175] *Id.* at 398; *see also* Winn v. First Bank, 581 S.W.2d 21 (Ky. App. 1978). The *Lincoln* court also cited with approval to WHITE & SUMMERS, *supra* note 101, § 15-4 at 588, where the co-authors maintain that practical considerations may likewise dictate the result reached here. *Lincoln*, 764 F.2d at 396. White and Summers believe that, where the payee has never gained possession of the check, the forgery is likely to be the result of negligence on the part of the drawer. WHITE & SUMMERS, *supra* note 101, § 15-4, at 588. Such negligence, they maintain, could not be easily litigated in a direct suit under section 3-419 between the payee and the depositary, collecting or drawee bank. *Id.*

[176] 180 N.J. Super. 170, 434 A.2d 618 (1981).

[177] *Id.* at 173, 434 A.2d at 619.

[178] *Id.* at 174, 434 A.2d at 620. In support of its conclusion that the debtor was acting as an agent for the payee, the court noted that (1) in lieu of the promissory notes called for by the original contract, Humberto had agreed to wait for the proceeds of the SBA loan; (2) by submitting a statement of indebtedness to Plaza National, Humberto assisted Tango in its loan application; and (3) Humberto looked to Tice for delivery of Humberto's share of the loan proceeds. *Id.* at 174-75, 434 A.2d at 620.

[179] *Id.* at 175, 434 A.2d at 620; *see also* Justus Co. v. Gary Wheaton Bank, 509 F. Supp. 103 (N.D. Ill. 1981) (where the court, applying Illinois law, noted that constructive delivery would suffice but did not, for procedural reasons, determine whether constructive delivery had occurred on the facts of the case before it); State v. Barclays Bank, 141 A.D.2d 19, 546 N.Y.S.2d 479 (1989), *appeal granted*, 75 N.Y.2d 704, 552 N.Y.S.2d 927, 552 N.E.2d 175 (1990) (where the New York Supreme Court, Appellate Division, recently adopted the rule requiring actual or constructive delivery).

Note also that, in denying recovery under the facts of the case before it, the *Lincoln* court cautioned that actual physical possession at the time of suit is not required. *Lincoln*, 764 F.2d at 398. Rather, the payee may also recover on a showing of constructive delivery. The *Lincoln* court explained that this rule is required to cover those situations in which one joint payee forges the indorsement of the other joint payee. *Id.* Courts generally have held that delivery to one joint payee constitutes constructive delivery to all joint payees. *See* Trust Co. of Columbus v. Refrigeration Supplies, Inc., 241 Ga. 406, 246 S.E.2d 282 (1978); Cook v. Great

Some courts have even suggested that the delivery requirement should be eliminated altogether. The court in *Thornton & Co. v. Gwinnett Bank & Trust Co.*,[180] considered an action for conversion brought by an insurance company whose indorsement had been forged on a check that the company had never had in its possession.[181] The court conceded that, since the check had never been delivered to the company, the company could not technically qualify as a "holder."[182] Nevertheless, the court was convinced that the insurance company, as the named payee on an instrument drawn to its order, had property rights in the instrument. The court therefore stated that the inclusion of the payee's name on the check gave it a right to possession sufficient to maintain an action for conversion.[183]

A similar conclusion was reached in *Lund v. Chemical Bank*,[184] where the unfairness of the "actual possession" rule was emphasized by the United States District Court for the Southern District of New York. In that case, payees brought an action for conversion against a drawee bank[185] that had paid checks bearing indorsements that had been forged in connection with a massive securities fraud.[186] The *Lund* court pointed out that section 3-419 envisions that the bank will be held liable for payment over a forged indorsement.[187] The purpose of this section would be defeated if a payee were denied recovery simply because he had not

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Western Bank & Trust, 141 Ariz. 80, 685 P.2d 145 (1984); Note, *A Co-Payee Has a Cause of Action in Conversion Against Both the Collecting and the Payor Banks for Payment of a Check Over His Missing Endorsement, Despite the Co-Payee's Lack of a Proprietary Interest in the Proceeds*, 13 GA. L. REV. 677 (1978-79). Occasionally, courts have held that the joint payee does not have the level of possession required to support an action for conversion. See the dissent in *Trust Co. of Columbus*, 241 Ga. 406, 246 S.E.2d 282.

180 151 Ga. App. 641, 260 S.E.2d 765 (Ga. Ct. App. 1979).

181 *Id.* at 641-42, 260 S.E.2d at 766.

182 *Id.* at 643, 260 S.E.2d at 767.

183 *Id.*

184 665 F. Supp. 218 (S.D.N.Y. 1987), *rev'd in part on other grounds*, 870 F.2d 840 (2d Cir. 1989).

185 As has been shown *supra* at text accompanying notes 156-160, section 3-419(1) has been construed to apply equally to all actions brought by payees, regardless of whether the defendant is a drawee, depositary or collecting bank. Thus, the fact that the defendant in Lund was a drawee bank does not make its holding on the question of possession any less applicable to cases where the payee instead chooses to sue the depositary or collecting bank.

186 *Lund*, 665 F. Supp. at 220-21.

187 *Id.* at 226.

received possession of the check.[188] Furthermore, a clear inequity would be created if a payee who had momentarily received possession could sue while one who had not been able to gain possession could not.[189] The court, therefore, held that delivery is not required as a condition precedent for recovery under section 3-419.[190]

So, the courts have failed to reach a clear resolution on the degree of possession required of a payee who wishes to maintain an action for conversion under section 3-419(1)(c). Because the Code does require "delivery" in order for a payee to become a holder, by right, delivery of some sort should also be required before a payee can maintain an action under section 3-419(1)(c). Actual possession, however, is too harsh a requirement, particularly for the payee whose check has been stolen before he ever had an opportunity to get possession of it. A better construction of section 3-419(1)(c) is that a named payee may sue whenever the drawer has relinquished control of the check.

(2) The payee's forged, missing, or unauthorized indorsement on the check

Section 3-419(1)(c) provides "an instrument is converted when . . . it is paid over a forged indorsement."[191] The Code does not define "forgery."[192] Courts construing section 3-419(1)(c) have, however, offered their own definitions. In *Salsman v. National Community Bank*,[193] a bank accepted for deposit

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188 *Id.*

189 *Id.*

190 *Id.*

191 U.C.C. § 3-419(1)(c).

192 The Code twice defines "unauthorized" indorsements or signatures to include forgeries. Section 1-201(43) states that an "[u]nauthorized signature or indorsement means one made without actual, implied, or apparent authority and includes a forgery." Similarly, Comment 1 to section 3-404 provides that an unauthorized indorsement "includes both a forgery and a signature made by an agent exceeding his actual or apparent authority." *See also* D & G Equip. v. First Nat'l Bank, 764 F.2d 950 (3d Cir. 1985) (applying Pennsylvania law). Given their apparent preference for the broader term "unauthorized," one wonders why the Code drafters chose, without explanation, to use the narrower term "forged" in section 3-419(1)(c). In any event, as the discussion, *infra*, indicates, when construing section 3-419, the courts have generally treated "forged" and "unauthorized" as interchangeable terms.

193 102 N.J. Super. 482, 246 A.2d 162 (Law Div. 1968), *aff'd*, 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969).

a check made payable to a widow, where the widow had specially indorsed the check to the order of the estate of her late husband. Her attorney then, without her knowledge or permission, indorsed the check first for deposit into the estate and then for deposit into his general attorney trustee account.[194] In determining whether the attorney's actions amounted to forgery under section 3-419(a)(c), the court opted for what it termed the "broad" definition of forgery.[195] According to this definition, a forgery consists of the false making of a "writing, which, if genuine, might apparently be of legal efficacy."[196] The court ultimately found that the attorney's acts did constitute a forgery actionable under the provisions of section 3-419(1)(c).[197]

Section 3-419(1)(c) has been also construed to govern missing indorsements. In *Humberto Decorators, Inc. v. Plaza Nat'l Bank*,[198] a collecting bank paid over a cashier's check that lacked the indorsement of the decorating company which had been named as payee.[199] The *Humberto* court acknowledged that section 3-419(1)(c) does not expressly address payment over a miss-

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194 *Id.* at 486-88, 246 A.2d at 164-66.

195 *Id.* at 492-93, 246 A.2d at 167-68.

196 *Id.* at 496, 246 A.2d at 170. This definition dates back to at least 1790. *See* Mead v. Young, 100 Eng. Rep. 876 (1790). A similar description can be found in Brady on Bank Checks. That traditional source of banking law defines the elements of a forgery as:

(1) a false making or alteration of an instrument in writing,
(2) a fraudulent intent,
(3) a writing that, if genuine, might apparently be of legal efficacy or the foundation of legal liability.

H. BAILY, BRADY ON BANK CHECKS; THE LAW OF BANK CHECKS § 25.2 at 25-3 (6th ed. 1987).

The "narrow" definition to which the *Salsman* court referred provides that a forgery is "the false making or alteration of an instrument with intent to defraud so as to make it appear to be that of one other than the person making it." 102 N.J. Super. at 496, 246 A.2d at 170.

197 *Id.*, at 496, 246 A.2d at 170. The *Salsman* court's definition, which describes an unauthorized indorsement as a type of forged indorsement, is thus the converse of the Code's definition, which defines a forged indorsement as a type of unauthorized indorsement. *See supra* note 192. The *Salsman* decision therefore gives further illustration of the interchangeable nature that "forged" and "unauthorized" have come to achieve. *See also* Equipment Distribs., Inc. v. Charter Oak Bank and Trust Co., 34 Conn. Supp. 606, 379 A.2d 682 (1977), where the court stated that "an unauthorized endorsement and a forged endorsement are one and the same." 34 Conn. Supp. at 608, 379 A.2d at 684.

198 180 N.J. Super. 170, 434 A.2d 618 (1981).

199 *Id.* at 172-73, 434 A.2d at 618-19.

ing indorsement.[200] The court also noted that section 1-103 expressly preserves the principles of law and equity, including the law merchants, unless these principles are displaced by particular provisions of the Code.[201] The *Humberto* court then pointed to the common law, which, for the purpose of conversion, treated payment over no indorsement in the same manner as it treated payment over a forged indorsement.[202] Since the Code had not expressly displaced this common law principle, the court held that, under the Code, payment over a missing indorsement is equivalent to payment over a forged indorsement and therefore constitutes a conversion under section 3-419(1).[203]

Payment over a missing indorsement was also evaluated in *Mid-Atlantic Tennis Courts, Inc. v. Citizens Bank and Trust Co.*[204] In that case, a tennis court company sued a collecting bank that had accepted for deposit into two accounts belonging to one of the company's salesmen some checks made payable to the company but which lacked the company's indorsement.[205] In determining whether the bank was liable for accepting checks lacking the company's indorsement, the *Tennis* court recognized that section 4-205(1)[206] does permit a depositary bank to take an item for col-

200 *Id.* at 174, 434 A.2d at 619.

201 *Id.*

202 *Id.* U.C.C. section 1-103 provides as follows:

> Supplementary General Principles of Law Applicable. Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

203 In support of this conclusion, the *Humberto* court cited to the following cases: FDIC v. Marine Nat'l Bank, 431 F.2d 341 (5th Cir. 1970) (applying Florida law); Gillespie v. Riley Management Corp., 59 Ill.2d 211, 319 N.E.2d 753 (1974); Peoples Nat'l Bank v. American Fidelity Fire Ins. Co., 39 Md. App. 614, 386 A.2d 1254 (1978); Berkheimer's Inc. v. Citizens Valley Bank, 270 Or. 807, 529 P.2d 903 (1974). *Humberto*, 180 N.J. Super. at 174, 434 A.2d at 619.

204 658 F. Supp. 140 (D. Md. 1987) (applying Maryland law).

205 *Id.* at 141-42.

206 Section 4-205(1) provides:

> A depositary bank which has taken an item for collection may supply any indorsement of the customer which is necessary to title unless the item contains the words "payee's indorsement required" or the like. In the absence of such a requirement a statement placed on the item by the depositary bank to the effect that the item was deposited by a customer or credited to his account is effective as the customer's indorsement.

lection and to supply on that item any indorsement of its customer that is necessary to establish title. Since the tennis court company was not a customer of the defendant bank, the bank was not privileged to supply missing indorsements for the company.[207] The bank could not become a holder in its own right of the checks because the checks still lacked the required indorsement.[208] Thus, when the bank paid the proceeds over to the employee, the bank converted the checks.[209]

A similar conclusion, once again based in the common law, has been reached on the question: Whether an action for conversion under section 3-419(1) can be maintained for payment over an unauthorized indorsement.[210] The court in *Salsman v. National Community Bank*[211] considered an attorney's unauthorized indorsement of a check made payable to one of his clients.[212] The *Salsman* court admitted that section 3-419(1)(c) does not expressly address indorsements other than those that are forged.[213]

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207 *Midlantic Tennis Courts*, 658 F. Supp. at 143.

208 *Id.*

209 *Id.* A like result was reached in Great Am. Ins. Co. v. American State Bank, 385 N.W.2d 460 (N.D. 1986), where a bank had accepted for deposit an insurance settlement draft that bore the indorsement of only one of the two named payees. As the Supreme Court of North Dakota explained, "the absence of an endorsement presents a more compelling case for conversion than a forged endorsement because a missing endorsement is easily discernible while a forged endorsement is the result of an error in the identification of a payee." *Id.* at 462.

For other cases that confirm the payee's right to maintain an action for conversion under section 3-419(1) based upon payment over a missing indorsement, see, e.g., Boyer v. First Nat'l Bank, 476 N.E.2d 895, 899 (Ind. Ct. App. 1985); Yeager and Sullivan, Inc. v. Farmers Bank, 162 Ind. App. 15, 17, 317 N.E.2d 792, 794 (1974); Peoples Nat'l Bank v. American Fidelity Fire Ins. Co., 39 Md. App. 614, 386 A.2d 1254 (1978); Ames v. Great Southern Bank, 672 S.W.2d 447 (Tex. 1984).

But see the dissent in Trust Co. v. Refrigeration Supplies, Inc., 241 Ga. 406, 246 S.E.2d 282 (1978), where the dissent maintained that the plain meaning of section 3-419(1)(c) restricts its scope to payment over a forged indorsement. The dissent in *Trust Company* did, however, acknowledge that payment over a missing indorsement can form the basis for a common law action in conversion. *Id.* 241 Ga. at 411, 246 S.E.2d at 285.

210 See *supra* note 192 for a discussion of the Code definition of "unauthorized" indorsements or signatures. *See also* Annotation, *Payee's Right to Recovery In Conversion Under UCC 3-149(1)(c), For Money Paid On Unauthorized Indorsement*, 23 A.L.R.4th 855 (1983).

211 102 N.J. Super. 482, 246 A.2d 162 (Law Div. 1968), *aff'd*, 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969).

212 *Id.* at 486-87, 246 A.2d at 164-66.

213 *Id.* at 493, 245 A.2d at 168.

The court maintained, however, that the Code's specific enumeration of acts constituting conversion was not intended to be exclusive but rather was intended to be supplemented by the general principles of law preserved by section 1-103.[214] The *Salsman* court therefore held that the use of the word "forgery" in section 3-419(1) does not preclude a finding of conversion based upon payment over an unauthorized indorsement.[215]

A similar result was also reached in *Smith v. General Casualty Co.*.[216] In that case, a joint payee sued a bank that had paid on a check that bore payee's unauthorized indorsement.[217] In upholding the payee's right to sue under section 3-419(1)(c), the *General Casualty* court maintained that an unauthorized indorsement does constitute a forgery.[218] As the court explained, liability under this section should not be "cut short merely because the converter's stylus is directed by the hand of an unscrupulous attorney or agent."[219]

Under section 3-419(1), then, a payee may meet the second element of a *prima facie* case for conversion by showing a missing, forged or unauthorized indorsement.[220]

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214 In support of this principle, the court cited to 1 ANDERSON'S UNIFORM COMMERCIAL CODE § 3-419.3 at 688 (1961). *Salsman*, 102 N.J. Super. at 492-93, 246 A.2d at 168.

215 *Id.*, at 492, 246 A.2d at 168. The *Salsman* rationale on unauthorized indorsements was cited with approval in Aetna Casualty and Sur. Co. v. Hepler State Bank, 6 Kan. App. 2d 543, 630 P.2d 721 (1981).

216 75 Ill. App. 3d 971, 394 N.E.2d 804 (1979).

217 *Id.* at 972, 394 N.E.2d at 805-06.

218 *Id.* at 974, 394 N.E.2d at 807. In support of this proposition, the court cited to Crahe v. Mercantile Trust & Sav. Bank, 295 Ill. 375, 129 N.E. 120 (1920) which was decided under the provisions of the Negotiable Instruments Law. *See supra* text accompanying notes 111-114.

219 *Smith*, 75 Ill. App. at 973, 394 N.E.2d at 806; *see also* First City Nat'l Bank v. FDIC, 782 F.2d 1344 (5th Cir. 1986) (applying Texas law), where the Fifth Circuit Court of Appeals considered the liability of a bank that accepted for deposit into an oil business' employee's trust account checks that were made payable to the owner of the business and that bore the unauthorized indorsement of the owner. *First City*, 782 F.2d at 1347. On appeal, the Fifth Circuit Court of Appeal concluded that, despite the facially restrictive language of section 3-419(1)(c), payment over an unauthorized indorsement likewise constitutes conversion under section 3-419. *Id.* at 1349; *see also* Equipment Distribs., Inc. v. Charter Oak Bank and Trust Co., 34 Conn. Supp. 606, 379 A.2d 682 (1977).

220 *But see* Berkheimers, Inc. v. Citizens Valley Bank, 270 Or. 807, 529 P.2d 903 (1974), where the court maintained that, since section 3-419(1) does not expressly address payment over a missing indorsement, an action based upon a missing indorsement should by right be maintained under section 1-103.

(3) The depositary or collecting bank's unauthorized payment of the check

In keeping with principles of the common law and the Negotiable Instruments Law, in order to meet his *prima facie* case under section 3-419(1)(c), a payee must show that the depositary or collecting bank converted the payee's check by making an unauthorized "payment." Although the Code does not define "payment," the courts have tended to construe the term broadly in the context of section 3-419(1)(c).[221] In *Burks Drywall, Inc. v. Washington Bank and Trust Co.*,[222] two construction companies brought an action for conversion against a bank that had cashed several checks made payable to the companies but bore forgeries of the companies' indorsements.[223] In upholding the trial court's entry of summary judgment for the payees, the appellate court declared that the third element of the payees' *prima facie* case in conversion was satisfied when the payees showed that the collecting bank paid cash over a forged indorsement.[224]

Similarly, a bank has been held liable for conversion when it accepted for deposit a check bearing an unauthorized indorsement. In *Mott Grain Co. v. First Nat'l Bank & Trust Co.*,[225] a grain company sued a bank that had cashed or accepted for deposit some seventeen checks upon which the manager and co-owner of the company placed unauthorized indorsements.[226] The *Mott Grain* court took a broad approach to the language of section 3-419(1)(c) and held that a bank that negotiates checks bearing forged or unauthorized indorsements is liable in conversion to the true owner of the checks.[227]

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221 *See* Comment, *Forged Indorsements, Depositary Banks and the Defense of Section 3-419(3) of the Uniform Commercial Code*, 18 HOUS. L. REV. 173, 181 n.37 (1980) for a brief discussion of a strict and less strict construction of "payment" in section 3-419(1)(c).

222 110 Ill. App. 3d 569, 442 N.E.2d 648 (1982).

223 *Id.* at 570-71, 442 N.E.2d at 650.

224 *Id.* at 574, 442 N.E.2d at 653.

225 259 N.W.2d 667 (N.D. 1977).

226 *Id.* at 668-69.

227 *Id.* at 669; *see also* Central, Inc. v. Cache Nat'l Bank, 748 P.2d 351 (Colo. Ct. App. 1987); Trust Co. Bank of Augusta v. Henderson, 185 Ga. App. 367, 364 S.E.2d 289 (Ga. Ct. App. 1987), *aff'd*, 258 Ga. 703, 373 S.E.2d 738 (1988); *but see* Dugan, *Stolen Checks—The Payee's Predicament*, 53 B.U.L. REV. 955, 964 n.4 (1973), where the author suggests that a collecting bank does not "pay" on a forged instrument. According to that author, the early cases that permitted suit against a collect-

b. *Action for money had and received.*

Similarly, section 3-419(1)(c) has been construed to continue the common law tradition of permitting the payee to elect to sue in assumpsit for money had and received.[228] In the event of such an election, the payee must show a wrongful collection by the defendant bank, which the payee then ratified but which ultimately resulted in damages to the payee.[229] Section 3-419(1)(c), then, has been read to follow the common law approach of authorizing a payee to sue a depositary or collecting bank directly, in either tort or contract, for paying over an instrument bearing a "forgery" of the payee's indorsement.

B. *Defenses to Payee's Cause of Action*

The courts of the various states have reached a level of relative uniformity in regard to the salient elements of the payee's cause of action under section 3-419(1)(c). The courts have di-

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ing bank proceeded under pre-Code law through the savings provision of section 1-103. For a brief reference to cases making this distinction, *see also* Note, Cooper v. Union Bank, *supra* note 145, at 721-22 nn. 30,31. And see Franklin v. Safeco Ins. Co. of Am., 303 Or. 376, 737 P.2d 1231 (1987), where a payee sued a bank that had initially given provisional credit for a check bearing a forged indorsement and that had subsequently removed the provisional label when the checks successfully made it through the collection process.

In determining whether the bank had "paid" over a forged indorsement, the *Franklin* court examined a wide variety of scholarly sources before it reached the conclusion that a depositary bank is liable in conversion under section 3-419 if it actually pays an instrument in cash on a forged indorsement. *Franklin*, 303 Or. at 386, 737 P.2d at 1236-37 (citing 6 ANDERSON, UNIFORM COMMERCIAL CODE 421 (3d ed. 1984); 2 BAILY, OREGON UNIFORM COMMERCIAL CODE 157 (1984); Comment, *Forged Indorsements, Depositary Banks, and the Defense of Section 3-419(3) of the Uniform Commercial Code*, 18 HOUS. L. REV. 173 (1980)).

But where, as in the *Franklin* case, a bank has granted only provisional credit and has not permitted withdrawal until proceeds have been received from the drawee bank, the bank has not "paid" on the forged instrument, thus, the *Franklin* court held that the bank did not convert the check. *Franklin*, at 386-87, 737 P.2d at 1237. The *Franklin* court reasoned that the receipt of the proceeds from the drawee bank and the removal of the hold on the depositor's account would not constitute retroactive payment by the depositary bank but rather would amount to no more than the receipt of the funds previously paid by the drawer. *Id.*

228 For a discussion of the common law rule, *see supra* text accompanying notes 73-98. For a discussion of such an election under the code, see, *e.g.*, Ervin v. Dauphin Deposit Trust Co., 38 Pa. D. & C.2d 473, 3 U.C.C. Rep. Serv. (Callaghan) 311 (1965).

229 *See, e.g.*, O.K. Moving & Storage Co. v. Eglin Nat'l Bank, 363 So. 2d 160 (Fla. Dist. Ct. App. 1978).

verged, however, on the scope and meaning of the defenses available to this cause of action. This is true of both the defense that section 3-419(3) expressly enumerates and the defenses that the banks have found outside that subsection.

1. Defense enumerated in section 3-419(3).

Section 3-419(3) provides that:

> Subject to the provisions of this Act concerning restrictive indorsements,[230] a representative, including a depositary or collecting bank, who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.[231]

As previously shown,[232] the drafters of the code ostensibly intended this section to continue the existing scheme of liability for payment over a forged indorsement. This scheme held banks to virtual strict liability for such a payment.

A literal reading of section 3-419(3), however, would provide depositary and collecting banks with virtual immunity from liability

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230 Section 3-205 defines a restrictive indorsement as an indorsement that either:
(a) is conditional; or
(b) purports to prohibit further transfer of the instrument; or
(c) includes the words "for collection," "for deposit," "pay any bank," or like terms signifying a purpose of deposit or collection; or
(d) otherwise states that it is for the benefit or use of the indorser or of another person.

U.C.C. § 3-205. Section 3-206 then describes the effect of a restrictive indorsement. Such an indorsement does not prevent further transfer or negotiation of the instrument. An intermediate bank or a payor bank that is not the depositary bank is not bound by the terms of a restrictive indorsement unless such an indorsement is made by the bank's immediate transferor. U.C.C. § 3-206(2). Any transferee other than such an intermediate bank must act in accordance with the terms of the restrictive indorsement. U.C.C. § 3-206(3). The first taker under a restrictive indorsement who pays value and who acts consistently with the terms of the indorsement becomes a holder for value of the instrument. U.C.C. § 3-206(4). Such a taker may become a holder in due course if he fulfills the requirements of section 3-302. The requirements are that he pays value and acts in good faith and without notice that the instrument is overdue, has been dishonored, or is subject to defenses against or claims to it on the part of any person. U.C.C. § 3-302.

231 U.C.C. § 3-419(3).

232 See *supra* text accompanying note 144.

for such payment.[233] In recognition of this dichotomy, some courts have taken a creative approach to interpreting section 3-419(3). In taking this approach, these courts have focused on the terms "representative," "proceeds remaining" and "adherence to reasonable commercials standards."

a. *"Representative" status and "proceeds remaining."*

(1) "Representative" status.

As demonstrated above,[234] the Code drafters intended section 3-419(3) to be a codification of the common law broker exception, which exempted from liability a broker who acted merely as an agent in the sale and purchase of negotiable instruments. In its final form, section 3-419(3) has gone far beyond the common law rule by apparently extending immunity to a depositary or collecting bank that has in any way, in a representative capacity, dealt with an instrument bearing a forged, missing or unauthorized indorsement.

The court in *Ervin v. Dauphin Deposit Trust Co.*[235] was one of the first courts to wrestle with the potential immunity created by the "representative" language of section 3-419(3). The Pennsylvania Court of Common Pleas considered the liability of a bank that paid over checks bearing forged indorsements.[236] The court acknowledged that the payee in this case would have been able to maintain his cause of action under both the common law and the Negotiable Instruments Law.[237] The *Ervin* court also recognized that the result would not necessarily be the same

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233 For an early assumption that section 3-419 would indeed provide a complete shield for depositary and collecting banks, *see* Comment, *Depositary Bank Liability Under 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676, 679 n.14 (1974).

234 See *supra* text accompanying note 144.

235 38 Pa. D. & C.2d 473, 3 U.C.C. Rep. Serv. (Callaghan) 311 (1965).

236 *Id.* at 476, 3 U.C.C. Rep. Serv. at 314.

237 *Id.* at 479-80, 3 U.C.C. Rep. Serv. at 316. Dauphin had demurred to Ervin's complaint, claiming it had no liability in contract. The Court of Common Pleas, however, confirmed the common law principle that a cause of action would lie in either tort or contract. *Id.* at 479-80, 3 U.C.C. Rep. Serv. at 314.

The Court of Common Pleas also confirmed that the facts as alleged would support a cause of action in tort under section 23 of the Negotiable Instruments Law, since a bank that honors checks has an absolute duty to pay only to the true payee or his order. (See *supra* text accompanying notes 102-120 for a discussion of a bank's liability in conversion under section 23.) Thus, the court concluded, under

under the innovations of the relatively new Uniform Commercial Code.[238]

The *Ervin* court therefore carefully approached the question of the bank's liability under the Code.[239] The court began by focusing on the wording of section 3-419(3), which had not yet construed by the court.[240] The court reasoned that section 3-419(3), by its express language, must apply to representatives.[241] The *Ervin* court further conceded, for the purposes of section 3-419(3), that "representative" does apparently include a depositary or a collecting bank.[242] The court did conclude that this "representative" status extends to a depositary or collecting bank only when it truly serves as a "representative."[243]

Under section 1-201(35), a person or entity serves as a "representative" when it acts as an agent or is empowered to act for another or when, in the terms of section 3-419(3), it deals with an instrument or proceeds on behalf of someone other than the true owner.[244] Nevertheless, the *Ervin* court was convinced that subsection (3) speaks to something entirely different from a bank's negotiating and honoring checks when it speaks of true "representative" status.[245] The court believed this conclusion was dictated by the fact that a bank that sends a check through the collection process will be liable under section 4-207 for any breach of its warranties on the check's indorsements.[246] The

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the principles of the NIL, Dauphin acted at its own peril when it paid the checks to someone other than Ervin. 38 Pa. D & C.2d at 477-78, 3 U.C.C. Rep. Serv. at 315.

238 *Id.* at 482-84, 3 U.C.C. Rep. Serv. at 318-19.

239 According to that court, section 3-404 of the Code, which protects a bona fide purchaser who takes and pays for a forged check, was not intended to alter the common law rights or the duties of the payee or the collecting bank. *Id.* at 479-80, 3 U.C.C. Rep. Serv. at 316.

240 *Id.* at 482, 3 U.C.C. Rep. Serv. at 318.

241 *Id.*

242 *Id.*

243 *Id.*

244 Section 1-201(35) provides:

> "Representative" includes an agent, an officer of a corporation or an association, and a trustee, executor or administrator of an estate, or any other person empowered to act for another.

245 *Ervin*, 38 Pa. D. & C.2d at 482-83, 3 U.C.C. Rep. Serv. at 318.

246 Section 4-207 provides:

> (1) Each . . . collecting bank who obtains payment or acceptance of an item . . . warrants to the payor bank . . . who in good faith pays or accepts the item that

court found such liability to be in direct conflict with the immunity seemingly provided by section 3-419(3).[247]

The *Ervin* court therefore believed that section 3-419(3) refers to the type of "representative" transaction covered by the common law broker rule rather than to the negotiating or honoring of a check.[248] As a result, the *Ervin* court decided that the immunity created under section 3-419(3) did not extend to the bank in the instant case, since in purchasing or cashing forged instruments drawn on other banks, the bank had engaged in the negotiation or honoring of checks.[249]

As might be expected, Pennsylvania courts initially attempted to adhere to the *Ervin* court's theory of "representative" status. In *Jones v. Commonwealth Bank & Trust Co.*,[250] the Pennsylvania Court of Common Pleas heard an action of conversion brought by a woman against a bank that had cashed a check, made payable to her, which bore her forged indorsement. Apparently, the woman's stepmother had forged the woman's signature

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(a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has good title; and
(b) he has no knowledge that the signature of the maker or drawer is unauthorized . . .
(c) the item has not been materially altered . . . .
(2) Each . . . collecting bank who transfers an item and receives a settlement or other consideration for it warrants to his transferee and to any subsequent collecting bank who takes the item in good faith that
(a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and
(b) all signatures are genuine or authorized; and
(c) the item has not been materially altered; and
(d) no defense of any party is good against him; and
(e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted item.
. . .

U.C.C. § 4-207. For a discussion of the interrelationship between the warranty provisions of sections 4-207 and 3-417, see WHITE & SUMMERS, *supra* note 101, § 15-5 at 600 n.47.

247 *Ervin*, 38 Pa. D. & C.2d at 483, 3 U.C.C. Rep. Serv. at 319.

248 *Id.* at 483, 3 U.C.C. Rep. Serv. at 319. The "something other" that the *Ervin* court thought section 3-419(3) referred to is apparently the traditional broker liability rule as embodied in First Nat'l Bank v. Goldberg, 340 Pa. 337, 17 A.2d 377 (1941).

249 *Id.*

250 71 Pa. D & C.2d 143, 19 U.C.C. Rep. Serv. (Callaghan) 1194 (Pa. Ct. C.P. 1976).

on the check and had presented the check to the cashing bank.[251] The *Jones* court recognized a problem with the *Ervin* theory.[252] That theory excludes banks engaged in the negotiation and honoring of checks.[253] Until the collection process is completed, section 4-201(1) presumes that a collecting bank is acting as an agent of the owner of the instrument.[254] The question in *Jones* thus became whether the defendant bank qualified as a collecting bank.[255]

The defendant bank in *Jones* clearly had acted as a depositary bank when it accepted the check in question. Under section 4-105(d),[256] a depositary bank is also a collecting bank, unless it is a payor bank. In *Jones*, since the defendant bank acted as a depositary but not a payor bank, it qualified as a collecting bank and therefore should have enjoyed the benefit of the presumption of agency created by section 4-201(1).

According to the *Jones* court, however, whether that presumption of agency should stand unrebutted is a question that should be decided on a case-by-case basis.[257] The court found this presumption to be rebutted by the fact that, when the defendant bank cashed the check, the bank became a holder in due course and the owner of the check.[258] When it attained that status, the bank thus ceased to be a collection agent or "representative."[259] Due to the court's belief that this reasoning was consistent with the *Ervin* rationale and did "no violence" to the presumption created by section 4-201(1), the court held that the plaintiff had stated a cause of action against the bank.[260]

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251 *Id.* at 144, 19 U.C.C. Rep. Serv. at 1194.

252 *Id.* at 145-47, 19 U.C.C. Rep. Serv. at 1195-96.

253 *Id.* at 146, 19 U.C.C. Rep. Serv. at 1196.

254 *Id.* at 147, 19 U.C.C. Rep. Serv. at 1196. Section 4-201(1) states that

> Unless a contrary intent clearly appears and prior to the time that a settlement given by a collecting bank for an item is or becomes final . . . the bank is an agent or sub-agent of the owner of the item and any settlement given for the item is provisional.

U.C.C. § 4-201(c).

255 *Jones*, 71 Pa. D. & C.2d at 147, 19 U.C.C. Rep. Serv. at 1196.

256 Under section 4-105(d), " '[c]ollecting bank' means any bank handling the item for collection except the payor bank." U.C.C. § 4-105(d).

257 *Jones*, 71 Pa. D. & C.2d at 146, 19 U.C.C. Rep. Serv. at 1196.

258 *Id.*

259 *See id.*

260 *Id.* at 147, 19 U.C.C. Rep. Serv. at 1196. Later Pennsylvania cases, however, have failed to comment further on the *Ervin* "representative" theory. The theory

Courts in some other jurisdictions initially embraced the "representative" theory.[261] In *Sherriff-Goslin Co. v. Cawood*,[262] a payee sued a depositary bank that had accepted some 300 checks bearing the payee's forged indorsement.[263] The court pointed out that, if the payee could not sue the depositary bank directly, the payee would have to sue either the various drawee banks[264] or the various drawers.[265] Thus, 300 actions might be required, while only one would be required under the *Ervin* approach to section 3-419(3).[266] The *Sherriff-Goslin* court decided to follow the *Ervin* approach and to deny immunity under section 3-419(3) to a depositary bank that deals with an instrument bearing a forged indorsement.[267]

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was apparently not even raised in Robinson Protective Alarm Co. v. Bolger & Picker, 337 Pa. Super. 503, 487 A.2d 373 (Pa. Super. Ct. 1985), *rev'd on other grounds*, 512 Pa. 116, 516 A.2d 299 (1986). Without even mentioning *Ervin*, the *Robinson* court simply assumed that section 3-419(3) shields a bank from liability when it acts according to reasonable commercial standards. *See also* D & G. Equip. v. First Nat'l Bank, 764 F.2d 950 (3d Cir. 1985), for another recent Pennsylvania decision that discusses reasonable commercial standards but that is also silent on the issue of "representative" status.

261 *See, e.g.*, Colonna and Co. v. Citibank, 105 Misc.2d 78, 431 N.Y.S.2d 750 (N.Y. Sup. Ct. 1980), *rev'd on other grounds*, 86 A.2d 789, 447 N.Y.S.2d 190 (1982).

262 91 Mich. App. 204, 283 N.W.2d 691 (1979).

263 *Id.* at 206, 210, 283 N.W.2d at 692, 693.

264 *Id.* at 209, 283 N.W.2d at 693-94. This action could be maintained under section 3-419(1)(c).

265 *Sherriff-Goslin*, 91 Mich. App. at 209, 283 N.W.2d at 693-94. This action could be maintained under section 3-804, which provides that "[t]he owner of an instrument which is lost, whether by destruction, theft or otherwise, may maintain an action in his own name and recover from any party liable thereon upon due proof of his ownership, the facts which prevent his production of the instrument and its terms." U.C.C. § 3-804.

266 The *Sherriff-Goslin* court further noted that under the warranty provisions of section 4-417, in the event that the payee succeeded in his actions against the drawee banks or the drawers, the drawee banks or drawers could in turn sue the depositary bank, as the first party to deal with the forger. *Sherriff-Goslin*, 91 Mich. App. at 209, 283 N.W.2d at 694.

267 *Id.* at 210, 283 N.W.2d at 694. As will be discussed *infra* text accompanying notes 355-56, the *Sherriff-Goslin* court also agreed with the *Ervin/Cooper* approach to "proceeds remaining."

A similar result was earlier reached on the Michigan trial court level in Grieshaber v. Michigan Nat'l Bank, 18 U.C.C. Rep. Serv. (Callaghan) 1248 (Mich Ct. C.P. 1976). That court was convinced that the drafters intended section 3-419(3) to extend no further than the common law broker exception that it purported to codify. *Id.* at 1253 (quoting R. Dugan, *Stolen Checks—The Payee's Predicament*, 53 B.U.L. REV. 955, 974 (1973)). But in the 1986 case of Walters v. Alden State Bank, 155 Mich. App. 29, 399 N.W.2d 432 (1986), the Court of Appeals of

The *Ervin* "representative" theory was not, however, immediately embraced by all courts. In *Jackson Vitrified China Co. v. People's Nat'l Bank*,[268] the "representative" theory was raised in an action for conversion brought by a china business against a depositary bank where the bank had accepted for deposit checks that had been stolen and fraudulently indorsed by an individual who had falsely represented himself as the sole proprietor of the china business.[269] In determining whether the china business had a direct cause of action against the depositary bank, the Florida Third District Court of Appeals first recognized that Comment 3[270] to section 3-419 does support the payee's right to bring an action for conversion against a depositary or collecting bank.[271] Despite its recognition of the payee's right, the *Jackson* court could not accept the *Ervin* "representative" theory as a method for preserving that right.[272] The *Jackson* court believed that, in striving to preserve the payee's traditional right, the *Ervin* court had reached a strained and artificial interpretation that runs contrary to the clear intent behind and the language of section 3-419(3).[273] The *Jackson* court maintained that the *Ervin* in-

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Michigan declined to follow *Sherriff-Goslin* "to the extent that [that case] is contrary to the plain language of the statute." *Id.* at 35, 399 N.W.2d at 435.

268 388 So. 2d 1059 (Fla. Dist. Ct. App. 1980).

269 *Id.* at 1059-60.

270 Comment 3 states:

> Subsection (1)(c) is new. It adopts the prevailing view of decisions holding that payment on a forged indorsement is not an acceptance, but that even though made in good faith it is an exercise of dominion and control over the instrument inconsistent with the rights of the owner, and results in liability for conversion.

U.C.C. § 3-419(3), comment 3.

271 *Jackson*, 388 So. 2d at 1060. As the *Sherriff-Goslin* court had done, the *Jackson* court also identified three other causes of action that were clearly available on the fact. First, the payee could sue the drawee bank under section 3-419(1). Second, the payee could sue the drawers of the stolen checks, who were the payee's customers, under section 3-804. Third, in the event of a suit, under section 4-401, the drawers would have a cause of action against their drawee banks for improper payment on the checks could proceed under sections 3-417(2) and 4-207 against the collecting bank for breach of warranties of presentment. *Id.* at 1060; *see also* Price v. Neal, 97 Eng. Rep. 871 (K.B. 1762) (underscoring the scant nature of the remedy against the forger; in that early case, the wrongdoer could not be sued because he had already been hanged for forgery).

272 *Jackson*, 388 So. 2d at 1061. As will be discussed *infra* text accompanying note 376-93, the *Jackson* court likewise rejected the "proceeds" theory, which was also developed by the *Ervin* court in an attempt to protect the payee's right to sue.

273 *Id.* at 1061.

terpretation would limit the section 3-419(3) defense to the period of time needed to effect collection.[274] Thus, once collection was completed, the defense would be lost because the bank would cease to act as an agent. The court felt that such a limitation would result in an unwanted "springing liability" for collecting banks.[275]

After rejecting the *Ervin* approach, the *Jackson* court tackled the question whether section 3-419(3) was intended to alter the payee's traditional right by immunizing banks that acted in good faith and according to reasonable commercial standards.[276] The *Jackson* court was convinced that the laws of commerce would be served if section 3-419(3) were eliminated from the code.[277] Indeed, the only possible benefit that the court could see in section 3-419(3) was to the banking community, which would be allowed to engage in whatever usual customer account resolution meth-

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274 *Id.*

275 *Jackson*, 388 So. 2d at 1061-62. In reaching this conclusion, the *Jackson* court was apparently attempting to analogize to springing executory interests, which "spring out" from the original transferor, thereby divesting a freehold estate in the transferor or his successors in interest. *Id.*; *see also* C. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY 191 (2d ed. 1988).

276 *Jackson*, 388 So. 2d at 1062. As the *Jackson* court pointed out, earlier Florida decisions had simply assumed that the defense enumerated in section 3-419(3) should be available to a depositary or collecting bank that acted in good faith and in accordance with reasonable commercial standards. *See, e.g.*, FDIC v. Marine Nat'l Bank, 431 F.2d 341 (5th Cir. 1970) (applying Florida law); Siegel Trading Co. v. Coral Ridge Nat'l Bank, 328 So. 2d 476 (Fla. Dist. Ct. App. 1976). The *Jackson* court did acknowledge that, in other jurisdictions, previous judicial application of section 3-419(3) had tended to prevent a depositary or collecting banks from relying on the section 3-419(3) defense on the ground that the bank had acted in bad faith or had engaged in commercially substandard behavior. *See, e.g.*, Salsman v. National Bank, 102 N.J. Super. 482, 246 A.2d 162 (Law Div. 1968), *aff'd* 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969); Belmar Trucking Corp. v. American Trust Co., 65 Misc. 2d 31, 316 N.Y.S.2d 247 (N.Y. Civ. Ct. 1970); *see also infra* text accompanying notes 399-464.

277 *Jackson*, 388 So.2d at 1063. The court reiterated the efficiency and convenience benefits that would result from a direct payee versus depositary or collecting bank suit. In addition, the court recognized the clear benefit that would result to Florida payees, since collecting banks are generally accessible in state courts. The court also underscored the scope of the increased litigation that would result from prohibiting a direct action. First, the number of payee suits would increase, since section 3-419(3) ostensibly requires as many actions as there are drawers and drawee banks. Second, to the extent that the drawees would choose not to absorb the loss or to negotiate a settlement, drawee suits would increase as drawees were forced in turn to sue collecting banks. *Id.*

ods it had developed for spreading risks.[278] The *Jackson* court therefore found section 3-419(3) to be "ill-conceived, as engendering a landslide of litigation inconsistent with the thrust of the Code toward simplification of commercial practice and remedy."[279]

The *Jackson* court found section 3-419(3) to be "the law" to which the court was bound to adhere[280] and upheld a depositary or collecting bank's right to take advantage of the defense provided by section 3-419(3).[281]

A similarly reluctant rejection of the *Ervin* "representative" theory is found in the opinion rendered by the Minnesota Supreme Court in *Denn v. First State Bank*.[282] In the *Denn* case, a sole shareholder of a business brought an action for conversion against a bank that had accepted for deposit two checks upon which an employee of the business had forged the business' indorsement.[283] In analyzing this case, the *Denn* court began by noting the "considerable controversy" that had been engendered by section 3-419(3).[284] In order to unravel the confusion that this controversial section had caused, the court determined from the section's legislative history[285] that the drafters did indeed intend to extend the broker exemption to depositary and collecting banks.[286] In making that determination, the court reluctantly[287]

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278 *Id.*

279 *Id.* at 1063; *see also* F.S.A. § 671.102(2)(a) (1975), U.C.C. § 1-202(2)(a) (1962).

280 *Jackson*, 388 So.2d at 1063. The *Jackson* court reached this conclusion in part by relying on the language of Comment 6 to section 3-419, which assures that

> [t]he provisions of this section are not intended to eliminate any liability on warranties of presentment and transfer (Section 3-417). Thus, a collecting bank might be liable to a drawee bank which had been subject to liability under this section, even though the collecting bank might not be liable directly to the owner of the instrument.

281 *Id.*

282 316 N.W.2d 532 (Minn. 1982).

283 *Id.* at 534.

284 *Id.*

285 *Id.* at 535; *see supra* text accompanying notes 134-152.

286 *Denn*, 316 N.W.2d at 535. The court found this support in Comment 5, which refers to "a representative such as a broker or depositary bank, who deals with a negotiable instrument for his principal," and Comment 6, which states that although a collecting bank might not be liable directly to the true owner, it might still be liable to a drawee bank that had been liable to the true owner under section 3-419(1)(c). *Denn*, 316 N.W.2d at 535.

287 *Id.* at 536. The *Denn* court cited with approval to Jackson Vitrified China v. People's Am. Nat'l Bank, 388 So. 2d 1059 (Fla. Dist. Ct. App. 1980), where the

rejected the *Ervin* logic, which the *Denn* court found persuasive.[288] The *Denn* court chose to follow the plain language of the section and the clear intent of the accompanying legislative history and comments.[289]

The *Ervin* approach ultimately lost when the two sides of the "representative" coin were juxtaposed in the decisions reached by the New Jersey Appellate Division and the New Jersey Supreme Court in *Knesz v. Central Jersey Bank and Trust Co.*.[290]

In *Knesz*, these two courts were faced with an action brought by the owner of a cooperative apartment against a bank that accepted for deposit into a law firm's trust account checks made payable to the apartment owner upon which a since-disbarred member of the firm had forged the owner's indorsement.[291] On appeal from the trial court's entry of judgment in favor of the bank, the Appellate Division denied the section 3-419(3) exemption to the defendant depositary bank.[292] The court reached this conclusion by equating "representative" status under section 3-419(3) with the status under section 4-201 of a bank acting as an agent for the true owner of a check submitted for collection.[293] The Appellate Division reasoned, however, that a bank could not be an agent when it accepts a check from a forger or his transferee, because a forger cannot pass good title absent the true owner's indorsement.[294] The Appellate Division concluded that

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court stated that its "sole remaining task is the choice between following what appears to be bad law or "adapting" that law to what we perceive to be commercial reality, as some other states' courts have done." 388 So. 2d at 1062-63. The *Jackson* court, of course, chose "adherence to lawful legislative decree." *Id.* at 1063.

288 *Denn*, 316 N.W.2d at 536. The court also found persuasive the judicial efficiency and convenience that would result from permitting the payee to sue directly the depositary or collecting bank. The court was particularly concerned with the inefficiency and difficulty that would result from forcing the payee to sue drawee banks in a number of different jurisdictions. *Id.* at 537.

289 *Id.*

290 188 N.J. Super. 391, 457 A.2d 1162 (App. Div. 1982), *rev'd*, 97 N.J. 1, 477 A.2d 806 (1984).

291 97 N.J. at 4-6, 477 A.2d at 807-08.

292 188 N.J. Super. at 408, 457 A.2d at 1171.

293 Section 4-201 states:

> [u]nless a contrary intent clearly appears and prior to the time that a settlement given by a collecting bank for an item is or becomes final . . . the bank is an agent or sub-agent of the owner of the item and any settlement given for the item is provisional.

U.C.C.§ 4-201.

294 *Knesz*, 188 N.J. Super. at 409, 457 A.2d at 1171.

since a bank that accepts an instrument with a forged indorsement cannot be an agent for the owner, the bank cannot qualify for the "representative' exemption provided in section 3-419(3).[295]

Upon receiving the case for further review, the New Jersey Supreme Court found the Appellate Court's holding on the availability of the section 3-419(3) defense too restrictive.[296] First, the supreme court did not agree that "representative" status under section 3-419(3) is equated with agency status under section 4-201.[297] According to the supreme court, agency status under section 4-201 is based upon the relationship between the collecting bank and the true owner, while "representative" status under section 3-419(3) expressly extends to a bank that deals with one who is not the true owner.[298]

Second, the New Jersey Supreme Court rejected the Appellate Division's contention that a bank cannot represent a customer who presents a forged instrument, since that customer cannot pass good title.[299] According to the supreme court, a depositary bank must be empowered to act for its customer, the person who presents a check, even if the check bears a forged indorsement.[300] Thus, the depositary or collecting bank serves as a "representative," as defined in section 1-201(35), for its customer throughout the entire check collection process.[301] The

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295 *Id.* The Appellate Division further maintained that, if the legislature had intended section 3-419(3) to protect banks dealing with forged instruments, the legislature should have used language such as "customer," which section 4-104(e) defines as any person for whom a bank has agreed to collect an item. *Knesz*, 97 N.J. at 10, 477 A.2d at 810.

The New Jersey Supreme Court, however, dismissed this argument on the ground that New Jersey Study Comment 1 to section 4-201 expressly refers to the depositary bank as the agent of the customer initiating collection, which the supreme court believed could be either the owner/payee or the forger or his transferee. *Id*, at 11, 457 A.2d at 810-11.

As final justification for continuing to permit the payee to sue the depositary or collecting bank directly, the Appellate Division also cited to the strong common law policy of avoiding circuity of litigation. *Id.* at 12, 477 A.2d at 811.

296 *Id.* at 10, 477 A.2d at 810.

297 *Id.* at 10-12, 477 A.2d at 810-11.

298 *Id.* at 18, 477 A.2d at 815. Indeed, comment 1 to section 4-201 suggests that the section was designed to deal with the even narrower issue of bank insolvency during the collection process.

299 *Knesz*, 97 N.J. at 12, 477 A.2d at 811.

300 *Id.* at 11, 477 A.2d at 810.

301 *Id.* at 11-12, 477 A.2d at 811. According to the New Jersey Supreme Court, if

bank, as such a representative, should therefore be entitled to the immunity that section 3-419(3) provides for a bank acting in a representative capacity for one not the true owner.[302]

The supreme court did not see any evidence that such a rule would cause "intolerable or absurd results."[303] That court felt

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the customer is also the true owner, then the bank would, in that case, represent but one party. But if the customer initiating collection is the transferee of the forger rather than the true owner, the court saw the possibility for dual representation. The bank can thus function as a representative of both the owner and the customer. *Id.*

[302] *Id.* While the New Jersey Supreme Court was not convinced by the substance of the Appellate Division's argument, it did find some merit in the policy behind the Appellate Division's decision. The supreme court acknowledged the advantage in the common law rule, which permitted a direct payee versus depositary or collecting bank suit. The court also recognized that a literal reading of section 3-419(3) would block a direct suit and would thus result in a chain of litigation. The court further admitted that such a result would run contrary to the strong body of common law, to which the New Jersey courts had clearly adhered. But the court was not willing to agree with the Appellate Division's belief, and the "respectable decisional and scholarly support for its result" that section 3-419(3) was not designed to run contrary to the existing law. *Id.* at 15, 477 A.2d at 813. In support of this view, the supreme court cited the following: Tubin v. Rabin, 389 F. Supp. 787, 789-90 (N.D. Tex. 1974), *aff'd*, 533 F.2d 255 (5th Cir. 1976); Cooper v. Union Bank, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973); Grieshaber v. Michigan Nat'l Bank of Detroit, 18 U.C.C. Rep. Serv. (Callaghan) 1248, 1255-56 (Mich. Ct. C.P. 1976); Ervin v. Dauphin Deposit Trust Co., 38 Pa. D. & C.2d 473, 3 U.C.C. Rep. Serv. (Callaghan) 311 (Pa. Ct. C.P. 1965). *Id.*; *see also* Comment, *Payee v. Depositary Bank: What Is the UCC Defense to Handling Checks Bearing Forged Indorsements?*, 45 U. COLO. L. REV. 281, 308-10 (1974); Note, Cooper v. Union Bank, *supra* note 145, at 736-38. The *Knesz* court was not sufficiently convinced by this line of cases to hold that the policy served by the common law rule overrides the plain language of section 3-419(3). Rather, the court maintained that, in adopting section 3-419(3), the legislature made a reasonable policy decision to restrict the payee and to protect the bank. *Knesz*, 97 N.J. at 15, 477 A.2d at 813.

[303] *Id.* at 18, 477 A.2d at 814. The New Jersey Supreme Court pointed out that the circuity of litigation argument has been criticized by some as being overblown in the era of long-arm jurisdiction, negotiated settlements, and liberal rules of interpleader. *Id.* at 18 n.5, 477 A.2d at 814 n.5. *See* WHITE & SUMMERS *supra* note 101, § 15-4 at 590-91 (1980).

The court further pointed out that foreclosing a direct suit against a depositary bank and forcing the payee to sue the drawer or the drawee bank may preserve the timely presentation of defenses that may otherwise have been unavailable to the bank, such as the drawer's negligence in causing or detecting forgery. *Id. See* Weinstein, *Recent Developments—Section 3-419(3) of the U.C.C. Does Not Limit the Liability of a Depositary Bank to the True Owner of a Check Paid on a Forged Indorsement*, 74 COLUM L. REV. 104, 114 (1974); *but see* Hinchey, *An Analysis of Bank Defenses to Check Forgery and Alteration Claims under Uniform Commercial Code Articles 3 and 4: Claimants' Negligence and Failure to Give Notice*, 10 PEPPERDINE L. REV. 1, 5-6 (1982); Comment, *Depositary Bank*

"constrained" to adhere to the plain meaning of the section[304] and to grant immunity to a depositary or collecting bank that, as a "representative," handles a forged check in the routine check collection process.[305]

In the end, the courts became openly frustrated with the tortuous path followed by the *Ervin* court.[306] This frustration was succinctly summarized in *Matco Tools Corp. v. Pontiac State Bank*,[307] where an action for conversion was brought by a tool company against a bank that had permitted one of the company's distributors to deposit insurance proceeds checks, payable to the distributor and the company, upon which the distributor had forged the company's indorsement.[308] In rejecting the *Ervin* "representative' theory, the *Matco* court labeled the *Ervin* line of cases as

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Liability under 3-419(3) of the Uniform Commercial Code, 31 WASH. & LEE L. REV., 676, 696 n.107 (1974).

304 *Id.* at 8, 477 A.2d at 815. The New Jersey Supreme Court read section 3-419(3) to restrict sharply the causes of action available to the payee whose indorsement has been forged. According to that court, while section 3-419(1)(c) authorizes the payee to sue the drawer or payor bank, a literal reading of section 3-419(3) expressly exempts from that liability a depositary or collecting bank that in the chain of collection handles the check. *Id.*

In reaching this conclusion, the court cited with approval the literal readings of section 3-419(3) found in cases such as Jackson Vitrified China Co. v. People's Am. Nat'l Bank, 388 So. 2d 1058 (Fla. Dist. Ct. App. 1980), and Denn v. First State Bank, 316 N.W.2d 532 (Minn. 1982). *Knesz*, 97 N.J. at 15-17, 477 A.2d at 813-14.

305 *Id.*; *see also* Hydroflo Corp. v. First Nat'l Bank, 217 Neb. 20, 349 N.W.2d 615 (1984). In that case, the Nebraska Supreme Court explored the *Ervin* theory with some interest. Nevertheless, the *Hydroflo* court ultimately chose "to be more faithful to the plain meaning" of section 3-419(3). *Id.* at 26, 349 N.W.2d at 619. However, in so doing, the court cautioned that the immunity enjoyed by a depositary or collecting bank is limited to those cases where the bank acts according to reasonable commercial standards. The court further noted, apparently with approval, White and Summers' suggestion that, in the face of the "mortal wounds" inflicted by *Ervin* and *Cooper*, legislative modification was probably in order. *Id.* (quoting WHITE & SUMMERS, *supra* note 101, § 15-4 at 593-94).

306 *See, e.g.*, Moore v. Richmond Hill Sav. Bank, 117 A.D.2d 27, 502 N.Y.S.2d 202 (N.Y. App. Div. 1986), where the New York Supreme Court finally decided to address the "representative" issue head-on. In *Moore*, the New York Supreme Court, Appellate Division noted the acceptance that the "representative" theory initially received in some courts. *Moore*, 117 A.D.2d at 32, 502 N.Y.S.2d at 206. *See generally* the discussion *supra* text accompanying notes 234-81. The court then cited with approval to courts that rejected this "strained interpretation" of the plain words of the section. *Moore*, 117 A.D.2d at 36, 502 N.Y.S.2d at 208. In the end, the *Moore* court decided to follow the language of section 3-419(3), which the court thought "clearly denominates" a depositary or collecting bank as a "representative." *Id.*

307 614 F. Supp. 1059 (E.D. Mich. 1985).

308 *Id.* at 1060-61.

"one of the more bizarre chapters of the law of commercial paper" that "flies in the face of" the express language of section 3-419(3).[309] The *Matco* court was ultimately persuaded by the argument, made by the New Jersey Supreme Court in *Knesz*, that the plain language of section 3-419(3) should be followed.[310]

(2) Proceeds remaining.

In attempting to shore up a payee's right to sue directly a depositary or collecting bank that paid over a forged indorsement, the *Ervin*[311] court took an additional creative tack. This tack reached beyond the court's innovative "representative" theory to focus upon the "proceeds remaining" language of section 3-419(3). The *Ervin* court reasoned that, even if the collecting bank were to be afforded "representative" status, the fact remained that the bank had proceeds on hand at the time the action was brought.[312] According to the court, when the bank purchased or cashed the forged checks, "it did so with its own money."[313] When the bank then put the checks through the collection process, the money that it obtained for those checks belonged to the payee named on the check.[314] That money, the *Ervin* court suggested, constituted the "proceeds remaining" referred to in section 3-419(3).[315]

The meaning of the phrase "proceeds remaining" was explored in detail in *Cooper v. Union Bank*.[316] In that case, members of a joint venture brought an action for conversion against various depositary and collecting banks[317] that had cashed or accepted for deposit checks upon which the joint venture's bookkeeper had forged its indorsement.[318] In determining the

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309 *Id.* at 1063.

310 *Id.* at 1064. As will be discussed *infra* note 399, the *Matco* decision ultimately rested on the "reasonable commercial standards" portion of section 3-419(3).

311 Ervin v. Dauphin Deposit Trust Co., 39 Pa. D. & C.2d 473, 3 U.C.C. Rep. Serv. (Callaghan) 311 (1965).

312 *Id.* at 483, 3 U.C.C. Rep. Serv. at 319.

313 *Id.*

314 *Id.*

315 *Id.* at 482-83, 3 U.C.C. Rep. Serv. at 318-19.

316 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

317 *Id.* at 375, 507 P.2d at 612, 107 Cal. Rptr. at 4. The plaintiffs also sued the various drawee banks that paid the checks. *Id.*

318 *Id.* at 374-76, 507 P.2d at 611-13, 107 Cal. Rptr. at 4-5.

liability of the defendant banks, the *Cooper* court focused upon the defense available under section 3-419(3).[319] According to that court, the question was whether the banks had retained any proceeds from the forged checks.[320] The court found the answer to that question in a protracted and difficult analysis that focused on two subissues: (1) whether the banks had received proceeds from the checks; and (2) whether they had parted with any proceeds that they might have received.[321]

In considering the first subissue, the *Cooper* court noted that a depositary bank receives no funds until proceeds are forwarded by the payor bank.[322] The court then asserted, however, that under both common law and Code rule, amounts remitted by a payor bank on a forged instrument are not considered proceeds from the check bearing the forgery.[323] According to the *Cooper* court, this rule is derived from the debtor/creditor nature of the relationship between a payor bank and its customer, the drawer of the check.[324] When a customer opens an account at a bank and deposits funds therein, the bank becomes indebted to its customers and promises to debit the customer's account only at his direction.[325] When the customer later draws a check on that account, he directs the bank to pay a stated sum to the person named as payee.[326] If the bank debits the customer/drawer's account and remits the sum stated to any person other than the designated payee or person to whom the instrument is negotiated, the bank has violated the customer/drawer's instructions.[327] The customer can compel the bank to recredit the debited amount.[328] This then means that the bank's total indebtedness to its customer is not diminished.[329] As a result, any sums that the payor bank has remitted come from the bank's funds

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319 *Id.* at 384-86, 507 P.2d at 619-20, 107 Cal. Rptr. at 11-12.

320 *Id.* at 376, 507 P.2d at 613, 107 Cal. Rptr. at 5.

321 *Id.*

322 *Id.*

323 *Id.* at 376-77, 507 P.2d at 613, 107 Cal. Rptr. at 6. This statement echoes the suggestion made in *Ervin*. See *supra* text accompanying note 311-15.

324 *Cooper*, 9 Cal. 3d at 377, 507 P.2d at 613, 107 Cal. Rptr. at 5.

325 *Id.*

326 *Id.*

327 *Id.*

328 *Cooper*, 9 Cal. 3d at 377, 507 P.2d at 613, 107 Cal. Rptr. at 5.

329 *Id.*

rather than from the customer/drawer's account.[330] The *Cooper* court thus reasoned that the remitted sums cannot constitute the proceeds of the check bearing the forged indorsement.

The *Cooper* court then rationalized that if the named payee chooses to sue for conversion of the check, the payee's suit is deemed under general bank collection law to constitute a ratification of the collection from the payor bank.[331] This transforms the previously improper remittance "by the payor bank into an authorized act for which it may debit the customer's account."[332] The *Cooper* court decided that, by bringing action against the defendant bank, these plaintiffs ratified collection by those banks.[333] As a result, the defendant depositary and collecting banks did indeed receive proceeds from the checks bearing forged indorsements.[334]

When the *Cooper* court had finally determined that proceeds had been paid on the checks in issue, the court tackled the task of determining whether the banks in question had parted with any of the proceeds that they may have received.[335] The court answered that question in the negative and offered a number of grounds in support of that answer.[336]

The first rationale offered by the *Cooper* court based on general banking principles.[337] Under these principles, amounts remitted by a collecting bank to a person who transfers to that bank a check bearing a forged indorsement do not constitute proceeds of the instrument.[338] This is particularly true where the instrument is cashed over the counter (at the time the bank takes such an instrument, the bank has not made a prior collection).[339]

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330 *Id.* at 377, 507 P.2d at 613, 107 Cal. Rptr. at 6. As authority for this proposition, the *Cooper* court cited, *inter alia*, to BRITTON, BILLS & NOTES § 142, at 406-07 (2d ed. 1961) and 10 AM. JUR.2d, *Banks*, §§ 622 and 623, at 586-89. *Cooper*, 9 Cal. 3d at 377 n.5, 507 P.2d at 613-14 n.5, 107 Cal. Rptr. at 6 n.5.

331 *Id.* at 377, 507 P.2d at 614, 107 Cal. Rptr. at 6. The court cautioned, however, that ratification of collection is not ratification of payment of the collected proceeds to the wrong person. *Id.* at 378, 507 P.2d at 614, 107 Cal. Rptr. at 6.

332 *Id.* at 377, 507 P.2d at 614, 107 Cal. Rptr. at 6.

333 *Id.* at 377-78, 507 P.2d at 614, 9 Cal. Rptr. at 6.

334 *Cooper*, 9 Cal. 3d at 378, 507 P.2d at 614, 9 Cal. Rptr. at 6.

335 *Id.* at 379, 507 P.2d at 615, 9 Cal. Rptr. at 7.

336 *Id.* at 380, 507 P.2d at 616, 107 Cal. Rptr. at 8.

337 *Id.* at 376-77, 507 P.2d at 613, 107 Cal. Rptr. at 5.

338 *Id.*

339 *Id.* at 378, 507 P.2d at 614, 107 Cal. Rptr. at 6.

Thus, the bank has nothing that could be considered proceeds as defined above.[340] The money paid over the counter must then come from the bank's funds. When collection on that check is eventually accomplished, "the proceeds become merged with the bank's general funds and are thus retained by the bank."[341]

"A bank that accepts an instrument for deposit likewise ultimately retains the proceeds of that instrument."[342] This bank is initially considered an agent of the person who delivers the instrument to it for collection.[343] When the bank eventually receives final settlement for a check that it "has forwarded for collection, the agency status typically ends, and the bank becomes a mere debtor of its customer."[344] The bank is now a mere debtor, and "entitled to use the proceeds as its own."[345] The depositary bank thus "retains" the proceeds of the check.[346]

Second, the *Cooper* court turned to the provisions of the Uniform Commercial Code.[347] Under section 4-213 of the Code, a collecting bank is liable to its customer not for the proceeds from a check but rather for the amount of the check.[348] In the normal scheme, upon presentation of a check, the collecting bank gives its customer provisional credit for the check, and, acting as the customer's agent, forwards the check for collection.[349] When the bank eventually receives a settlement for that check, the credit previously given becomes final.[350] At that point, the bank's agency status generally terminates and the bank becomes a debtor to the customer for the amount of the check.[351] So, unless the parties agree to the contrary, upon the completion of the

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340 *Id.*
341 *Id.*
342 *Id.*
343 *Id.* at 378, 507 P.2d at 614, 107 Cal. Rptr. at 6.
344 *Id.*
345 *Id.*
346 *Id.*
347 *Id.* at 380, 507 P.2d at 616, 107 Cal. Rptr. at 8.
348 *Id.* at 379, 507 P.2d at 615, 107 Cal. Rptr. at 7. U.C.C. section 4-213(3) states "[i]f a collecting bank receives a settlement for an item which is or becomes final . . . the bank is accountable to its customer for the amount of the item." U.C.C. § 4-213(3).
349 *Cooper*, 9 Cal.3d at 379, 507 P.2d at 615, 107 Cal. Rptr. at 7; *see* U.C.C. § 4-213, comment 9.
350 *Cooper*, 9 Cal.3d at 379, 507 P.2d at 615, 107 Cal. Rptr. at 7.
351 *Id.* The court noted that the agency status thus created can be extended until the amount of the instrument is received by the customer. In that case, the pro-

collection process, the collecting bank "retains" the proceeds which become merged with the bank's own funds, even though the amounts set forth in the instrument have been remitted to the bank's customer or credited to the customer's account.[352] Because no agreement to the contrary was made in *Cooper*, upon collection, the defendant banks ceased to be agents for and instead became debtors of their customer, the bookkeeper.[353] As such, the banks retained the proceeds of the checks although sums had been remitted to the bookkeeper.[354]

The *Cooper* court also looked to the language of section 3-419(3). The court found this language, which refers only to "proceeds remaining," to be ambiguous.[355] The *Cooper* court reasoned that, if the individuals who drafted the code and the legislators who adopted it had intended to extend the protection provided by section 3-419(3) to collecting banks that had merely given value for an instrument, rather than to banks that had acted as true representatives, the drafters and legislators should have been more explicit in their choice of words.[356]

Third, the *Cooper* court relied upon the effectiveness of the pre-Code law approach to payment over a forged indorsement.[357] Under this approach, upon completion of the collection process, collecting banks are deemed to hold the proceeds from the checks collected for the interest of the true owner.[358] The

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ceeds are to be maintained in a separate fund until paid to the customer. No such agreement was made in the instant case.

352 *Id.* See *supra* notes 342-51 and accompanying text.

353 *Cooper*, 9 Cal. 3d at 382-83, 507 P.2d at 618, 107 Cal. Rptr. at 10.

354 *Id.* at 380, 507 P.2d at 616, 107 Cal. Rptr. at 8. The court found support for this argument in the law of constructive trusts. Under that law, sums received by a bank and mingled with that bank's own funds are traceable by the proper claimant. Withdrawals do not affect this result so long as the amount of cash on hand is not lower than the amount claimed by the plaintiff. Since no such diminution occurred in the case at bar, the Cooper court reasoned that the depositary and collecting banks had received proceeds, which they continued to retain, and which the plaintiff, as the proper claimant, could trace. *Id.*

355 *Id.* at 380, 507 P.2d at 616, 107 Cal. Rptr. at 8.

356 *Id.* The *Cooper* court believed that, in order to have absolved collecting banks that merely give value, the drafters and legislators should have used the word "for value." *Id.* This is because collecting banks stand in a position comparable to a holder in due course, since they take property and in return give consideration to the transferor. The consideration given by a holder, of course, is called "value." *Id.*

357 *Id.* at 377, 507 P.2d at 614, 107 Cal. Rptr. at 6.

358 *Id.* at 378, 507 P.2d at 614, 107 Cal. Rptr. at 6. As authority for this state-

common law uniformly permitted the payee, as the true owner, to maintain a direct cause of action against a collecting bank for converting those proceeds by paying over a forged indorsement.[359] This was true even if the bank had acted in good faith, with the highest degree of care and had remitted the amount of the instrument to another party.[360] Since this direct cause had been operating satisfactorily, the *Cooper* court saw no reason to believe that the drafters or the legislators had intended to abrogate it.[361] The court noted that, under the Code, the payee can also sue the payor bank, which can in turn sue the collecting bank for breach of warranty of good title.[362] Given the Code's express purpose of simplifying commercial transactions,[363] the *Cooper* court doubted that the drafters and legislators had intended to foreclose the previously sanctioned direct suit in favor of the "cumbersome and uneconomical circuity of action" that could be required to achieve the same result.[364]

After following *this* tortuous route, the *Cooper* court ulti-

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ment, the court referred to cases that it had previously cited, including United States Portland Cement Co. v. United States Nat'l Bank, 61 Colo. 334, 157 P. 202 (1916) and Mackey-Woodard, Inc. v. Citizens State Bank, 197 Kan. 536, 419 P.2d 847, 853-54 (1966).

359 *Cooper*, 9 Cal. 3d at 377, 507 P.2d at 614, 107 Cal. Rptr. at 6.

360 *Id.* at 380, 507 P.2d at 616-17, 107 Cal. Rptr. at 8. In support of this statement, the court cited, Annotation, *Right of Check Owner to Recover Against One Cashing it on Forged or Unauthorized Indorsement and Procuring Payment by Drawee*, 100 A.L.R.2d 670 (1965); 10 AM. JUR. 2d *Banks* § 632, at 599-600.

361 *Cooper*, 9 Cal. 3d at 381, 507 P.2d at 616-17, 107 Cal. Rptr. at 8. Indeed, the court found convincing the total lack of words to that effect in the official comments to section 3-419. The *Cooper* court pointed out that the one comment that does speak to section 3-419(3) refers to the rule that protects brokers. The court believed that collecting banks were not intended to take advantage of the broker exception as contained in section 3-419(3) because collecting banks stand on a different footing than brokers. *Id.* at 380, 507 P.2d at 616, 107 Cal. Rptr. at 8.

362 *Id.*; *see* U.C.C. § 4-207.

363 U.C.C. § 1-102(2)(a).

364 *Cooper*, 9 Cal. 3d at 381, 507 P.2d at 616-17, 107 Cal. Rptr. at 8. In a nod toward the policy of promoting efficient and convenient litigation, the court also saw a significant potential for injustice if payees were relegated to indirect recoveries. Since payor banks are generally situated in more diverse and distant locations than are collecting banks, payees would be forced to pursue numerous expensive and difficult suits. Because that might well prove to be an insurmountable obstacle for payees, the collecting banks might ultimately be relieved from liability. This would cause payees to bear the loss for payments over the forged indorsement, which the court believed would produce a windfall for collecting banks. *Id.*

mately reached the "inevitable" conclusion that the defendant depositary and collecting banks should be held liable to the plaintiff joint venture members for certain of the checks.[365]

The initial reaction to the *Cooper* decision was divided. Some courts chose to follow the *Ervin/Cooper* "proceeds remaining" theory,[366] while others felt compelled to reject it.[367]

On the "yea" side was the Michigan Court of Appeals in *Sherriff-Goslin Co. v. Cawood*.[368] That court was so determined to protect the payee's right to sue, it assumed a results-oriented approach to the text of section 3-419(3). That approach led the court to embrace the "proceeds remaining" theory developed in *Ervin*.[369]

On the "nay" side was the New Jersey Supreme Court in *Knesz v. Central Jersey Bank and Trust Company*.[370] According to that court, "proceeds" is defined as the amount that is "received from the drawee-payor bank in return for the check of its drawer.[371] "Remaining proceeds," the court reasoned, consist of whatever sums the bank actually received as a result of dealing with the forged instrument that are still left in the bank's control.[372] Pro-

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365 *Id.* at 383, 507 P.2d at 618, 107 Cal. Rptr. at 10. The court found the banks liable for the amounts of the instruments received by the banks as of April 1, 1966. The court still absolved the banks for the checks received after that date on the ground that the plaintiffs were barred by their own negligence as to those checks. *Id.* For a discussion of contributory negligence as a defense to an action brought under section 3-419, see *infra* text accompanying notes 405-84.

366 *See, e.g.*, Sonnenberg v. Mfrs. Hanover Trust Co., 87 Misc. 2d 202, 383 N.Y.S.2d 863 (1976).

367 *See, e.g.*, Moore v. Richmond Hill Sav. Bank, 177 A.D.2d 27, 502 N.Y.S.2d 202 (1986).

368 91 Mich. App. 204, 283 N.W.2d 691 (1979).

369 *Id.* The *Sherriff-Goslin* court was particular to protect the plaintiff payee from the heavy burdens which resort to an indirect recovery would inevitably place on the payee. For an analysis of those burdens, see *supra*, text accompanying notes 264-66.

370 97 N.J. 1, 477 A.2d 806 (1984). The New Jersey Supreme Court was also on the "nay" side of the debate over the *Ervin* "representative" theory.

371 *Id.* at 20, 477 A.2d at 816. In describing this definition, the *Knesz* court noted that the only UCC definition of "proceeds" is found in section 9-306(1). *Id.* at 20 n. 6, 477 A.2d 816 n.6. This definition, which was not incorporated into Article Three, describes proceeds as including " 'whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. * * * Money, checks, deposit accounts, and the like are "cash proceeds.' " *Id.* (citing U.C.C. § 9-306(1)).

372 *Id.* at 20, 477 A.2d at 816.

ceeds would thus remain where the bank gave its customer provisional credit and suit was brought before the hold placed on the customer's account had been lifted. No proceeds would remain where, as in the *Knesz* case, full credit had been given and the customer was permitted to withdraw the credited amounts from his account.

In the end, the New Jersey Supreme Court was mindful of the objections that had been raised to a literal reading of section 3-419(3).[373] The court, however, was convinced that the legislature had been aware of those objections and had nevertheless chosen to grant immunity to depositary and collecting banks.[374] Absent a legislative change to the clear language of section 3-419(3), the court felt constrained to reject the "proceeds remaining" theory and to grant exemption to the defendant banks.[375]

The division which, for a time, existed between the courts on the issue of "proceeds remaining" is well illustrated in two opinions from branches of the New York Supreme Court. In 1980, the "proceeds remaining" theory found favor with the New York Supreme Court, Special Term, in *Colonna and Co. v. Citibank*.[376] In that case, a corporation sued a bank that had permitted an employee of the corporation to open an unauthorized account in the corporation's name and that had accepted for deposit into that account checks upon which the employee had forged the corporation's indorsement.[377] The court recognized the near absolute liability that the collecting bank would have faced under the common law.[378] The court further recognized that, as a basic rule of statutory construction, " 'a clear and specific legislative

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373 *Id.* at 21, 477 A.2d at 816.

374 *Id.*

375 *Id.* The court did, however, acknowledge that the immunity could be lost where the bank (1) acted in bad faith; (2) failed to adhere to reasonable commercial standards of the banking profession; or (3) had given provisional credit to the forger or his transferor and had not yet disbursed the entire amount of the collected proceeds. *Id.* at 21-22, 477 A.2d at 816.

376 105 Misc. 2d 78, 431 N.Y.S.2d 750 (Special Term 1980), *rev'd on other grounds*, 86 A.D.2d 789, 447 N.Y.S.2d 10 (App. Div. 1982). The theory had also found favor with the New York Supreme Court, Individual Calendar, in Sonnenberg v. Manufacturers Hanover Trust Co., 87 Misc. 2d 202, 383 N.Y.S.2d 863 (1976).

377 *Colonna*, 105 Misc. 2d at 78, 431 N.Y.S. 2d at 750.

378 *Id.* at 80, 431 N.Y.S.2d at 751; *see generally supra* text accompanying notes 23-99.

intent is required to override the common law.' "[379] The court did not find such a clear intent in section 3-419(3).[380]

The *Colonna* court was also concerned with the apparent inconsistency in depositary or collecting bank liability that a literal reading of section 3-419(3) would create.[381] If the plaintiff corporation had sued the drawer under section 3-802(1)(b), the plaintiff could have recovered to the extent that the drawer's underlying obligation had not been discharged by the stolen instrument.[382] This would be true regardless of any amounts that the collecting bank had paid to the forger.[383] If the drawer's account had been "wrongfully debited for the forged instrument, the drawer could then recover from the drawee bank for paying an item that was not properly payable."[384] Under sections 4-207 and 3-417, the drawee bank could then sue the collecting bank for breach of "its warranty of good title."[385] Since the drawee's recovery in that case would be for the full amount paid and collected, the collecting bank would bear the ultimate responsibility for the full value of the forged instrument.[386]

Under a literal reading of section 3-419(3), however, the collecting bank's liability would be limited to the amount still remaining in its hands.[387] The *Colonna* court could see no rational

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379 *Colonna*, 105 Misc. 2d at 82, 431 N.Y.S. 2d at 752. To support this proposition, the court cited to Hechert v. N.Y. Life Ins. Co., 46 N.Y.2d 34, 38, 39, 412 N.Y.S.2d 812, 815, 385 N.E.2d 551, 554 (1978). *Colonna*, 105 Misc. 2d at 82, 431 N.Y.S.2d at 752.

380 *Id.* The court likewise cited to Hechter v. New York Life Ins. Co., 46 N.Y.2d 34, 38, 39, 412 N.Y.S.2d 812, 815, 385 N.E.2d 551, 554 (1978).

381 *Colonna*, 105 Misc. 2d at 82, 431 N.Y.S.2d at 752.

382 *Id.*

383 *Id.*

384 *Id.*

385 *Id.* at 82, 431 N.Y.S.2d at 752.

386 *Id.*

387 *Id.* at 82-83, 431 N.Y.S.2d at 752; *see* Tette v. Marine Midland Bank, 78 A.D.2d 383, 435 N.Y.S.2d 413 (N.Y. App. Div. 1981), where the court was concerned with a different inconsistency. The *Tette* court focused on section 3-419(2), which provides that "in an action against a drawee under subsection (1) the measure of the drawee's liability is the face amount of the instrument. In any other action under subsection (1) the measure of liability is presumed to be the face amount of the instrument." U.C.C. § 3-419(2). Thus, a literal reading of section 3-419(2) would result in harsher treatment of a drawee bank than a depositary or collecting bank, since the drawee's liability is absolute, while the depositary or collecting bank can assert defenses. The *Tette* court could find no rationale for this inconsistency, especially since the depositary or collecting bank, as the party that usually deals directly

reason for such a difference[388] and found that the collecting bank did not pay out proceeds, rather, it retained those proceeds for the payee as the true owner.

In 1986 the New York Supreme Court, Appellate Division reached an opposite conclusion in *Moore v. Richmond Hill Sav. Bank*,[389] where a seller of a condominium sued a bank that accepted, for deposit, a check bearing a forgery of the seller's indorsement. In analyzing the bank's liability, the court chose to adhere to the plain language of the statue.[390] The *Moore* court maintained that the *Ervin/Cooper* approach to "proceeds remaining" runs contrary to the official comments to section 3-419(3), which indicate that a depositary or collecting bank is liable only to the extent that it actually retains proceeds in the forger's account.[391] The *Moore* court further believed that the *Ervin/Cooper* theory "is not in line with common sense and reality," since a collecting bank retains no proceeds once the collection and payment process has been completed.[392] As a result and despite the clear public policy arguments to the contrary, the *Moore* court declared that section 3-419(3) does shield collecting banks from direct liability to payees, except in limited circumstances.[393]

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with the forger, is generally in the best position to discover the forgery. The *Tette* court concluded, however, that the elimination of this inconsistency was a matter for the legislature. Indeed, as the *Tette* court pointed out, the California legislature has done exactly that by amending section 3-419(2) to eliminate absolute recovery for the drawee bank and to substitute presumed recovery in all cases. *Tette*, 78 A.D.2d at 386, 435 N.Y.S.2d at 416-17; *see* California Commercial Code § 3-419(2) (Bankcroft-Whitney Co. 1990). This change has apparently not been advocated by the permanent editorial board for the U.C.C.

388 *Colonna*, 105 Misc. 2d at 82-83, 431 N.Y.S. 2d at 752.

389 117 A.D.2d 27, 502 N.Y.S.2d 202 (N.Y. App. Div. 1986). The court initially noted that, as of that date, the New York Court of Appeals had not decided the issue whether a depositary or collecting bank could be held liable directly to a payee. *Id.* at 32, 502 N.Y.S.2d at 207. (Indeed, that court apparently has still not answered the question.) As the *Moore* court further noted, however, in Hutzler v. Hertz Corp., 39 N.Y.2d 209, 383 N.Y.S.2d 266, 347 N.E.2d 627 (1976), the Court of Appeals had recognized the issue, and the divergent opinions thereupon, but had declined to resolve it. *Moore*, 117 A.D.2d at 32, 502 N.Y.S.2d at 207; *see also* Hechter v. N.Y. Life Ins. Co., 46 N.Y.2d 34, 412 N.Y.S.2d 812, 385 N.E.2d 551 (1978).

390 *Moore*, 117 A.D.2d at 33, 520 N.Y.S.2d at 208.

391 U.C.C. § 3-419(3) comment.

392 *Moore*, 117 A.D. 2d at 33, 520 N.Y.S. 2d at 208. The court found that to be especially true in the case at bar, since the forger, De Dios, had withdrawn all of her funds at the defendant collecting bank.

393 *Id.* at 34, 502 N.Y.S.2d at 209. These limited circumstances would, of course,

These decisions clearly demonstrate both the attractive and unattractive elements of the *Ervin* "representative" and the *Ervin/Cooper* "proceeds remaining" theories. The theories are attractive in a number of ways. First, adherence to these theories allows courts to reverse the existing common law framework which favors the payee's rights. Second, application of these two theories produces results that conform with the Code's warranty of title scheme by pinning the loss on the party that took directly from the wrongdoer. Third, adoption of these theories also promotes common law and Code policies by encouraging judicial efficiency and convenience through the elimination of circuitous litigation.[394] Finally, conformity with these theories allows the risk to be allocated to collecting and depositary banks, which,

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include cases in which the bank fails to act in good faith and in accordance with reasonable commercial standards. See *infra* text accompanying notes 399-464 for a discussion of the reasonable commercial standards test.

Courts of other states have also rejected the *Ervin/Cooper* logic. Such a rejection was clearly voiced by the Florida Third District Court of Appeal in Jackson Vitrified China Co. v. People's Am. Nat'l Bank, 388 So. 2d 1059 (Fla. Dist. Ct. App. 1980). Prior to the *Jackson* decision, Florida courts had simply assumed without question that section 3-419(3) absolved the depositary or collecting bank that had in good faith disposed of the proceeds of an instrument bearing a forged indorsement. *See, e.g.*, FDIC v. Marine Nat'l Bank, 431 F.2d 431 (5th Cir. 1970) (applying Florida law); Siegel Trading Co. v. Coral Ridge Nat'l Bank, 328 So. 2d 476 (Fla. Dist. Ct. App. 1976).

The *Jackson* court acknowledged the boost that the "proceeds remaining" theory could give to the payee's cause of action. *Jackson*, 388 So. 2d at 1061. Nevertheless, as it would with the *Ervin* "representative status" approach, the *Jackson* court rejected the "proceeds remaining" analysis outright on the ground that it involved a strained and artificial construction of the express words of section 3-419(3). *Id.*

The *Jackson* court further stated that the facts of that case did not, in any event, support such an argument, since payment had not been made until after the collection process had been completed. Thus, the bank had made the transfer from the actual proceeds of the checks. *Id.*

For a similar rejection, see also Denn v. First Nat'l Bank, 316 N.W.2d 532 (Minn. 1982). Other courts did not expressly reject the *Ervin/Cooper* rationale but nevertheless followed the plain language of section 3-419(3) in denying liability where no proceeds remained with the bank at the time suit was brought. *See, e.g.*, American Nat'l Ins. Co. v. Fidelity Bank, 691 F.2d 464 (10th Cir. 1982) (applying Oklahoma law); Messeroff v. Kantor, 261 So. 2d 553 (Fla. Dist. Ct. App. 1972).

394 Acknowledgement for the just results that these theories produced can be found in Note, *Section 3-419(3) of the U.C.C. Does Not Limit the Liability of a Check Paid on a Forged Indorsement*, 74 COLUM. L. REV. 104, 116 (1974); Comment, *Depositary Bank Liability Under § 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676, 697 (1974).

through vehicles such as forgery insurance, are best able to absorb the losses associated with payment over forged indorsements.[395]

The unattractive facets of the "representative" and "proceeds remaining" theories are equally clear. These two theories definitely run contrary to the plain meaning of the statute, which expressly extends "representative" status to both depositary and collecting banks and which expressly exempts a bank that has disposed of the funds in question. Secondly, if one believes that the strong influence of the bank lobby caused the drafters to expand the broker rule beyond its traditional bounds, the theories also run contrary to legislative intent.[396] Finally, since the theories require the courts to ignore both the plain meaning of and the legislative intent behind the statute, the theories force courts to face a journey of judicial lawmaking upon which most will ultimately decline to embark.[397]

In the end, largely in recognition of their role as interpreters rather than as makers of law, many courts have capitulated, albeit reluctantly, to the plain meaning of the "representative" and "proceeds remaining" words of section 3-419(3). Unfortunate as that decision may seem for innocent payees, it is difficult to argue with courts that chose not to overstep the conceptual bounds of their judicial powers.

The abandonment of these creative vehicles, however, has not signaled an era of absolute immunity for the banks. As will be discussed below, even cautious courts have discovered that, through the manipulation of the "reasonable commercial standards" language of section 3-419(3), the payee's rights can still be preserved without resort to judicial legislation.[398]

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395 *See* Farnsworth, *Insurance Against Check Forgery*, 60 COLUM. L. REV. 284 (1960); Kessler, *Forged Indorsements*, 47 YALE L.J. 863, 896 (1938).

396 White and Summers suggest "[p]erhaps those bankers whose hands were doubtless at work in the drafting of 3-419(3) got what they deserved." WHITE & SUMMERS, *supra* note 101, § 15-4 at 593.

397 Criticism of this theory can also be found in Dugan, *Stolen Checks—the Payee's Predicament*, 53 B.U.L. REV. 955 (1973)[hereinafter R. Dugan]; Note, Cooper v. Union Bank, *supra* note 145; Comment, *Forged Indorsements, Depositary Banks, and the Defense of Section 3-419(3) of the Uniform Commercial Code*, 18 HOUS. L. REV. 173 (1980); Comment, *Depositary Liability Under 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676 (1974).

398 For an early suggestion that the courts would do well to focus on the "reasonable commercial standards" language, see R. Dugan, *supra* note 397, at 981-83.

b. *Adherence to reasonable commercial standards.*

As outlined above,[399] the vast majority of courts now agree that section 3-419(3) does provide a limited immunity to the depositary or collecting bank that is sued by a payee for paying over a forged indorsement. This immunity attaches to a bank that acts in good faith and in accordance with reasonable commercial standards.[400]

Under the construction provided by the courts, however, section 3-419(3) has proven to provide far less protection than its literal wording might suggest.

Courts have construed section 3-419(3) to create an affirmative defense that must be raised by banks that seek to take advantage of it.[401] Banks have the burden of proof on the question of reasonableness.[402] The determination of whether a bank acted in good faith[403] and in accordance with reasonable commercial

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399 *See supra* text accompanying note 397.

400 As discussed *supra* note 145, the "adherence to reasonable commercial standards" immunity contained in section 3-419(3) finds a parallel in sections 60, 80 and 82 of the English Bills of Exchange Act of 1882 and sections 4 and 5 of the English Cheques Act of 1957. The scope of the protection provided by section 82 of the Bills of Exchange Act (which has since been replaced by sections 4 and 5 of the Cheques Act of 1957) was stated in A.L. Underwood, Ltd. v. Bank of Liverpool and Martins, [1924] All E.R. 230, 235, 237 (C.A.): "what are the ordinary inquiries which mercantile men would in the course of their business have made in presentation of these cheques for collection . . . [i]f banks, for fear of offending their customers, will not make inquiries into unusual circumstances, they must take with the benefit of not annoying their customers, the risk of liability because they do not inquire." *See also* Lloyds Bank v. E.B. Savory & Co., [1932] All E.R. Rep. 106.

As we suggested *supra* note 145, the scope of the protection provided by section 82 was perhaps a contributing model to the liability that the code drafters had envisioned for section 3-419(3). As will be discussed below, the Code drafters did not necessarily succeed in bringing their vision to life.

401 *See, e.g.*, Landmark Bank v. Hegeman-Harris Co., 522 So. 2d 1051 (Fla. Dist. Ct. App. 1988); Barnett Bank v. Lipp, 364 So. 2d 28 (Fla. Dist. Ct. App. 1978).

402 *See, e.g.*, Montgomery v. First Nat'l Bank, 265 Or. 55, 508 P.2d 428 (1973); Inventory Locator Services, Inc. v. Dunn, 776 S.W.2d 523, 526 (Tenn. Ct. App. 1989).

403 The "good faith" language in section 3-419(3) has received little attention. Most of the few cases that have considered this portion of section 3-419(3) have treated "good faith" in a cursory fashion. *See, e.g.*, United States v. Bankers Trust Co., 17 U.C.C. Rep. Serv. (Callaghan) 136 (E.D.N.Y. 1975), where the court merely concluded that the subsection "does not apply to Chase as a collecting bank, since Chase did not sustain its burden of showing that its payment was made in good faith and in accordance with . . . reasonable commercial standards." *Id.* at 141. For similar passing references to "good faith," *see also* Siegel Trading Co. v Coral Ridge

standards[404] has generally been construed to be a question of fact.

Thus, the issue has been decided on a case-by-case basis.[405] Nevertheless, certain generalizations about commercial reasonableness of different types of banking activities can be drawn.[406]

Nat'l Bank, 328 So. 2d 476 (Fla. Dist. Ct. App. 1976); Moore v. Richmond Hill Savings Bank, 120 Misc. 2d 488, 466 N.Y.S.2d 131 (1983), *aff'd* 117 A.D.2d 27, 502 N.Y.S.2d 202 (1986); Inventory Locator Service, Inc. v. Dunn, 776 S.W.2d 523 (Tenn. Ct. App. 1989).

In Trust Co. Bank of Augusta v. Henderson, 185 Ga. App. 367, 364 S.E.2d 289 (Ga. Ct. App. 1987), *aff'd*, 258 Ga. 703, 373 S.E.2d 738 (1988), the Georgia appellate court did note that "good faith and commercial reasonableness are separate requirements." *Id.* at 370, 364 S.E.2d at 291. *See also* Coulter Elects., Inc. v. Commercial Bank, 727 F.2d 1078,1079 n.5 (11th Cir. 1984); Matco Tools Corp. v. Pontiac State Bank, 614 F. Supp. 1059 (E.D. Mich. 1985). The Henderson court simply assumed, arguendo, that the good faith requirement had been met so that the commercial reasonableness requirement could be addressed. *Henderson*, 185 Ga. at 370, 364 S.E.2d at 291.

Some attempt to define "good faith" under section 3-419(3) can be found in *Matco*, 614 F.Supp. at 1065. In that case, the court looked to section 1-202(19) for the Code's general definition of "good faith." According to that section, "good faith" means "honesty in fact in the conduct of the transaction concerned." U.C.C. § 1-202(19). The *Matco* court was not required to apply that definition, however, since the plaintiff had not alleged that the defendant bank had failed to act in good faith. *Matco*, 614 F. Supp. 1059.

404 Under the "reasonable commercial standards" language of section 3-419(3), the bank must be judged not according to its own standards but rather according to the standards applicable to the banking business. Siegel Trading Co. v. Coral Ridge Nat'l Bank, 328 So. 2d 476,478 (Fla. Dist. Ct. App. 1976).

405 The types of evidence considered in determining whether a bank has acted in accordance with reasonable commercial standards have varied widely. Testimony from a party actually involved in the transaction, such as the teller who received the check for deposit, has been a logical source. *See, e.g.*, Walters v. Alden State Bank, 155 Mich. App. 29, 399 N.W.2d 432 (1986). Testimony by experts in the field of banking has likewise been a favorite source of information. *See id.* Testimony in the form of proffered portions of bankers publications has also been considered. *See, e.g.*, Hydroflo Corp. v. First Nat'l Bank, 217 Neb. 20, 349 N.W.2d 615 (1984).

In the absence of, or in conjunction with, testimony at trial, some courts have also taken judicial notice of banking standards. *See, e.g.*, FDIC v. Marine Nat'l Bank, 431 F.2d 341 (5th Cir. 1970) (applying Florida law); Matco Tools Corp. v. Pontiac State Bank, 614 F. Supp. 1059 (E.D. Mich. 1985) (applying Michigan law). Banking publications have been the frequent source of the judicially noticed standards. *See* Belmar Trucking Corp. v. American Trust Co., 65 Misc. 2d 31, 316 N.Y.S.2d 247 (N.Y.C. Civ. Ct. 1970). When all other sources have failed, some courts have even found the governing standard by taking judicial notice of the results reached by courts in other jurisdictions on similar sets of facts. *See, e.g.*, Clark v. Griffin, 481 N.E.2d 170 (Ind. Ct. App. 1985).

406 Interestingly, the earliest cases to construe section 3-419(3) paid little attention to the "reasonable commercial standards" language in that subsection. *See,*

The cases that have raised the issue of adherence to reasonable commercial standards have tended to involve fact patterns that have focused upon one of two events: (1) the opening of a bank account; or (2) the presentation of a check to a bank, either for cash payment or deposit.[407] The latter category of cases further breaks down into two sub-categories: (a) those cases in which the check lacks an indorsement; and (b) those cases in which the check bears an indorsement, but the indorsement is either forged or unauthorized.[408]

(1) Opening of bank account.

The several cases that have fallen into this category have focused upon the reasonableness of a bank's actions in permitting a wrongdoer to open up a bank account without proper authorization into which the wrongdoer eventually deposits checks bearing forged indorsements. In these cases, the courts have held that, in failing to require proper authorization for the opening of an account, the depositary bank did not act in accordance with reasonable commercial standards.

In *Hydroflo Corporation v. First Nat'l Bank*,[409] for example, the Supreme Court of Nebraska heard an action brought against a bank that had permitted deposits of checks made payable to a corporate payee in an account opened by a third party without an authorizing corporate resolution.[410] In considering whether the bank had adhered to reasonable commercial standards when it failed to request a corporate resolution, the court considered tes-

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e.g., Berkheimers, Inc. v. Citizens Valley Bank, 270 Or. 807, 529 P.2d 903 (1974). Those early cases that did address that language did not appear eager to use it to deny the payee's cause of action in favor of the bank's immunity. In Salsman v. National Community Bank, 102 N.J. Super. 482, 246 A.2d 162 (Law Div. 1968), *aff'd*, 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969), the New Jersey Superior Court, Law Division approached the section from the traditional viewpoint and noted that section 3-419(3) by implication imposes liability on a depositary or collecting bank that does not act in accordance with reasonable commercial standards. *Id.* at 493, 246 A.2d at 168.

407 As will be demonstrated below, the majority of the cases focus on this latter event.

408 For a collection of cases construing "reasonable commercial standards," see, Annotation, *Bank's "Reasonable Commercial Standards" Defence Under UCC § 3-419(3)*, 49 A.L.R.4th 888 (1986).

409 217 Neb. 20, 349 N.W.2d 615 (1984).

410 *Id.* at 22-23, 349 N.W.2d at 613.

timony from the defendant bank's second vice president.[411] He confirmed that although the bank had no written requirement that a corporate resolution be obtained, the bank routinely requested such a resolution for its files.[412] In addition, the court consulted a publication for commercial bankers[413] which stated that corporate accounts could be opened only with a properly executed corporate resolution.[414] Given the clear gap between customary practice and the defendant bank's actual practice, the *Hydroflo* court declared that the trial court erred in holding as a matter of law that the bank had acted in accordance with reasonable commercial standards.[415]

A similar focus can be found in *Walters v. Alden State Bank*.[416] In that case, a bank had permitted a corporate treasurer to open an account in the corporation's name without inquiring into his authority to do so.[417] The corporation sued the bank for conversion when the bank later accepted for deposit checks that a treasurer had embezzled from his corporation.[418] The *Walters* court considered, in detail, testimony provided by a variety of witnesses, which indicated that the teller who had opened the account had failed to inquire whether the checks to be deposited into the account were corporate or noncorporate or whether the customer had authority to indorse and deposit the checks.[419] From these testimonies, the court determined that the bank had failed to meet its burden of proving that it had acted within rea-

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411 *Id.* at 27, 349 N.W.2d at 619.

412 *Id.*

413 *Id.* at 27-28, 249 N.W.2d at 619-20. The publication that the court consulted was F. BEUTEL & M. SHROEDER, BANK OFFICER'S HANDBOOK OF COMMERCIAL BANKING LAW § 19-40 at 319 (5th ed. 1982).

414 *Id.* § 19-35 at 318.

415 *Hydroflo*, 217 Neb. at 29-31, 349 N.W.2d at 620-21. As part of its reason for holding that the trial court had so erred, the Supreme Court also stated that a genuine issue of fact existed as to whether the bank acted in accordance with reasonable commercial standards when it accepted for deposit into Hearn's personal account a check made payable to Hydroflo in its corporate capacity. *Id.* at 29, 349 N.W.2d at 620.

416 155 Mich. App. 29, 399 N.W.2d 432 (1986).

417 *Id.* at 29-32, 399 N.W.2d at 433-34.

418 *Id.*

419 These witnesses included a bank teller, who assisted the embezzler in opening an account into which were deposited the checks in issue, and two expert witnesses called by the bank. *Id.* at 31-35, 399 N.W.2d at 433-36.

sonable commercial standards.[420]

(2) Acceptance of check to bank for payment in cash or deposit.

Most of the cases involving the "reasonable commercial standards" test have focused not on the actions of the bank in opening and maintaining an account but rather on the actions of the bank in accepting checks for payment in cash or for deposit after an account has been opened. In some of these cases, the check lacked a proper indorsement; in others, the check bore an indorsement that was either forged or unauthorized.[421]

(a) Missing indorsements.

Cases in this first category have involved indorsements lacking some or all of the named payees. The courts have almost unanimously held that a collecting bank has not adhered to reasonable commercial standards when, without further inquiry, it has paid cash for or has accepted for deposit a check that lacks an essential indorsement.

In *Millens v. Kingston Trust Company*,[422] the New York Supreme Court considered the liability of a depositary bank that

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[420] *Id.* at 35, 399 N.W.2d at 436; *see also*, Inventory Locator Service, Inc. v. Dunn, 776 S.W.2d 523, 526 (Tenn. Ct. App. 1989)(holding that expert testimony is a basis for finding failure to follow reasonable commercial standards); Kuwait Airways Corp. v. American Security Bank, 890 F.2d 456 (D.C. 1989)(noting disapprovingly that one of the defendant banks had, in disregard of its own procedures, permitted a corporate employee to open a corporate account without any documentation or authorization from the corporation); *but see* Keane v. Pan Am. Bank, 309 So. 2d 579 (Fla. Dist. Ct. App. 1975)(considering the reasonableness of a bank that permitted a law firm's account to remain open after the firm had dissolved). After the dissolution in *Keane*, the bank allowed a former partner of the firm to deposit a check into the account without the knowledge or consent of the other partners and to withdraw the full value of that check.

On appeal, the Florida Second District Court of Appeal noted that, although the bank knew that the firm had dissolved, it made sense for the firm to continue to keep the account open for the purpose of depositing checks received for work done by the old firm. In light of these facts, and according to expert testimony offered at trial, the bank's handling of the check in question was thus in accordance with reasonable commercial standards. 309 So.2d at 581.

[421] As discussed *supra* note 192, two sections of the Code treat a forged indorsement as a type of unauthorized indorsement. As has been shown, the line between a forged indorsement and one made by an agent who exceeds his authority is thus finely drawn. In any event, the cases dealing with the "reasonable commercial standards" language of section 3-419(3) have not distinguished between the two.

[422] 118 Misc. 2d 512, 461 N.Y.S.2d 938 (1983).

had accepted for deposit into a third party's account checks that were not indorsed in the name of the payee.[423] The court held that, as a matter of law, where a check drawn to a named payee lacks an indorsement or carries an indorsement either in the name of a stranger or "for deposit" or the like, a depositary bank violates reasonable commercial standards if it accepts the check for deposit to any account other than that of the named payee.[424]

A similar conclusion was reached by the Supreme Court of Oregon in *Berkheimers, Inc. v. Citizens Val. Bank*.[425] In that case, the defendant collecting bank accepted for deposit into the account of one joint payee a check that lacked the indorsement of the other joint payee.[426] The court noted that, since the check was payable to both named payees jointly, it could not be negotiated without both indorsements.[427] The court concluded that the bank did not act in a commercially reasonable manner because the absence of one joint payee's indorsement could readily have been detected by an examination of the check.[428]

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[423] *Id.* at 514, 461 N.Y.S.2d at 939-40. The New York Supreme Court did not limit its findings on the question of adherence to reasonable commercial standards to drawee-depositary cases; rather, the court spoke generally in terms of the relief that section 3-419(3) provides to a "depository or collecting bank from liability if they have dealt with the instrument in accordance with reasonable commercial standards." *Id.* at 517, 461 N.Y.S.2d at 941.

[424] *Id.*

[425] 270 Or. 807, 529 P.2d 903 (1974).

[426] *Id.* at 810, 529 P.2d at 904.

[427] *Id.* Section 3-116 of the Code provides:

> An instrument payable to the order of two or more persons
>
> . . . .
>
> (b) if not in the alternative is payable to all of them and may be negotiated, discharged or enforced only by all of them.

U.C.C. § 3-116.

The Official Comment to this section goes on to provide that when a check is made payable to A and B, "both must indorse in order to negotiate the instrument, although one may of course be authorized to sign for the other." U.C.C. § 3-116 comment. As the court noted in *Berkheimers*, Bauer & Bronec was not authorized to sign for Berkheimers. *Berkheimers*, 270 Or. at 812, 529 P.2d at 905.

[428] *Id.* at 812, 529 P.2d at 905. A similar conclusion was reached in FDIC v. Marine Nat'l Bank, 431 F.2d 341 (5th Cir. 1970) (applying Florida law). In that case, a check that was issued jointly to two named payees was indorsed by only one and deposited by that one into his own bank account. In determining that the bank had failed to adhere to reasonable commercial standards, the court noted that the bank's assistant cashier noted in deposition that the bank had failed to comply with its own commercial standards. *Id.* at 343-44. Further, the court took judicial notice of the fact that banks do not customarily deal with instruments that lack the in-

(b) Forged or unauthorized indorsements.

As with the acceptance of checks without necessary indorsements, the courts have invariably found a failure to adhere to reasonable commercial standards when a bank has paid a check bearing a forged or unauthorized indorsement that could have been discovered from the face of the instrument or from the circumstances that surrounded the check's cashing or deposit.

In *Salsman v. National Community Bank*,[429] a bank accepted for deposit a check made payable to a widow, which the widow had specially indorsed to the order of the estate of her late husband and which her attorney indorsed without the widow's knowledge or permission first for deposit into the estate and then for deposit into his general attorney trustee account.[430] The court noted that although the attorney had presented the check for deposit into his own personal account, an examination of the face of the check would have revealed that the indorsement purportedly made on behalf of the estate was expressly restricted "for deposit" into the account of the estate.[431] The court held that the bank failed to adhere to reasonable commercial standards by accepting the check in contravention of the direction of the restrictive indorsement made on behalf of the estate.[432]

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dorsement of a payee. In support of the latter proposition, the court cited to 9 WIGMORE, EVIDENCE § 2580 at 571 (3d ed. 1940); Lewis, Hubbard & Co. v. Montgomery Supply Co., 59 W. Va. 75, 52 S.E. 1017 (1906). *Marine National*, 431 F.2d at 344 n.4.

For another case that discussed but did not, for procedural reasons, decide the issue of whether a bank fails to adhere to reasonable commercial standards when it pays over a check with a missing indorsement, see Cartwood Constr. Co. v. Wachovia Bank & Trust Co., 84 N.C. App. 245, 352 S.E.2d 241 (1987), *aff'd*, 320 N.C. 164, 357 S.E.2d 373 (1987).

But see, Ahrens v. Westchester Federal Sav. & Loan Ass'n, 19 U.C.C. Rep. Serv. (Callaghan) 898 (N.Y. Sup. Ct. 1976), *aff'd as modified*, 58 A.D.2d 799, 396 N.Y.S.2d 246 (1977) (where a bank was found to have adhered to reasonable commercial standards despite that it had accepted for deposit a check that had previously been indorsed in blank but that lacked the indorsement of the party who deposited it).

429 102 N.J. Super. 482, 246 A.2d 162 (Law Div. 1968), *aff'd*, 105 N.J Super. 164, 251 A.2d 460 (App. Div. 1969).

430 *Id.* at 486-88, 246 A.2d at 164-65.

431 *Id.*

432 *Id.* at 493-94, 246 A.2d at 168. The court also found that the bank had failed to adhere to reasonable commercial standards by accepting the check without inquiring into the attorney's authority to indorse the check on behalf of the estate. *Id.* at 494, 246 A.2d at 168.

A similar result was reached in *National Bank of Georgia v. Refrigerated Transport Co.*[433] In that case, a bank accepted for deposit into a collection agency's general corporate checking account checks made payable to the agancy's client where the checks bore various forms of rubber stamp indorsements made by the agency but without the client's knowledge or consent.[434] The court held that the bank had failed to act in accordance with reasonable standards because it accepted checks that were irregular enough on their face to raise some question as to their validity.[435]

Facial irregularity was also considered by the Georgia Court of Appeals in *Trust Co. Bank of Augusta v. Henderson*.[436] In that case, a bank accepted for deposit and/or cashed some $71,000 worth of checks upon which an employee had handwritten his employer's business indorsement.[437] The court noted that the indorsements in question were unusual, since the checks had been indorsed in blank by hand rather than with the business' customary rubber stamp or cashier register mark, with their accompanying restrictive indorsement.[438] The court thought that this amounted to the type of facial irregularity that should have put the bank on notice that further inquiry was required.[439]

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433 147 Ga. App. 240, 248 S.E.2d 496 (1978). Indeed, in adopting the trial courts findings of facts and conclusions of law, the *Refrigerated Transport* court cited with approval to *Salsman*. *Id.* at 244, 248 S.E.2d at 499.

434 *Id.* at 241-42, 248 S.E.2d at 498.

435 *Id.* at 245, 248 S.E.2d at 500. The Court of Appeals made that holding by adopting the findings of the trial court. The Court of Appeals also maintained that, when checks were presented for deposit into the general corporate account of someone other than the named payee, the bank had a duty to inquire into the authority of the presenter to indorse and deposit the checks. *Id.*

436 185 Ga. App. 367, 364 S.E.2d 289 (1987), *aff'd*, 258 Ga. 703, 373 S.E.2d 738 (1988).

437 *Id.* at 368, 364 S.E.2d at 290.

438 *Id.* at 370, 364 S.E.2d at 291-92.

439 *Id.* The court thought this to be particularly true, since a teller had on one occasion actually made further inquiry. The court also thought the bank had a duty to inquire where, as here, the checks had been made payable to a corporation but had been presented for deposit into a personal account. *Id.*

For other cases holding that a bank failed to act in accordance with reasonable commercial standards when it paid over a facially irregular indorsement, *see, e.g.*, Tubin v. Rabin, 389 F. Supp. 787 (N.D. Tex. 1974), *aff'd*, 533 F.2d 255 (5th Cir. 1976) (bank failed to authenticate the signature of a non-customer); Sonnenberg v. Manufacturers Hanover Trust Co., 87 Misc. 2d 202, 383 N.Y.S.2d 863, (N.Y. County Ct. 1976) (holding that despite the legend, "this check must be endorsed by the payee in person as drawn," a bank accepted for deposit that check, which had been fraudulently indorsed out of the presence of the bank); United States v. Bank-

Where the cash or deposit transaction involved some irregularity other than the indorsement itself, the courts have generally found that the depositary bank did not act in accordance with reasonable commercial standards when it failed to make further inquiry into the depositor's authority to indorse and to cash or deposit checks. The court in *Belmar Trucking Co. v. American Trust Co.*[440] considered the commercial reasonableness of a bank that accepted for deposit into a noncorporate account an insurance settlement check made payable to a trucking corporation.[441] The court took judicial notice that reasonable banking practice requires a collecting bank to inquire as to the reason and authority for the deposit in a third party's account of a check purportedly indorsed by a corporate payee.[442] The court reasoned that a corporate payee would not, in the normal course of business, indorse a check in blank and then deliver it to a third person without a duly executed corporate resolution stating the reason and authorization for the endorsement.[443] That resolution would serve "as a reasonable warrant for the acceptance of the check for deposit."[444] The *Belmar* court held that the bank had failed to adhere to reasonable commercial standards because the bank had failed to secure that warrant.

In *Clark v. Griffin*,[445] a collecting bank permitted one joint payee to cash a check made out to and ostensibly indorsed by multiple payees, to take most of the cash and to deposit the rest

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ers Trust Co., 17 U.C.C. Rep. Serv. (Callaghan) 136 (E.D.N.Y. 1975) (holding that a bank had accepted a check bearing a forged indorsement of an agency representative that had been handwritten above typed words on the back of the check, despite that all other corporate indorsements on the check were in rubber stamp with signatures in ink, and the agency customarily indorsed checks by rubber stamp with signatures in ink).

For a case that considered a facially irregular indorsement but that did not, for procedural reasons, determine whether commercial reasonable standards were adhered to see Forys v. McLaughlin, 436 So. 2d 280 (Fla. Dist. Ct. App. 1983). In *Forys*, a bank failed to inquire as to the genuineness of indorsements despite the fact that the signatures were almost illegible. *Id.*

440 65 Misc. 2d 31, 316 N.Y.S.2d 247 (N.Y.C. Civ. Ct. 1970).

441 *Id.* at 32-33, 316 N.Y.S.2d at 249.

442 *Id.* at 35, 316 N.Y.S.2d at 251.

443 *Id.* at 35, 316 N.Y.S.2d at 251-52.

444 *Id.* As authority for this position, the court cited to, *inter alia*, Wagner Trading Co. v. Battery Park Nat'l Bank, 228 N.Y. 37, 126 N.E. 347 (1920); Wen Kroy v. Public Nat'l Bank & Trust Co., 260 N.Y. 84, 183 N.E. 73 (1932).

445 481 N.E.2d 170 (Ind. Ct. App. 1985).

in his personal account.[446] In assessing whether the collecting bank had acted reasonably in that situation, the Indiana Court of Appeals, First District, found certain circumstances existed that should "raise the suspicions of a bank and put it on notice that further inquiries are necessary.[447] Such circumstances include where a bank accepts for deposit into a personal account a check made payable to a corporation,[448] and where an attorney indorsed and cashed a check made payable to an estate and deposited the proceeds into his personal account.[449] From these examples, the *Clark* court reasoned that the defendant collecting bank should likewise have been put on notice that further inquiry was required when the depositor cashed most of the check, which was made payable to multiple corporate payees, and deposited the rest into his personal account.[450] The defendant bank's failure to make such an inquiry, was a sufficient basis to find that the bank neglected to observe reasonable commercial standards.

In *D & G Equipment Co. v. First Nat'l Bank*,[451] a bank, having knowledge that the president of an equipment leaving corporation had recently been fired, nevertheless permitted the ex-president to open a personal account and to deposit into the account checks made payable to the corporation.[452] According to the Third Circuit Court of Appeals, a bank, as a matter of law, and in the absence of exceptional circumstances, engages in unreasonable banking practices when it, without inquiry, accepts for deposit into a personal account a check made payable to a

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446 *Id.* at 171.

447 *Id.* at 173; *see also* Waukon Auto Supply v. Farmers & Merchants Savings Bank, 440 N.W.2d 844 (Iowa 1989), where the court confirmed that the question is whether any circumstances existed that would have alerted the bank that the authority of the party presenting the check was in doubt.

448 *Clark*, 481 N.E.2d at 173. In support of this proposition, the court cited to Am. Machine Tool Distributors Ass'n v. National Permanent Fed. Sav. & Loan Ass'n, 464 A.2d 907 (D.C. Cir. 1983); Aetna Casualty & Sur. Co. v. Hepler State Bank, 6 Kan. App. 2d 543, 630 P.2d 721 (1981); Belmar Trucking Corp. v. American Trust Co., 65 Misc. 2d 31, 316 N.Y.S.2d 247 (1970).

449 *Clark*, 481 N.E.2d at 173. In support of this proposition, the court cited to Salsman v. National Community Bank, 102 N.J. Super. 482, 246 A.2d 162 (Law Div. 1968), *aff'd*, 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969). *Clark*, 481 N.E.2d at 173.

450 *Id.*

451 764 F.2d 950 (3d Cir. 1985) (applying Pennsylvania law).

452 *Id.* at 953.

corporation.[453] The unreasonableness of the banks actions in the instant case was underscored by the fact that the bank was persuaded by the ex-president to open the account and to permit corporate checks to be deposited therein, despite that the corporation had just given the bank both oral and written notice of the president's removal from office.[454]

Questionable circumstances were also found by the *Sherriff-Goslin Co. v. Cawood*[455] court, where a bank accepted for deposit into a personal account some three hundred checks, worth over $100,000, which were made payable to the business that employed the depositor.[456] The court noted that, other than the deposit of the checks just described, the only activity in the employee depositor's account amounted to less than $1,000.[457] No one at the defendant bank knew that the employee worked for the business to whom the checks in question had been made payable.[458] The *Sheriff-Goslin* court concluded that the bank had not acted in accordance with reasonable commercial standards when it failed to make inquiry into the deposit of the checks in controversy.[459]

The courts have generally agreed that a failure to adhere to reasonable commercial standards has occurred where the face of the check or the circumstances surrounding its cashing or deposit were irregular enough to put the bank on notice that further inquiry was required but not effectuated. In some cases, however, a wrongdoer may obtain possession of a check and may manage

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453 *Id.* at 956. The court did not find exceptional circumstances to have existed in the case at bar. *Id.*

454 *Id.* A similar conclusion was reached in Aetna Cas. and Sur. Co. v. Hepler State Bank, 6 Kan. App. 2d 543, 630 P.2d 721 (1981), where a corporation brought an action for conversion against a bank that had accepted for deposit into a third party's personal account checks that were made payable to the corporation and that bore the unauthorized indorsement of the corporation.

See also Al Sarena Mines, Inc. v. South Trust Bank, 548 So. 2d 1356 (1989); *but see* Denn v. First State Bank, 316 N.W.2d 532 (Minn. 1982)(the Supreme Court of Minnesota was not willing to adhere to that rule where the plaintiff had failed to introduce evidence showing that the bank either knew that the checks were payable to a corporation or that the wrongdoer was depositing them into a personal account).

455 91 Mich. App. 204, 283 N.W.2d 691 (Mich. Ct. App. 1979).

456 *Id.*

457 *Id.* at 210, 283 N.W.2d at 694.

458 *Id.*

459 *Id.*

to indorse the check in the name of the payee and to cash or deposit it in such a way that the forgery may not be obvious from an inspection of the instrument itself or from the circumstances surrounding its cashing or deposit. The question in those cases becomes whether a collecting bank acts in a reasonable commercial manner when, without further inquiry, the bank accepts that check for deposit into an account in the name of someone other than the payee.

In *Peoples Life Ins. Co. of S.C. v. Community Bank*,[460] the South Carolina Supreme Court considered whether reasonable commercial standards had been adhered to by a bank that, without inquiry, accepted checks for deposit into an insurance agency's account which were made payable to an insurance company that had been represented by the agency, but were indorsed by the agency without authority in the company's name.[461] One of the justices, with another justice concurring, argued that in failing to question the insurance agency's authority to indorse, cash or deposit checks made out to the insurance company, the collecting bank failed to adhere to reasonable commercial standards.[462] Two other justices maintained that the bank did adhere to reasonable commercial standards because even if the bank had requested the written contract containing the agency's authorization, that contract did not by itself prohibit the agency from acting as it did.[463]

So a depositary or collecting bank has clearly failed to adhere to reasonable commercial standards when it has paid over a missing indorsement. The bank also faces liability if it has paid over a check bearing a facially irregular indorsement or under circumstances that should have put the bank on notice that further inquiry was required. Only where the instrument appeared on its face to be properly indorsed and where it was presented for cash or deposit under circumstances that were in no way suspicious will the bank be deemed to have adhered to reasonable

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460 278 S.C. 70, 292 S.E.2d 188 (1982).

461 *Id.* at 72, 292 S.E.2d at 189.

462 *Id.* at 74, 292 S.E.2d at 190.

463 *Id.* at 75-76, 292 S.E. 2d at 191. The prohibition was made orally.

Ultimately, because three of the four justices of the South Carolina Supreme Court did not agree to reverse, the state constitution compelled the *Peoples Life* court to affirm the lower court judgment of nonsuit in this case. *Id.* at 71 n.*, 292 S.E.2d at 189 n.*.

commercial standards under the terms of section 3-419(3). Despite the belief that the courts have ultimately considered themselves bound by the express language of section 3-419(3), they have been able to construe that language in such a way that the majority of the banks that have been sued under section 3-419(1)(c) have still been found liable in conversion for payment over a forged indorsement.[464]

2. Defenses outside section 3-419(3).

Section 3-419 does not purport to make the defense enumerated in subsection (3) an exclusive defense to a payee's cause of action against a depositary or collecting bank for payment over a forged indorsement. Banks have therefore been free to look outside the wording of section 3-419(3) for defenses to the payee's cause of action, such as the negligence of the payee and the running of the statute of limitations.

a. *Negligence of the payee.*

As discussed above,[465] pursuant to the common law, the proprietary nature of an action for conversion was generally held to preclude a depositary or collecting bank from raising contributory negligence as a defense against a payee that sued the bank for paying over a forged indorsement. Some early cases construing section 3-419 followed this common law rule.[466] In *Federal Deposit Ins. Corp. v. Marine Nat'l Bank*,[467] the FDIC, as assignee of the payee, sued a collecting bank for conversion of a draft that had been paid over a missing indorsement.[468] In determining whether the FDIC could recover, the Florida Fifth Circuit Court of Appeals considered and quickly dismissed the bank's defense of contributory negligence.[469] According to that court, contribu-

464 For a brief analysis of the strict approach taken by the courts under the "adherence to reasonable commercial standards" test, see Comment, *Forged Indorsements, Depositary Banks, and the Defense of Section 3-419(3) of the Uniform Commercial Code*, 18 HOUS. L. REV. 173, 185-88 (1980).

465 *See supra* notes 52-55. Note, however, that estoppel was available as an affirmative defense under both the common law and the NIL. *See supra* notes 56-59.

466 *See, e.g.*, Rosenthal v. Manufacturers Hanover Trust Co., 30 A.2d 650, 291 N.Y.S.2d 19 (N.Y. App. Div. 1968).

467 431 F.2d 341 (5th Cir. 1970).

468 *Id.* at 343.

469 *Id.* at 344.

tory negligence is available only when the cause of action is based on negligence.[470] A cause of action for conversion, however, is proprietary in nature.[471] The *Marine* court thus reasoned that contributory negligence is not available as a defense to an action for conversion, even if it is brought under section 3-419.[472]

Some courts have recognized contributory negligence as a valid defense to an action for conversion brought under section 3-419.[473] These courts[474] have permitted defendant collecting or depositary banks to raise the affirmative defense[475] found in section 3-406, which provides that "[a]ny person who by his negligence substantially contributes to . . . the making of an unauthorized signature is precluded from asserting the . . . lack of authority against . . . a drawee or other payor who pays the instrument in good faith and in accordance with reasonable commercial standards."[476]

In *Central, Inc. v. Cache Nat'l Bank*,[477] a bank permitted a corporate treasurer to deposit into his personal account checks that were made payable to the corporation.[478] The court did not ulti-

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470 *Id.*

471 *Id.* at 344-45.

472 *Id.*

473 Section 47 of the English Banking Act of 1979 (1979 ch. 37) provides:

> In any circumstances in which proof of absence of negligence on the part of a banker would be a defence in proceeds by reason of section 4 of the Cheques Act of 1957, a defence of contributory negligence shall also be available to the banker."

Thus, under the English scheme, a collecting bank that is sued by a payee for conversion by payment over a forged indorsement is expressly authorized to raise the contributory negligence of the payee.

474 *See, e.g.*, Tubin v. Rabin, 389 F. Supp. 787 (N.D. Tex. 1974), *aff'd*, 533 F.2d 255 (5th Cir. 1976); American Machine Tool Distribs. Ass'n. v. National Permanent Fed. Sav and Loan Ass'n, 464 A.2d 907 (D.C. Cir. 1983). See also *supra* note 145, for a discussion of the relationship between sections 3-406 and 3-419(3) that was originally envisioned by the drafters of the UCC.

475 According to Comment 5 to section 3-406:

> This section does not make the negligent party liable in tort for damages resulting from the alteration. Instead it estops him from asserting it against the holder in due course or drawee . . . . The holder or drawee is protected by an estoppel, and the task of pursuing the wrongdoer is left to the negligent party.

U.C.C. § 3-406 comments; *see also* Seattle First Nat'l Bank v. Pacific Nat'l Bank, 22 Wash. App. 46, 587 P.2d 617 (1978).

476 U.C.C. § 3-406.

477 748 P.2d 351 (Colo. Ct. App. 1987).

478 *Id.* at 352-53.

mately render an opinion on whether the corporation had acted negligently by failing to maintain adequate internal control over the treasurer.[479] The court, however, did expressly recognize that section 3-406 provided an affirmative defense to a cause of action in conversion.[480]

Similarly, in *Matco Tools Corp. v. Pontiac State Bank*,[481] a tools manufacturer brought an action for conversion against a bank that permitted a distributor of those tools to deposit into his own account an insurance settlement check that had been made jointly payable to the manufacturer and the distributor.[482] The District Court for the Eastern District of Michigan did acknowledge that, in the appropriate circumstances, contributory negligence can be raised as a defense to an action for conversion brought under section 3-419.[483] The court also pointed out that by its own terms, the defense enumerated in section 3-406 is not available to a bank unless it has paid the instrument in question in good faith and according to reasonable commercial standards.[484]

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479 At trial, Cache submitted expert and lay testimony to the effect that Central had acted negligently due to inadequate internal controls that permitted the treasurer to embezzle the funds. Cache further tried to prove that the treasurer's actions and lifestyle were sufficient notice that the treasurer was receiving substantial sums of money from a source other than the salary that he drew from Central. The trial court, however, refused to allow this evidence because Cache had, as a matter of law, acted unreasonably when it failed to inquire as the treasurer's authority to deposit corporate checks into his personal account. The Court of Appeals upheld this ruling. *Id.* at 354.

480 *Id.* at 353. The court did caution, however, that before it could consider the question of Central's negligence, section 3-406 required Cache to establish, *prima facie*, that it acted in good faith and in a commercially reasonable manner. *Id.*; *see also* Matco Tools Corp. v. Pontiac State Bank, 614 F. Supp. 1059 (E.D. Mich. 1985) (applying Michigan law); Inventory Locator Service, Inc. v. Dunn, 776 S.W.2d 523 (Tenn. Ct. App. 1989). Furthermore, the *Central* court maintained in the event that both Cache and Central were proved to have acted negligently, the bank would be held strictly liable. *Central*, 748 P.2d at 353; *but see* Trust Co. of Georgia Bank v. Port Terminal & Warehousing Co., 153 Ga. App. 735, 266 S.E.2d 254 (1980) (maintaining that, in the event that there is some evidence that both the payee and the collecting bank were negligent, the case should be decided by the jury).

481 614 F. Supp. 1059 (E.D. Mich. 1985).

482 *Id.* at 1060-61.

483 *Id.* at 1065.

484 *Id.* at 1066. A further clarification of the contributory negligence defense can be found in Trust Co. of Georgia Bank v. Port Terminal & Warehousing Co., 153 Ga. App. 735, 266 S.E.2d 254 (1980). In that case, a warehousing company sued a depositary bank for conversion of checks made payable to the company upon which

So in at least some jurisdictions, contributory negligence may be available to a collecting or depositary or collecting bank that has been sued by a payee for paying over a forged indorsement. This affirmative defense, however, is limited in scope, since a bank that wishes to take advantage of it must first make a *prima facie* showing of its own good faith and adherence to reasonable commercial standards. In this limited form, the defense of contributory negligence can actually help to pin the loss on the party directly responsible for a forged indorsement. It does not, however, immunize a bank that has acted improperly. The proper course, therefore, should be to permit this limited defense in an action brought under section 3-419.

b. *Statute of Limitations.*

In some states, the statute of limitations is longer for the

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a company employee had forged the company's endorsement and which the bank permitted the employee to deposit into his personal account.

The Georgia Court of Appeals confirmed that, under section 3-406, the bank would not be entitled to raise the company's contributory negligence absent a demonstration of the bank's good faith and adherence to reasonable commercial standards. *Id.* at 738, 266 S.E.2d at 257. The court then noted that, while at trial, the burden of proving affirmative defenses would be on the bank, and in a case of summary judgment, the warehousing company had the burden of "piercing the bank's defenses." *Id.* at 739-40, 266 S.E.2d at 258. The court did not believe that the company had succeeded in piercing the bank's defense, since the company had shown only that the bank had failed to verify ostensibly valid indorsements. The court went on to state that, in determining whether a bank has acted properly in paying over a forged indorsement, a court may assess the reasonableness of the bank's conduct in light of the plaintiff's conduct. Furthermore, where there is some evidence of negligence on the part of both parties, the case should be decided by the jury. The court therefore determined that summary judgment had been erroneously granted in this case. *Id.* at 739-42, 266 S.E.2d at 258-59.

Note, however, that a narrower reading of section 3-406 can be found in Lund v. Chem. Bank, 665 F. Supp. 218 (S.D.N.Y. 1987) (applying New York law), *rev'd in part on other grounds*, 870 F.2d 840 (2d Cir. 1989).

The *Lund* court, on appeal in the Second Circuit, did recognize that some courts have ignored the roots of section 3-406 and have permitted that section to provide a defense against payees as well as makers or drawers. *Lund*, 870 F.2d at 840. The court emphasized, however, that the common law did not permit contributory negligence as a defense against any plaintiff in conversion, regardless of whether the plaintiff was a maker or drawer or payee. The *Lund* court also pointed out that the official comments to section 3-406 speak only in terms of drawer negligence. The court thus believed that, given the common law rule and the clear language of the official comments to section 3-406, the defense created by section 3-406 should be available only against the maker or drawer who contributes to a material alteration of an instrument. *Id.* at 849-51.

contractual action of money had and received than it is for the tort action of conversion,[485] while in others, the reverse is true.[486] With the enactment of section 3-419, the courts were occasionally faced with the question of which Statute of Limitations to apply to the payee's cause.

Some jurisdictions have held the payee who sues under section 3-419 to the shorter tort statute of limitations. In *Continental Casualty Co. v. Huron Valley Nat'l Bank*,[487] the Michigan Court of Appeals was faced with an action brought in 1976 by the subrogee of an electrical apparatus company against a bank that had, during the years 1970-1972,[488] accepted for deposit checks upon which the company's bookkeeper had forged the company's indorsements.[489] The plaintiff in that case argued that its cause of action was actually based in an implied contract and thus should be governed by the six-year statute of limitations governing contractual matters.[490] The court, however, deemed the plaintiff's action one to recover damages for injury to property.[491] As a result, the court held that the three-year statute of limitations should apply.[492]

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485 *See, e.g.*, Continental Casualty Co. v. Huron Valley Nat'l Bank, 85 Mich. App. 319, 271 N.W.2d 218 (1978).

486 *See, e.g.*, Fabricon Products v. United Cal. Bank, 264 Cal. App. 2d 113, 70 Cal. Rptr. 50 (1968).

487 85 Mich. App. 319, 271 N.W.2d 218 (1978).

488 *Id.*

489 *Id.*

490 *Id.* at 321, 271 N.W.2d at 219.

491 *Id.* at 324, 271 N.W.2d at 221.

492 *Id.* at 325, 271 N.W.2d at 221. In a nod toward uniformity amongst the various states, the court was also swayed by the fact that courts in California, New York and Tennessee have also adopted three-year statutes of limitations for conversion actions based on forged indorsements. *Id.* In support of this proposition, the court cited Fabricon Products v. United California Bank, 264 Cal. App. 2d 113, 70 Cal. Rptr. 50 (1968); Forman v. First Nat'l Bank of Woodridge, 66 Misc. 2d 432, 320 N.Y.S.2d 646 (1971); McConnico v. Third Nat'l Bank in Nashville, 499 S.W.2d 874 (Tenn. 1973).

For other cases that have applied the three-year statute of limitations, *see, e.g.*, Daube v. Bruno, 493 So. 2d 606 (La. 1986); Kuwait Airways Corp. v. American Security Bank, 890 F.2d 456 (D.C. Cir. 1989). In the *Kuwait* case, an air company sued several banks for losses that occurred when an employee of the air company opened an unauthorized corporate account and siphoned off corporate funds to his own use. The court determined that the three-year Statute of Limitations should apply. The court then considered whether the plaintiff was not entitled to take advantage of the "discovery rule." *Id.* at 460. Under this rule, a cause does not accrue until the plaintiff knows or through the exercise of due diligence should

A strong dissent was lodged against the decision reached by the majority in *Continental Casualty*.[493] According to the dissenting judge, many jurisdictions allow a payee to bring an action against a depositary or collecting bank based upon a theory of implied contract.[494] This implied contract theory is implicit in section 3-419(3), since a depositary or collecting bank faces liability "in conversion or otherwise" if it does not act in good faith and according to reasonable commercial standards.[495] The dissent maintained, therefore, that while the plaintiff was barred by the three-year statute of limitations from suing in conversion, an action based on an implied contract should still be available under the six-year Statute.[496]

Other courts have agreed with the *Continental Casualty* dissent that a payee should be allowed to take advantage of the longer contract statute of limitations. In *Hechter v. New York Life Ins. Co.*,[497] a payee waited more than five years after forged instruments were deposited to bring an action against the collecting bank that accepted the instruments.[498] The New York Court of Appeals again recognized the payee's option under section 3-419 to sue either for conversion or for money had and received.[499] In light of this option, the court held that the payee's action will not be barred by the Statute of Limitations if the action is based in contract and is brought within six years of accrual.[500]

The courts are thus split on the question whether a payee may take advantage of the longer contract statute of limitations.

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have known of the injury. The court opinioned that, in the ordinary course of business, and without the assistance of a professional, the plaintiff in this case could have discovered the opening of the account and the resulting siphoning within three years of their occurrence. The court therefore decided that the plaintiff was not entitled to the benefits of the discovery rule. As a result of the latter decision, a portion of the plaintiff's claim was barred by the running of the statute of limitations. *Id.* at 460-63.

493 *Continental Casualty*, 85 Mich. App. at 326-32, 271 N.W.2d at 221-24.

494 *Id.* at 326, 271 N.W.2d at 221. In support of this proposition, the dissent cited to Annotation, *Right of Check Owner to Recover Against One Cashing it or Forged or Unauthorized Indorsement and procuring Payment by Drawee*, 100 A.L.R.2d 670 (1965).

495 *Continental Casualty*, 85 Mich. App. at 327-28, 271 N.W.2d at 221-22; *see also* the discussion *supra* text accompanying notes 399-464.

496 *Continental Casualty*, 85 Mich. App. at 327-28, 271 N.W.2d at 221-22.

497 46 N.Y.2d 34, 412 N.Y.S.2d 812, 385 N.E.2d 551 (1978).

498 *Id.* at 36-37, 412 N.Y.S.2d at 813, 385 N.E.2d at 552-53.

499 *Id.* at 37, 412 N.Y.S.2d at 813, 385 N.E.2d at 53.

500 *Id.* at 39-40, 412 N.Y.S.2d at 815, 385 N.E.2d at 554-55.

Since section 3-419 does give the payee the option to sue in either tort or contract, a payee who does opt to style his complaint in contract should be entitled to rely on the longer statute.

C. *Measure of Damages.*

According to section 3-419(2), "[i]n an action against a drawee under [section 3-419](1) the measure of the drawee's liability is the face amount of the instrument. In any other action under [section 3-419](1) the measure of liability is presumed to be the face amount of the instrument."[501] Section 3-419(2) sets up a rebuttable presumption[502] that a collecting or depositary bank that is sued in conversion for payment over a forged indorsement is liable for damages in the amount of the face value of the instrument so paid.[503]

The manner in which the presumption can be rebutted was

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501 *See* Atlas Bldg. Supply Co. v. First Indep. Bank, 15 Wash. App. 367, 550 P.2d 26 (1976).

The different standards established by section 3-419(2) were criticized by the New York Supreme Court, Appellate Division, in Tette v. Marine Midland Bank, 78 A.D.2d 383, 435 N.Y.S.2d 413 (App. Div. 1981). The court noted that a literal reading of section 3-419(2) would result in harsher treatment for the drawee than for the collecting or depositary bank: under section 3-419(2), the drawee's liability is absolute, while the depositary or collecting bank can assert defenses. The court could find no rationale for this inconsistency, especially since the depositary or collecting bank, as the party that usually deals directly with the forger, is generally in the best position to discover the forgery. The *Tette* court concluded, however, that the elimination of this inconsistency was a matter for the legislature. *Tette*, 78 A.D.2d 384, 435 N.Y.S.2d at 416-17.

Indeed, as the *Tette* court pointed out, the California legislature has done exactly that by amending section 3-419(2) to eliminate absolute recovery for the drawee bank and to substitute presumed recovery in all cases. *Id.* (citing CAL. COMMERCIAL CODE § 3419(2) (Bankcroft-Whitney Co. 1990)). The California legislature enacted this change in response to criticism voiced by, among others, the California Bankers Association, which objected to the potential unfairness that could result from imposing absolute liability for the face value of a check. *See* CAL. COMMERCIAL CODE § 3419 (Bankcroft-Whitney Co. 1990), California Code Comment at 395-96. While this change undoubtedly promotes fairer results, it has apparently not won the support of the permanent editorial board for the U.C.C.

502 According to Comment 4 to section 3-419, subsection (2) was intended to adopt the existing common law approach to the measure of the payee's damages. *See* Lund v. Chem. Bank, 665 F. Supp. 218 (S.D.N.Y. 1987), *rev'd in part on other grounds*, 870 F. Supp. 840 (2d Cir. 1989).

503 Most cases have simply assumed that section 3-419(2) provides the measure of liability for collecting and depositary banks as well as drawees. *See, e.g.*, D & G Equip. v. First Nat'l Bank, 764 F.2d 950 (3d Cir. 1985) (applying Pennsylvania law);

explored in detail in *D & G Equipment v. First Nat'l Bank of Greencastle*.[504] In that case, a bank had permitted the ex-president of a corporation to open an account and to deposit into that account checks made payable to his former corporation.[505] After the court determined that the bank had indeed converted the corporation's funds by accepting them for deposit into the ex-president's account, the court considered the measure of damages that should be awarded to the plaintiff.[506] The court noted that, absent evidence to overcome the presumption created by that subsection, section 3-419(2) entitled the plaintiff to recover the face value of the checks that had been converted by the bank.[507] The question then became whether the bank could meet its burden of proving the affirmative defense of mitigation of damages.[508] The *D&G* court maintained that that defense could only be met by a preponderance of the evidence that the converted funds were used to discharge the legitimate and intended debts of the plaintiff.[509] Furthermore, any such payments must have

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Tette v. Marine Midland Bank, 78 A.D.2d 383, 435 N.Y.S.2d 413 (N.Y.A.D. 1981); Ames v. Great So. Bank, 672 S.W.2d 447 (Tex. 1984).

At least one court has refused to apply section 3-419(2) to an action for conversion brought against a collecting bank. In Clark v. Griffin, 481 N.E.2d 170 (Ind. Dist. Ct. App. 1985), a general contractor sued a bank that had cashed for the buyer of a house a check that had been made payable to the contractor and to the buyer and the sellers of the house. After the court found the collecting bank liable to the contractor, the court considered the appropriate measure of damages for the plaintiff's loss. The court noted the presence of section 3-419(2) but felt that that subsection applies only to actions expressly maintained under section 3-419(1), which the court thought was restricted to drawees. Since the action in the instant case was brought against a collecting bank, and thus, according to the court could be maintained only under section 3-419(3), the court believed that it would not be governed by section 3-419(2). *Id.*

The court therefore decided to turn to the common law measure of damages. The court found that, under this measure, the bank would be liable only to the extent of the loss actually suffered by the contractor (which in this case was the value of the repair work that he had done on the house. This measure thus would permit the bank to raise the affirmative defense of mitigation of damages. The court remanded the case to the trial court for a trial on damages because the court did not have sufficient facts before it to determine the ultimate liability of the bank. *Id.*

504 764 F.2d 950 (3d Cir. 1985) (applying Pennsylvania law).

505 *Id.* at 953.

506 *Id.* at 957.

507 *Id.*

508 *Id.* at 958.

509 *Id.*

been made to discharge the specific debts that the plaintiff would have elected to pay at the time the conversion occurred.[510] The *D&G* court was not convinced that the payments made by the ex-president[511] were not applied to debts that the corporation would have elected to pay at the time of the conversion.[512] The court, therefore, held that the bank had failed to meet its burden of proving mitigation.[513]

VI. Proposals For The Future

As illustrated in the discussion above, the courts have ultimately striven to preserve and protect a payee's right to recover, in either tort or contract, the face value of a check when a depositary or collecting bank pays over a forged indorsement. In so striving, the courts have wreaked havoc upon the literal terms of section 3-419.

The courts have persisted in this text-destroying course of action because they cannot tolerate the restrictions embodied in section 3-419. These restrictions run contrary to long-standing common law tradition, which permitted a payee to sue a depositary or collecting bank either in tort or in contract. Such suits were permitted so that the loss could be pinned on the party that dealt directly with the wrong-doer and thus had the best opportunity to discover the forgery. They also encouraged judicial efficiency and convenience by lowering the total number of suits that would be required to resolve any one instance of forgery. Finally, they allocated the loss on the party best able to handle it financially.

The restrictions contained in section 3-419 also run contrary to the stated goals of the Uniform Commercial Code. Through its system of warranties of presentment and title, the Code is

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510 *Id.* As the *D & G* court noted, this rule is in keeping with the common law rules governing tort damages. *See* RESTATEMENT (SECOND) OF TORTS § 923 and the discussion *supra* text accompanying notes 71-72.

511 *D & G*, 764 F.2d at 958. According to the court, most of these payments were applied to insurance premium charges. *Id.*

512 *Id.* Indeed, the president of the corporation testified that the corporation would instead have reinvested the sums in question in equipment maintenance in order to continue operations. *Id.* at 959.

513 *Id.* The court thereupon remanded the case to the trial court to render the findings of fact necessary for a determination of the amount of compensatory damages due to D & G. *Id.* at 960.

clearly designed to pin the loss on the first bank to deal with a forged indorsement. The Code is plainly drafted to encourage judicial efficiency and convenience. Finally, the Code is intended to provide for uniform laws among the states.[514] As the discussion above clearly demonstrates, judicial construction of section 3-419 has created a serious disunity of law in the fifty states.

Hence, the plain language of section 3-419 leads to a result that runs contrary to both common law and Code theory. It is no surprise, then, that the courts have been largely unwilling to apply section 3-419 in its strictest sense. This unwillingness has led some courts to hand down decisions that flaunt the words of the statute. While these decisions are undoubtedly clever in their innovation, they stand on shaky analytical ground.

The questionable nature of this analysis has caused some courts to stay reluctantly within the literal text of the statute. Even these cautious courts have, for the most part, managed to pin liability on collecting and depositary banks. In the end, remarkably few banks have actually been absolved from liability under the terms of section 3-419.

What, then, should be the future of section 3-419? Since this section has been rendered all but useless by the courts, one could argue that there would be no harm in continuing to let the statute stand as is. Such a "solution," however, would only lead to further judicial disharmony and flaunting of the plain words of a statute.

Section 3-419 should, therefore, be amended in a manner that as smoothly as possible blends the prevailing judicial deference to the traditional common law approach with the Code's express scheme for loss allocation. The National Conference of Commissioners on Uniform State Laws[515] (hereinafter "NCCUSL") has recognized this need for reform. During the past few years, the NCCUSL has engaged in a concerted effort to produce a complete redraft of Articles 3 and 4.[516] The most recent

514 U.C.C. § 1-102(1)(c).

515 The NCCUSL is composed of law professors and other attorneys from various parts of the United States.

516 According to William D. Warren, the redrafting process was conceived in July 1985 and began in earnest in the summer of 1987. *See* Remarks of William D. Warren, recorded at Association of American Law Schools Workshop on Commercial Law (March 1-3, 1990) (tape one).

version of this redraft includes the following revision of section 3-419:

> § 3-420.[517] CONVERSION OF INSTRUMENT.
>
> (a) The law applicable to conversion of personal property applies to instruments. An instrument is also converted if the instrument lacks an indorsement necessary for negotiation and it is paid, purchased, or taken for collection. An action for conversion of an instrument may not be brought by (i) the maker, drawer, or acceptor of the instrument or (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.
>
> (b) In an action under subsection (a), the measure of liability is presumed to be the amount payable on the instrument, but recovery may not exceed the amount of the plaintiff's interest in the instrument.
>
> (c) A representative, other than a depositary bank, that has in good faith dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion to that person beyond the amount of any proceeds that it has not paid out.[518]

At first glance, this revision appears to take a major step toward eliminating many of the problems that plague the current text of section 3-419. The following analysis will show that, in attempting to cure the ambiguities that dominate section 3-419, the drafters have created a whole new set of problems.

A. *Subsection (a)*

The first sentence of this proposed subsection purports to recognize the application to negotiable instruments of the law governing the conversion of personal property. As the discussion above indicates,[519] that application has never been seriously in doubt. What has been questioned by some courts, however, is the continued viability of other causes traditionally available to

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517 The difference in section numbers is due to the addition of several new sections to the 400 portion of Article 3. *See* Uniform Commercial Code Article 3 - Negotiable Instruments, Drafted by the NCCUSL (Proposed Final Draft, April 12, 1990) [hereinafter Proposed Final Draft]. A copy of the Proposed Final Draft may be obtained by writing: The American Law Institute, 4025 Chestnut Street, Philadelphia, Pa. 19104.

518 U.C.C. Proposed Final Draft § 3-420 (Proposed Final Draft, April 12, 1990).

519 See *supra* text accompanying notes 23-72, 102-120, 162-227.

the payee, including the action in assumpsit for money had and received[520] and the suit in equity based upon a constructive trust.[521] By failing to address these alternative causes, the NCCUSL has perpetuated the confusion surrounding the methods of recovery available to the payee.[522] Furthermore, the first sentence of this proposed subsection refers to "the law" that governs conversion. As has been demonstrated,[523] this "law" has hardly been uniform. Hence, this vague reference to an unsettled set of governing rules in the first sentence only muddles the nature of the payees cause.

The second sentence of this proposed subsection provides that an instrument is "also" converted when it is paid, purchased, or taken for collection over a missing indorsement. Apparently, this language was intended to insure that cases involving missing indorsements are treated in the same manner as the unmentioned cases involving forged or unauthorized indorsements.[524] No explanation is given, however, for the express recognition of some traditional instances but not of others.

The third and final sentence of this proposed subsection precludes a maker, drawer or acceptor from bringing an action pursuant to this section. According to Comment 1 to this proposed

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520 See *supra* text accompanying notes 73-99, 121-133, 228-229.

521 See *supra* note 99.

522 This failure is particularly perplexing in light of the fact that the NCCUSL does refer to the action for money had and received in proposed section 3-118(g), which is a new section that prescribes the appropriate statute of limitations for various actions involving negotiable instruments. Proposed section 3-118(g) provides:

> Unless governed by other law regarding claims for indemnity or contribution, an action (i) for conversion of an instrument, for money had and received, or like action based on conversion . . . must be commenced within three years after the cause of action accrues.

Proposed Final Draft, *supra* note 517, at 30. This proposed section thus eliminates the opportunity to elect a longer contractual statute of limitations that some courts have traditionally provided to the payee. See *supra* text accompanying notes 484-88.

523 See *supra* text accompanying notes 23-42, 103-120, 162-227.

524 Comment 1 to this proposed subsection provides that "[t]he second sentence of Section 3-420(a) makes clear that it includes not only cases of forged indorsement, but also cases in which the instrument lacks an indorsement necessary for negotiation." Proposed Final Draft, *supra* note 517, at 30; *see also* Smith v. General Casualty Co., 75 Ill. App.3d 971, 394 N.E.2d 804 (1979); Salsman v. National Community Bank, 102 N.J. Super. 459, 246 A.2d 162 (Law Div. 1968), *aff'd*, 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969); People v. Bank of N. Am., 75 N.Y. 547 (1879).

section, this sentence was intended to resolve the question whether a drawer may maintain an action in conversion against depositary or collecting banks.[525] The NCCUSL has chosen to answer that question in the negative, primarily because the drawer has an adequate remedy against the payor bank.[526] Although some may question the wisdom of such a restriction,[527] at least it does not produce an undesirable effect on the payee's right to recover.

The third section of this proposed subsection denies recovery to a payee or indorsee who did not receive delivery of the instrument. In so restricting recovery, the NCCUSL has thereby rejected the established line of cases that permit a payee who has not acquired possession to gain the right to sue by ratifying the possession obtained by the wrongdoer.[528] Such a restriction is unfair to the payee whose failure to obtain possession is not due to any neglect on his part.[529]

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525 According to this comment:

> The cases are divided on the issue of whether the drawer of a check with a forged indorsement can assert rights against a depositary bank that took the check. The last sentence of Section 3-420(a) resolves this conflict . . . .

Proposed Final Draft, *supra* note 517, at 106.

526 Comment 1 states, "[t]he check represents an obligation of the drawer rather than property of the drawer. The drawer has an adequate remedy against the payor bank for recredit of the drawer's account for unauthorized payment of the check." Proposed Final Draft, *supra* note 517, at 106.

527 This paper has focused solely on the recovery rights of the payee. Hence, an analysis of this restriction is left for another paper.

528 *See supra* text accompanying notes 176-190.

529 *See, e.g.*, Lund v. Chemical Bank, 665 F. Supp. 218 (S.D.N.Y. 1987), *rev'd in part on other grounds*, 870 F.2d 840 (1989). Comment 1 to proposed section 3-420 notes that subsection 1 of that section would indeed preclude recovery where a check is stolen before the payee obtains possession. Proposed Final Draft, *supra* note 517 at 160. According to Comment 1, if the payee never receives that check, the drawer's liability continues. Comment 1 therefore suggests that, in the event of such a theft and a resulting payment over a forged indorsement, the payee's proper remedy lies in an action against the drawer. Ultimately, Comment 1 reasons that in a series of suits based upon breaches of warranties, "[t]he loss will fall on the person who gave value to the thief for the check." Proposed Final Draft, *supra* note 517 at 163. This logic would once again result in circuity of litigation and would also prevent the payee from pursuing directly the party best able to absorb the loss. This solution would thus run contrary to several traditional stated goals of the UCC. See *supra* text accompanying notes 266-277.

B. *Subsection (b)*

Proposed subsection (b) provides that, in all cases brought under proposed section 3-420, the presumed measure of liability is the amount payable on the instrument. This subsection thus eliminates the much-criticized absolute measure of liability that the current text of section 3-419(2) applies to actions for conversion brought against drawees.[530]

C. *Subsection (c)*

This proposed subsection contains a revision of the controversial expansion of the traditional broker rules that is embodied in the text of current section 3-419(3). In an apparent nod toward the overwhelming criticism of current section 3-419(3),[531] the NCCUSL has restricted the application of this proposed subsection to "[a] representative, other than a depositary bank." The NCCUSL has thus at least attempted to achieve a compromise between the competing interests of the payee and banking communities. This compromise preserves the payee's right to sue directly the depositary bank that, as the party that deals directly with the wrongdoer, has the best opportunity to avoid the loss.[532] By continuing to include a version of the expanded broker exemption, this compromise has opened the door to further judicial legislation by courts that do not wish to exempt banks of any type from conversion liability.[533] Furthermore, by preserving

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530 As comment 2 to this proposed section asks, "[w]hy should there be a conclusive presumption that the liability is face amount if a drawee refuses to pay or return an instrument or pays on a forged indorsement while the liability of a maker who does the same thing is only presumed to be the face amount?" Proposed Final Draft, *supra* note 517, at 107. *See supra* note 501; *see also* Nutt v. Chemical Bank, 231 N.J. Super. 57, 555 A.2d 8 (App. Div. 1989) (urging the adoption of this revision).

531 Comment 3 to this proposed subsection states that "[s]ubsection (3) of present Section 3-419 has drawn criticism from the courts, who see no reason why a depositary bank should have the defense stated in the subsection." Proposed Final Draft, *supra* note 517, at 108. According to Comment 3, this is true since the depositary bank is ultimately liable under the warranties contained in section 4-207(1)(a) and since the depositary bank is usually the most convenient defendant in cases where multiple checks have been drawn on multiple banks.

532 *See, e.g.*, Tette v. Marine Midland Bank, 78 A.D.2d 383, 435 N.Y.S.2d 413 (1981).

533 *See, e.g.*, Cooper v. Union Bank, 27 Cal. App. 3d 85, 9 Cal.3d 371, 107 Cal. Rptr. 1, 507 P.2d 609 (1973); Ervin v. Dauphin Deposit Trust Co., 38 Pa. D. & C.2d 473, 3 U.C.C. Rep. Serv. (Callaghan) 311 (1965).

the exemption of collecting banks, the NCCUSL compromise has shielded a party that, through the vehicle of forgery insurance, could easily bear the loss.[534]

Proposed subsection (3) must also be read in light of proposed sections 3-405 and 3-406. Proposed section 3-405 concerns an employer's responsibility for a fraudulent indorsement made by an employee.[535] Under this new section, the risk of loss for a forged indorsement made by an employee falls on the employer/payee if the latter has entrusted the former with responsibility for indorsing or for handling instruments on the latter's behalf.[536] The risk shifts to the bank only where the bank has failed to exercise ordinary care and has, through that failure, substantially contributed to the resulting loss.[537] In that case, a portion of the loss is allocated to the bank to the extent of the bank's negligence.[538]

Many of the actions for conversion previously brought under either the common law or section 3-419 have involved employee embezzlement.[539] Hence this new section severely restricts the

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534 *See supra* text accompanying note 395.

535 The full text of proposed section 3-405 is found in Appendix, *infra*.

536 According to Comment 1 to this proposed section, the section is based "on the belief that" the employer is better able to avoid the loss by exercising care in the hiring and supervision of employees. Proposed Final Draft, *supra* note 517, at 80-81.

537 "Ordinary care" is defined in proposed section 3-103(a)(7), which speaks in the familiar terms of the "observance of reasonable commercial standards, prevailing in the area in which that person is located, which respect to the business in which that person is engaged." Proposed Final Draft, *supra* note 517, at 3. Note, however, that according to Comment 1 to proposed section 3-405, the level of care exercised by the employer is irrelevant. Proposed Final Draft, *supra* note 517, at 80.

538 This allocation scheme bears a certain resemblance to the tort concept of comparative negligence. See *infra* text accompanying notes 542-547 for a discussion of the comparative negligence scheme as embodied in proposed section 3-406.

539 *See, e.g.*, D & G Equip. Co. v. First Nat'l Bank, 764 F.2d 950 (3d Cir. 1984); Cooper v. Union Bank, 9 Cal. 3d 371, 107 Cal. Rptr. 1, 507 P.2d 609 (1973); Trust Co. Bank v. Henderson, 185 Ga. App. 367, 364 S.E.2d 289 (1987), *aff'd*, 258 Ga. 703, 373 S.E.2d 738 (1988); Colonna & Co. v. Citibank, 195 Misc. 2d 78, 431 N.Y.S.2d 751 (1980); Peoples Life Ins. Co. v. Community Bank, 278 S.C. 70, 292 S.E.2d 188 (1982).

As illustrations of the application of proposed section 3-405, Comment 3 to that section sets forth examples, including the following familiar scenario:

> *Case 3.* The duties of Employee, a bookkeeper, include posting the amounts of checks payable to Employer to the accounts of the drawers of the checks. Employee steals a check and forges Employer's indorsement. The check is deposited by Employee to an account in Depositary

number of conversion cases that could successfully be maintained. Where an employee has embezzled, the employer loses all, apparently even if the employer was not negligent. Where a bank has acted in a clearly negligent manner in handling the result of an embezzlement, the bank loses only to the extent of its negligence. The new section represents yet another example of the pro-bank bias that permeates the NCCUSL's text because proposed section 3-405 once again shifts the loss away from this bank, even where the bank has contributed to the embezzlement.[540] When proposed section 3-405 is read in conjunction with proposed section 3-420, the burden imposed upon the non-negligent employer appears onerous indeed.[541]

Proposed section 3-405 must further be read in the light of proposed section 3-406,[542] which presents a reworking of the

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> Bank which Employee opened in the same name as Employer, and the check is honored by the drawee bank. The indorsement is effective as Employer's indorsement because Employee's duties include processing checks for bookkeeping purposes. Thus, Employee is entrusted with "responsibility" with respect to the check. Neither Depositary Bank nor the drawee bank is liable to Employer for conversion of the check. The same result follows if Employee deposited the checking the account in Depositary Bank without indorsement. Under subsection (c) deposit in a depositary bank in an account in a name substantially similar to that of Employer is the equivalent of an indorsement in the name of Employer.

Proposed Final Draft, *supra* note 517, at 82.

[540] During the March 1990 AALS Workshop on Commercial Law, speakers William D. Warren and Emma Coleman Jordan both made several references to the constant "howling" of the banking community. Remarks of William D. Warren and Emma Coleman, recorded at Association of American Law Schools Workshop on Commercial Law (March 1-3, 1990) (tape 1). As various provisions of the proposed final draft of Article 3 show, the "howls" of the banking community have clearly been heard.

[541] Indeed, Comment 3 to proposed section 3-420 expressly recognizes that "[u]nder proposed Section 3-405, which puts the loss in cases of forged indorsement by employees on the employer, forged indorsement losses by depositary banks should be substantially reduced." Proposed Final Draft, *supra* note 517, at 108.

[542] The full text of proposed section 3-406 is as follows:

> § 3-406. *Negligence Contributing to Forged Signature or Alteration of Instrument.*
>
> A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded form asserting the alteration or the forgery against a person that, in good faith, pays the instrument or takes it for value or for collection. If the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and

contributory negligence principles embodied in current section 3-405.[543] Under both the current and the proposed section, a bank that has exercised ordinary care can completely avoid liability by raising the negligence of the payee if that negligence has substantially contributed to the loss. Under the proposed section, the loss is apportioned if both parties have been negligent. This rule of apportionment, as embodied in proposed sections 3-405 and 3-406 runs contrary to the rule currently in effect in some jurisdictions.[544] It does, however, bring the Code defense closer to the comparative negligence concepts that currently pervade tort law.[545] In adopting a form of comparative negligence, proposed section 3-406 may actually work a benefit by providing a familiar and thus convenient vehicle for unifying the negligence defense as it applies to forged indorsements. Without the interference of the unfair provisions of proposed sections 3-405,[546] and 3-420(c),[547] proposed section 3-406 might indeed provide for a more unified and probably more equitable method of allocating the loss caused by a forged indorsement.

VII. Conclusion and Proposed Revisions

As the above analysis demonstrates, proposed section 3-420 does not achieve a proper balance between the competing rights of payees and banks. Particularly when read in the light of proposed section 3-405, section 3-420 severely restricts the payee's ability to recover from a collecting or depositary bank that has dealt with an instrument bearing a forged, missing or unauthorized indorsement. The combined strength of these two sections tips the balance far too heavily in favor of the banking community, which, in the end, is far better able to bear the loss.

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that failure substantially contributes to the loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

Proposed Final Draft, *supra* note 517, at 84.

543 See *supra* text accompanying note 475.

544 Under the current section, some courts have held that where both the payee and the bank have acted negligently, the bank loses. *See, e.g.*, Central, Inc. v. Cache Nat'l Bank, 748 P.2d 351 (Colo. Ct. App. 1987).

545 *See* PROSSER and KEETON on the LAW OF TORTS (5th ed. 1984) 468-479.

546 See *supra* text accompanying notes 535-541.

547 See *supra* text accompanying notes 531-534.

A fairer — and less confusing — resolution must therefore be reached. Such a resolution can be attained by deleting proposed section 3-405[548] and subsection (c) of proposed section 3-420[549] and by rewording the remaining two subsections of proposed section 3-420 in the following manner:

> § 3-420. PAYEE'S ACTION OR SUIT AGAINST A PARTY THAT HAS DEALT WITH AN INSTRUMENT BEARING A FORGED, MISSING, OR UNAUTHORIZED INDORSEMENT.
>
> (1) Subject to the provisions of this Code, when an instrument is paid, purchased, taken for collection, or otherwise dealt with on a forged, missing, or unauthorized indorsement, a payee may maintain an action at law or a suit in equity, including, but not limited to, an action for conversion or for money had and received or a suit to enforce a constructive trust.
>
> (2) In an action under subsection (1), the measure of liability is presumed to be the amount payable on the instrument, but recovery may not exceed the amount of the plaintiff's interest in the instrument.[550]

The resolution suggested above seeks to achieve a clear and equitable solution to the forged instrument dilemma. The resolution first seeks to clarify and simplify the language of the section. To attain this clarity and simplicity, the confusing first and second sentences of the NCCUSL's proposed version of section 3-420, with their vague references to "[t]he law applicable to conversion of personal property" and to "[a]n instrument [that] is also converted," are deleted.[551] In place of these sentences is one sentence, which contains a comprehensive definition of the payee's cause of action. The first clause of this sentence makes section 3-420 expressly subject to other proposed Code provisions. Thus, causes brought under proposed section 3-420 are subject to the uniform three-year

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548 As discussed *supra* text accompanying notes 535-541, proposed section 3-405 unfairly shields a collecting or depositary bank from liability simply because a forgery has been made by an employee of a payee-employer.

549 See *supra* text accompanying notes 531-547 for an analysis of the problems inherent in the text of proposed section 3-420(c).

550 This version mirrors the language of the NCCUSL's proposed revision for subsection (2). As discussed above, the NCCUSL's proposed text should be retained, because it prescribes a uniform measure of damages for all actions brought under proposed section 3-420. See *supra* text accompanying note 530.

551 See *supra* text accompanying note 517 for the wording of these two sentences. And see *supra* text accompanying notes 519-524 for a criticism of the sentences.

Statute of Limitations prescribed in proposed section 3-118(g).[552] Causes brought under proposed section 3-420 are, likewise, subject to the provisions in proposed section 3-406, which permits a bank to raise the negligence of a payee.[553]

The comprehensive definition suggested above further describes the classic factual situations upon which the payee's cause will lie and contains a catch-all phrase to cover the occasional situation where a bank deals with an instrument in a manner other than those specifically enumerated. This definition also expressly recognizes the payee's longstanding right to bring an action for conversion[554] or to eschew conversion in favor of other available causes, including, but not limited to, an action in assumpsit for money had and received[555] or a suit in equity to enforce a constructive trust.[556]

In addition, a payee is the only party that is authorized to sue under this section. This approach is consistent with the first part of the last sentence of proposed section 3-420, which precludes a maker, drawer or an acceptor from bringing an action under the provisions of that section.[557] Under this approach, however, the recovering party is not restricted to a payee who has gained possession of the check since such a restriction would be unduly prejudicial to the payee whose check is stolen due to no fault of his own.[558]

Second, the resolution suggested above seeks to achieve a clear and equitable solution to the forged instrument dilemma by creating an acceptable balance between the rights of the payee and the rights of the collecting or depositary bank. As is always the case when rights are balanced, this resolution does compromise the

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552 See *supra* note 522 for the text of proposed section 3-118(g). And see *supra* text accompanying notes 485-508 for a discussion of the Statutes of Limitations choices currently available to the payee in at least some states.

553 See *supra* text accompanying notes 542-547 for a discussion of proposed section 3-406.

554 See *supra* text accompanying notes 23-72, 102-120, 162-227 for a discussion of the payee's action in conversion. Because some courts at least initially questioned whether the current test of section 3-419 permits a payee to maintain a direct action, an express recognition of the payee's right to sue is advisable here. See *supra* note 160.

555 See *supra* text accompanying notes 73-99, 121-133, 228-229 for a discussion of the action in assumpsit for money had and received.

556 See *supra* note 99 for a discussion of the constructive trust theory.

557 See *supra* text accompanying notes 525-527.

558 See *supra* text accompanying notes 528-529.

rights of both sides. So under this proposal, the collecting or depositary bank is forced to forego the virtually absolute immunity that some courts have fashioned for it under the aegis of the current text of section 3-419(3).[559] This proposal also requires the payee to forego judicially fashioned benefits that have traditionally been available to him, such as choice of statutes of limitations[560] and, in at least some states, recovery even in the face of his own negligence.[561]

This proposed revision, nevertheless, does protect the most important rights of both sides: the payee is guaranteed the right to maintain a direct suit against the depositary or collecting bank, while the bank is expressly permitted to avoid or at least to diminish liability by proving the payee's comparative negligence. So the bank, which dealt directly with the wrongdoer and which should best be able to bear the loss, is liable, at least where the payee is blameless. The payee, however, is forced to absorb the loss to the extent that he caused it where the payee is negligent.

When an instrument has been dealt with over a forged, missing, or unauthorized indorsement, some party must bear the loss. While in the best of all possible worlds, the wrongdoer should pay, chances are that he will not. As the parties best able to both avoid and to absorb the loss, collecting and depositary banks provide the next-best target. The NCCUSL should therefore redraft proposed section 3-420 so that the Code adequately and accurately reflects these commercial realities.

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559 See generally *supra* text accompanying notes 230-464.

560 See *supra* text accompanying notes 485-498.

561 As discussed *supra* text accompanying notes 52-59, 127-133, 465-484, the courts have been divided on the question of whether a bank can raise a payee's contributory negligence in an action brought for payment over a forged indorsement. Even those states that have permitted contributory negligence to be asserted by a bank, the courts have not been in agreement as to the effect of that assertion: some states have found it to be a complete bar to liability, while others have pinned the loss on the bank if both parties have been negligent. *See supra* note 480.

As discussed *supra* text accompanying notes 542-547, proposed section 3-406 apportions the loss if both parties have substantially contributed to the loss.

APPENDIX

§ 3-405. *Employer Responsibility For Fraudulent Indorsement by Employee.*

(a) This section applies to fraudulent indorsements of instruments with respect to which an employer has entrusted an employee with responsibility as part of the employee's duties. The following definitions apply to this section:

(1) "Employee" includes, in addition to an employee of an employer, an independent contractor or employee of an independent contractor retained by the employer.

(2) "Fraudulent indorsement" means (i) in the case of an instrument payable to the employer, a forged indorsement purporting to be that of the employer, or (ii) in the case of an instrument with respect to which the employer is drawer or maker, a forged indorsement purporting to be that of the person identified as payee.

(3) "Responsibility" with respect to instruments means authority (i) to sign or indorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to act otherwise with respect to instruments in a responsible capacity. "Responsibility" does not include the assignment of duties that merely allow an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access.

(b) For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employee entrusted with responsibility with respect to the instrument or a person acting in concert with the employee makes a fraudulent indorsement to the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to the loss resulting from the

fraud, the loss may be recovered from that person to the extent of the failure to exercise ordinary care contributed to the loss.

(c) Under subsection (b) an indorsement is made in the name of the person to whom an instrument is payable if (i) it is made in a name substantially similar to that of that person or (ii) the instrument, whether or not indorsed, is deposited in a depositary bank to an account in a name substantially similar to that of that person.

Proposed Final Draft, April 12, 1990, at 79-80.