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Negotiable Instruments - Forged Indorsements - Liability of Payor and Collecting Banks - Uniform Commercial Code §3-419; Cooper v. Union Bank

James A. Wagner

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NEGOTIABLE INSTRUMENTS—FORGED INDORSEMENTS—
LIABILITY OF PAYOR AND COLLECTING BANKS—
UNIFORM COMMERCIAL CODE § 3-419

Cooper v. Union Bank, 9 Cal. 3d 123,
609, 107 Cal. Rptr. 1 (1973).

THE HOLDING IN *Cooper v. Union Bank*¹ is based on the court's interpretation of Uniform Commercial Code (hereinafter Code) section 3-419² and the application of this section to collecting and payor banks.

Joseph Stell brought an action in conversion³ as payee and true owner to recover funds paid by defendant banks on checks cashed by Stell's secretary. The secretary forged plaintiff's indorsement on twenty-nine checks over a sixteen-month period, cashing the checks at both payor and collecting banks. In an opinion affirmed by the appellate court the trial court held that the defendant banks qualified as representatives, acted in good faith, in accordance with reasonable commercial standards, and had no proceeds remaining in their hands.⁴ After disallowing recovery on certain checks due to Stell's negligent supervision of his secretary,⁵ the court allowed the defendant banks, both payor and collecting, a complete defense under California Commercial Code section 3419(3).⁶

The Supreme Court of California, following the decision in *Ervine*

¹ *Cooper v. Union Bank*, 9 Cal. 3d 123, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

² UNIFORM COMMERCIAL CODE § 3-419:

(1) An instrument is converted when
... (c) it is paid on a forged indorsement
.....

(3) Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depository 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 beyond the amount of any proceeds remaining in his hands.

³ The court expressly states a cause of action exists in conversion under Code § 3-419 (1) (c) against the payor bank. The existence of a cause of action in conversion under that section against a collecting or depository bank is not as definite. The word *paid* in that section, if given its technical meaning, would exclude collecting banks. Collecting banks are generally considered to purchase checks rather than pay them. If that section is narrowly construed the injured party will have to look to the general principles of law and equity available under Code § 1-103.

⁴ *Cooper v. Union Bank*, 27 Cal. App. 3d 351, 357, 103 Cal. Rptr. 610, 616 (1972).

⁵ Basing part of their decision on plaintiff's negligence, Code § 3-406, the court barred recovery on those checks cashed more than six months after the time of the first forgery.

⁶ CALIFORNIA COMMERCIAL CODE § 3419 (West 1963). The CALIFORNIA COMMERCIAL CODE is identical to the UNIFORM COMMERCIAL CODE in all respects relevant to this note and all further cites will be to the UNIFORM COMMERCIAL CODE.

v. Dauphin Deposit Trust Co.,⁷ held the trial court's interpretation of Code section 3-419 to be erroneous and reversed the lower court's decision as to those checks cashed prior to April 1, 1966, wherein no negligence was found on the part of Stell. The court held that the collecting bank did not act in a *representative* capacity and that neither payor nor collecting bank had paid out the *proceeds* of the instruments.⁸ To fully understand the holding of the court it is necessary to consider the relationships between banks and their customers and the effect of Code section 3-419 on these relationships.

When a drawer deposits funds in his checking account the drawee bank becomes a debtor of the drawer.⁹ As debtor, the bank is required to pay out the funds only on the order of the depositor and only to the proper party.¹⁰ Since the bank cannot pay over the drawer's funds without authority, any funds it pays out or transfers to a collecting bank on a forged instrument are deemed to be the payor's funds.¹¹ When the payor bank does pay out funds on a forged endorsement both the drawer and the payee have a cause of action against the drawee, the drawer to have his account recredited¹² and the payee for the conversion of an instrument of which he is the true owner.¹³ Pre-code law and general banking theory support the right of action by the payee directly against the payor bank.

Barring negligence, the Code is silent as to any defense on the liability of the payor bank to the true owner of a forged instrument upon its conversion. A defense is not provided by subsection 3-419(3) which, if a defense at all, is limited to collecting and depository banks acting in a

⁷ *Ervine v. Dauphin Deposit Trust Co.*, 38 Pa. D. & C. 2d. 473, 3 U.C.C. REP. SERV. 311 (Pa. C.P. 1965). Dauphin accepted certain checks made payable to plaintiff for his professional services on which plaintiff's name was forged, collected the checks and paid over the amounts of the checks to persons unknown to plaintiff. The court held, in overruling a demurrer, that subsection (3) of Code § 3-419 does not provide a defense to the collecting bank.

⁸ *Cooper v. Union Bank*, 9 Cal. 3d 123, 129, 130, 134, 507 P.2d 609, 615, 616, 620, 107 Cal. Rptr. 1, 7, 8, 12 (1973).

⁹ 5 A. SCOTT, THE LAW OF TRUSTS § 526 (3d ed. 1967). If a general deposit of money is made in a commercial bank, the bank becomes a debtor to the depositor with a superadded duty to honor the checks of the depositor for a violation of which it may be held liable for damages. . . . The money deposited belongs absolutely to the bank, which it can deal with as it sees fit.

¹⁰ UNIFORM COMMERCIAL CODE §§ 4-401, 4-402.

¹¹ *Los Angeles Inv. Co. v. Home Savings Bank*, 108 Cal. 601, 604, 182 P. 293, 294 (1919); *United States Guarantee Co. v. Hamilton Nat'l Bank* 189 Tenn., 143, 223 S.W.2d 519 (1949). The payment is deemed to be made out of the funds of the bank and not out of the funds of the depositor. 10 AM. JUR. 2d *Banks* § 622 (1963).

¹² *Schenke v. Central Trust Co.*, 58 O. App. 441, 16 N.E.2d 700 (1938); 10 AM. JUR. 2d *Banks* § 623 (1963).

¹³ *State Nat'l Bank v. Sumco Eng'r Inc.*, 46 Ala. App. 244, 240 So.2d 366; *cert. denied* 286 Ala. 740, 240 So.2d 369 (1970); *Mississippi Bank & Trust Co. v. County Supplies & Diesel Service, Inc.*, 253 So.2d 828 (Miss. 1971). See generally *Annot.*, 23 A.L.R. 3d 936 (1969).

representative capacity. Even though a payor bank may be a depository bank, in such instances the bank would not be acting in a representative capacity. The extent of the payor's liability arising from a payment made on a forged instrument is provided in subsection 3-419(2).¹⁴ Code section 3-419(1)(c) designates a cause of action in conversion which has been held to accrue to the true owner.¹⁵

Prior to the enactment of the Code a payee could proceed against a collecting bank for paying on a forged indorsement under several theories of recovery: money had and received, conversion or contract.¹⁶ The great majority of pre-code cases held that the payee could recover directly from the collecting bank on the theory of money had and received.¹⁷ When a bank has taken possession of an instrument cashed upon a forged indorsement and has collected the amount of the instrument from the drawee bank, the collecting bank is liable to the payee for the entire proceeds of the instrument even though the bank has paid out all of the funds. The theory of recovery embodied in the Code is an action in conversion. In order to sustain the action in conversion, the paying over of the proceeds of the instrument by the drawee to the collecting bank was deemed to have been ratified by the payee upon his bringing an action directly against the collecting bank.¹⁸

Having determined that a payee had a right of action against the collecting bank prior to the Code's adoption, the question remains whether a defense now exists under Code section 3-419(3):

¹⁴ UNIFORM COMMERCIAL CODE § 3-419(2): "In an action against a drawee under subsection (1) the measure of the drawee's liability is the face amount of the instrument. Comment four indicates that the drawee's liability may be absolute."

¹⁵ *Ervine v. Dauphin Deposit Trust Co.*, 38 Pa. D. & C. 473, 484, 3 U.C.C. REP. SERV. 311, 322 (Pa. C.P. 1965); Comment, *Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 YALE L.J. 417, 471 (1953).

¹⁶ See *Mackey-Woodward, Inc. v. Citizens State Bank*, 197 Kan. 536, 419 P.2d 847 (1966), where the action was brought in contract.

¹⁷ *Saf-T-Boom Corp. v. Union Nat'l Bank*, 236 Ark. 518, 521, 367 S.W.2d 116, 119 (1963). The court stated the basis for the almost universal approval of this rule can be summarized in the statement that the possession of a check based on a forged or unauthorized indorsement of the payee's signature is wrongful and when the money is collected on such a check the collecting bank is liable as for money had and received, the bank receiving the proceeds for the use of the payee; *George v. Security Trust & Savings Bank*, 91 Cal. App. 708, 267 P. 560 (1928); *Merchants' Bank v. Nat'l Capital Press*, 288 F.265, 31 A.L.R. 1066 (D.C. App. 1923). But see *Soderlin v. Marquette Nat'l Bank*, 214 Minn. 408, 8 N.W.2d 331 (1943).

¹⁸ *Chemical Workers Basic Union, Local No. 1744 v. Arnold Savings Bank*, 411 S.W.2d 159 (Mo. 1966); *Crisp v. State Bank of Rolla*, 32 N.D. 263, 155 N.W. 78 (1915); *Lindsley v. First Nat'l Bank*, 325 Pa. 393, 190 A. 876 (1937); *Zidek v. Forbes Nat'l Bank*, 159 Pa. Super. 442, 48 A.2d 103 (1946). But see *Smith v. Louisiana Bank & Trust Co.*, 255 So.2d 816 (La. App. 1971), where the payee was not considered to have a right of action directly against the collecting bank.

... (3) Subject to the provisions of this Act concerning restrictive endorsements a *representative, including a depository 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 proceedings 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. (Emphasis added.)

Assuming good faith and dealing within reasonable commercial standards the existence of a defense depends on whether the collecting bank acted in a *representative*¹⁹ capacity and whether the bank has any *proceeds* remaining in its hands.

The collecting bank in the normal course of collection acts as the agent of the depositor until the check is collected.²⁰ "If commercial paper is deposited with a bank for collection, although the bank presumptively receives it and holds it as an agent . . . [u]ntil collection, it presumptively becomes a debtor to the depositor after it has collected. . . ." After collection of the proceeds of the instrument from the drawee, the agency relationship between customer and bank terminates and a debtor-creditor relationship is created.²¹ Until collection is finalized, any payment made or credit given by the depository bank to the customer is provisional, the bank maintaining a right of recovery. At the time payment to the customer is final no agency relationship exists and the bank is no longer acting in a representative capacity.

A collecting bank may act as the representative or agent throughout the collection process if some additional agreement is made between the bank and its customer.²² This situation may also arise where the bank acts as a broker of negotiable securities²³ or as an agent in the sale of negotiable bonds.²⁴ Under these circumstances collecting banks are not held liable in conversion for the proceeds paid over to the unauthorized

¹⁹ UNIFORM COMMERCIAL CODE § 1-201 (35): "'Representative' includes an agent, an officer of a corporation or association, and a trustee, executor, or administrator of an estate, or any other person empowered to act for another."

²⁰ 5 A. SCOTT, THE LAW OF TRUSTS § 534 (3d ed. 1967).

²¹ Jennings v. United States Fidelity & Guaranty Co., 294 U.S. 216 (1935); Brownell v. Turmam, 75 F.2d 1913 (7 Cir. 1935); UNIFORM COMMERCIAL CODE § 4-201, Comment 4.

²² Sorrells Bros. Packing Co. v. Union State Bank, 144 So.2d 74 (Fla. App. 1962); 5 A. SCOTT, THE LAW OF TRUSTS § 534 (3d ed. 1967): "... (a) bank . . . in making collections is presumptively entitled to use the proceeds as its own. . . . [W]hen cash comes into its hands, it is not normally to be expected that the bank should keep the cash as a separate fund, in the absence of an agreement that it should do so."

²³ McAlister v. Bache & Co., 169 So.2d 332 (Fla. App. 1964); Pratt v. Higginson, 230 Mass. 256, 119 N.E. 661 (1918).

²⁴ Bank of America Nat'l Trust & Savings Ass'n v. Rocco 241 F.2d 455 (3d Cir. 1957); First Nat'l Bank v. Goldberg, 340 Pa. 337, 17 A.2d 377 (1941).

holders of the instruments. The banks are acting in a true representative capacity and the proceeds are not considered the bank's own funds as they are in the normal collection process.

There is commentary²⁵ but no case law to support the view that the Code intended to treat collecting and depository banks as "representatives" in all relations with their customers and thus afford them a new defense under section 3-419(3). This view is not in line with pre-code law or the intent of the Code. Collecting and depository banks should only be afforded the protection of section 3-419(3) when they are acting as a representative throughout the transaction or are operating under a special agreement in the collection process.

A second question is posed by the meaning of *proceeds* and whether the bank pays out proceeds of the instrument or pays out its own funds. Early commentary on the code, as well as some present text-writers construe proceeds to mean the amount or value of the instrument paid by the bank to the forger.²⁶ But this is not the interpretation given the section by the courts in either *Cooper or Ervine*,²⁷ nor does it seem to be consistent with other sections of the Code.

When a collecting bank pays out cash or credits an account upon the receipt of an instrument such payment is considered provisional and becomes final only upon final collection of the instrument.²⁸ Initially a bank is paying out its own funds and maintains a right to charge-back against the depositor's account or otherwise recover until the collection is final.²⁹ As discussed, the payor bank has no authority to make payment on a forged indorsement and to the extent it does so is deemed to be paying out its own funds and not the proceeds of the instrument.³⁰ It only seems logical that the funds the collecting bank receives from the payor bank are not the proceeds of the instrument either. The true owner of the instrument can ratify the transfer of funds to the collecting bank by bringing his action directly against the collecting bank. This ratification of collection does not constitute a ratification of the disbursement by the

²⁵ WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 502 (1972); 2 N.Y. LAW REVISION COMM. 1082 (1955); O'Malley, *Common Check Frauds*, 23 RUTGERS L. REV. 189, 231 (1969); Comment, *Check Forgeries: Rights, Duties and Liabilities of Payor and Collecting Banks Under the Uniform Commercial Code*, 43 MISS. L.J. 311, 328 (1972); Comment, *Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 YALE L.J. 417, 471 (1953).

²⁶ *Id.*

²⁷ *Cooper v. Union Bank*, 9 Cal. 3d 123, 129, 507 P.2d 609, 615, 107 Cal. Rptr. 1, 7 (1973); *Ervine v. Dauphin Deposit Trust Co.*, 38 Pa. D. & C. 473, 483, 3 U.C.C. REP. SERV. 311, 321 (Pa. C.P. 1965).

²⁸ UNIFORM COMMERCIAL CODE § 4-201.

²⁹ UNIFORM COMMERCIAL CODE § 4-212.

³⁰ Cases cited note 10 *supra*.

collecting bank to the forger. The collecting bank is deemed to hold the funds for the benefit of the true owner and at the time of suit to have the proceeds on hand.

The court in *Cooper* presents an additional argument against the collecting bank on the theory that the bank holds the proceeds in constructive trust for the owner.³¹ The argument is based on the discussion in *Scott on Trusts*³² concerning the right of a claimant to follow his money even though mingled with the cash of the bank. The tracing theories employed in the application of a constructive trust become difficult to work with in the bank collection system. No one check is processed individually, the transfer of large amounts between banks by the use of remittance drafts or the offsetting of accounts that occurs at a central clearing house are not conducive to the application of tracing. In many instances there is no actual transfer of funds between banks. The sections of *Scott* cited are concerned with the rights of a claimant after a bank has been placed in receivership and do not appear to be a strong argument under the present facts.

The view taken by many commentators³³ on the section causes a circuity of action in that the depository bank, as the party accepting the instrument from the forger, will eventually be held liable under the warranties of Code section 4-207.³⁴ This view suggests the only proper actions by the true owner are against the drawer of the instrument under Code section 3-804³⁵ or against the drawee bank under Code section 3-419(1)(c). The immediate result of the first action would be the drawer requiring the drawee bank to recredit his account under Code section 4-401. Under either action the drawee bank would then sue the collecting or depository bank(s) under the good title warranties set forth in Code section 4-207. The end result of this wealth of litigation would be identical to that achieved under the court's interpretation of Code section 3-419 in the principle case.

³¹ *Cooper v. Union Bank*, 9 Cal. 3d 123, 129, 507 P.2d 609, 615, 107 Cal. Rptr. 1, 7 (1973).

³² 5 A. SCOTT, *THE LAW OF TRUSTS* §§ 536, 538, 540 (3d ed. 1967).

³³ *Supra* note 25.

³⁴ UNIFORM COMMERCIAL CODE § 4-207(2):

Each customer and 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 takes the item in good faith that

- (a) he has 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;

³⁵ UNIFORM COMMERCIAL CODE § 3-804: "The 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. . . ."

The court in *Cooper* states several policy arguments in addition to the prevailing case law and banking theory to support their decision, allowing the true owner to proceed directly against the depository and collecting banks.³⁶ There is a greater probability that the depository banks are fewer in number and geographically closer than the payor banks, reducing the burden of litigation. Drawers are likely to be equally as diverse, but of more importance, they may be customers of the true owner, a relationship the owner may not wish to disturb with unnecessary litigation.

The stated purpose of the Uniform Commercial Code is "to simplify, clarify and modernize the law governing commercial transactions; . . . to make uniform the law among the various jurisdictions,"³⁷ not to create new causes of action or defenses, but simply to codify the existing laws in a uniform manner. The draftsmen of the Code in many instances have failed to comply with this purpose. If a new defense for banks was intended to be embodied in Code section 3-419 the draftsmen of the section have fallen well short of their intention. Where the meaning or intention of a statute is subject to various constructions, the courts will, as in the present case, implement their own interpretation, not necessarily consistent with the intention of the original draftsmen. The interpretation given Code section 3-419 by the court in *Cooper* is consistent with pre-code law and the stated purpose of the Code. A *contra* decision would have significantly changed the liability of depository and collecting banks from that prior to the Code.

JAMES A. WAGNER

³⁶ *Cooper v. Union Bank*, 9 Cal. 3d 123, 131, 507 P.2d 609, 617, 107 Cal. Rptr. 1, 9 (1973).

³⁷ UNIFORM COMMERCIAL CODE § 1-102(2).