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IN DEFENSE OF U.C.C. § 3-419(3)

I. Introduction

A thief steals a check from the drawer,¹ forges the payee's² name on it as a signature or an indorsement,³ and deposits it at a local bank (the collecting bank⁴). The bank sends the check up the collection stream⁵ where it is eventually paid by the distant drawee bank,⁶ which in this case is also the payor bank.⁷ Can the payee sue the collecting bank directly to recover the amount of the check?

Under the common law, the answer was clearly yes.⁸ With the emergence of the Uniform Commercial Code,⁹ however, this long-established doctrine of a collecting bank's liability to the true owner of an instrument paid on a forged indorsement seemed to come to an abrupt end. Although the Code states explicitly that "an instrument is converted when it is paid on a forged indorsement,"¹⁰ the literal language of section 3-419(3) appears to give collecting banks an absolute defense to a conversion action as long as they act "in good faith and in accordance with . . . reasonable commercial standards." Section 3-419(3) provides:

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 owner beyond the amount of any proceeds remaining in his hands.

1 The person who draws a bill of exchange or order for payment; the person writing the check.

2 The person to whom the money is paid or is to be paid; he takes the check as payment from the drawer.

3 The "indorser" is the person who signs his name as payee on the back of the check to obtain the cash or credit represented on its face.

4 U.C.C. § 4-105(d): "Collecting Bank" means any bank handling the item for collection except the payor bank. This definition includes the first bank which handles an item, sometimes referred to as the "depository bank."

5 J. WHITE & R. SUMMERS, HANDBOOK ON THE LAW UNDER THE UNIFORM COMMERCIAL CODE 493 (1972) [hereinafter cited as WHITE & SUMMERS].

6 The person on whom a bill of exchange or order is drawn; the bank on which the check is written.

7 U.C.C. § 4-105(b): "Payor bank" means a bank by which an item is payable as drawn or accepted [in this note, "payor bank" will be used interchangeably with "drawee bank"].

8 Pre-Code law held that the collecting bank acted at its own risk in paying a check on a forged indorsement. The courts allowed an action either in contract (for money had and received), or in tort (for conversion). The theory of the former action was that the collecting bank held the proceeds for the true owner, the payee. This obligation to pay only the true owner held even though the bank had already paid the amount of the check to another party; it was still presumed to be holding the proceeds of the item in privity for the payee. See cases collected in Annot., 99 A.L.R.2d 637 (1965); Kessler, *Forged Indorsements*, 47 YALE L.J. 863, 874-75 (1938). The collecting bank's liability in the tort action of conversion was based on the theory that the payee's intangible rights in the instrument had been compromised. See cases collected in RESTATEMENT (SECOND) OF TORTS 242 (1965). The result under both the contract and tort theories of recovery was identical for the collecting bank: full liability without any defenses founded in good faith or the absence of proceeds.

9 UNIFORM COMMERCIAL CODE (1972 Official Text with Comments) [hereinafter cited as U.C.C. or the Code and cited by section number].

10 U.C.C. § 3-419(1)(c).

Section 3-419(3) omits drawee banks from the scope of its protection, however, and at the same time leaves intact the collecting bank's strict liability to the drawee bank under warranties of presentment and transfer.¹¹ Thus, the apparent net effect of section 3-419¹² on the hypothetical presented above is to allow the payee to recover from the drawee bank for conversion of the check, with the collecting bank in turn liable to the payee bank for breach of warranty. The payee may not, however, recover from the collecting bank directly.

Strong policy considerations militate against such a result.¹³ First, the litigation would be circuitous. Because of the Code's warranty provisions, the collecting bank will probably bear the ultimate loss regardless of whom the payee brings action against.¹⁴ Second, the collecting bank is likely to be a more convenient defendant than the drawee bank because it is likely to be a local bank, as in the example above. If the collecting bank is the distant party and the drawee bank is local, the payee can always elect to bring action against the drawee directly. In short, the wronged party should as a matter of policy be given his choice of defendants when, as in the hypothetical, both are culpable.

Motivated by these policy considerations, the courts have used three approaches to hold the defense of section 3-419(3) inapplicable to the basic fact situation presented in the above hypothetical. None of these approaches has been completely satisfactory, however, because each is subject to inherent weaknesses

11 See U.C.C. §§ 3-417, 4-207; see also U.C.C. § 3-419, Comment 6, which provides in part, "The provisions of this section are not intended to eliminate any liability on warranties of presentment and transfer (Section 3-417)."

12 U.C.C. § 3-419:

(1) An instrument is converted when

(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 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 owner beyond the amount of any proceeds remaining in his hands.

(4) An intermediary bank or payor bank which is not a depository 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.

13 For a discussion of the policy reasons against a broad interpretation of § 3-419(3), see WHITE & SUMMERS, *supra* note 5, at 502-04; Note, *Payee v. Depository Bank: What is the UCC Defense to Handling Checks Bearing Forged Indorsements?*, U. COLO. L. REV. 281 (1974); Note, *Depository Bank Liability Under § 3-419(3) of the Uniform Commercial Code*, 31 WASH. & LEE L. REV. 676 (1974); Comment, 74 COLUM. L. REV. 104 (1974); Comment, 7 AKRON L. REV. 158 (1973). See also U.C.C. § 3-417, Comment 8, which states that "Where there is an indorsement the warranty runs with the instrument and the remote holder may sue the indorser-warrantor directly and thus avoid a multiplicity of suits . . ."; 1 W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 438-40 (1964) [hereinafter cited as HAWKLAND].

14 If, however, the drawer substantially contributes to the creation of a forged indorsement, he is precluded from compelling the drawee bank to reinstate his account. U.C.C. § 3-406. The collecting bank does not benefit from this defense, however, because Article 3 contains no specific provisions that would allow it to force its loss onto the negligent drawer.

when analyzed in light of the provisions and explanatory Comments of the U.C.C. itself. This note suggests that a close reading of section 3-419(3) in context with its related sections in the Code discloses the true scope and proper interpretation of this defense drafted for the benefit of collecting banks.

II. Judicial Interpretation of Section 3-419(3)

In determining the precise construction to be given this new statute, the courts refused to construe the statutory language broadly and thus rejected an interpretation that would radically depart from the common law of banking. Only a few courts that considered the matter held that section 3-419(3) provided a defense when the collecting bank paid over a forged indorsement. Without exception, these cases so held without discussion or analysis of the issue.¹⁵ The majority of courts that have addressed the issue directly have held that, notwithstanding the language of the Code provision, the defense was not available to a collecting bank for its mistaken payment to a forger. These cases allowed the payee to sue the collecting bank directly and to recover from it the amount of the instrument.¹⁶

In their desire to circumvent the Code and impose common law liability on collecting banks, the courts have utilized three basic approaches. The first approach merely skirts the issue by finding that a bank which pays over a forged indorsement does not act within "reasonable commercial standards" and therefore is not entitled to protection under section 3-419(3).¹⁷

The second approach turns on the precise definition of the term "proceeds." This approach holds that when a bank pays on a forged indorsement, it does not pay the proceeds of the check to the forger; rather, the bank pays out its own funds and holds the *proceeds* in an equitable trust for the true owner. Thus, the proceeds "remain in the bank's hands," and section 3-419(3) does not protect the collecting bank from a direct action by the payee.¹⁸

These first two theories hold section 3-419(3) applicable to collecting banks in the ordinary course of business but manipulate the Code's statutory language to negate the section's effect. The third approach, on the other hand, uses the statutory language to hold the section wholly inapplicable. This approach turns on the precise meaning of the word "representative"¹⁹ and holds that section 3-

15 *West Penn Administration, Inc. v. Union National Bank of Pittsburgh*, 233 Pa. Super. Ct. 311, 335 A.2d 725 (1975); *Keane v. Pan American Bank*, 309 So. 2d 579 (Fla. Dist. Ct. App. 1975); *Messeroff v. Kantor* 261 So. 2d 553 (Fla. Dist. Ct. App. 1972).

16 See notes 17-18, 20 *infra*.

17 *F.D.I.C. v. Marine National Bank*, 431 F.2d 341 (5th Cir. 1960); *Salsman v. National Community Bank*, 102 N.J. Super. 482, 246 A.2d 162 (1968), *aff'd*, 105 N.J. Super. 164, 251 A.2d 460 (1969). See also *Sullivan Construction Co. v. Wilton Manors National Bank*, 290 So. 2d 561, 562 (Fla. Dist. Ct. App. 1974), which held that action "in the usual course of business" was insufficient to qualify as action within reasonable commercial standards.

18 *Sonnenberg v. Manufacturers Hanover Trust Co.*, 87 Misc. 2d 202, 383 N.Y.S.2d 863 (1976); *Gillen v. Maryland National Bank*, 274 Md. 96, 333 A.2d 329 (1975); *Cooper v. Union Bank*, 9 Cal. 3d 123, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

19 U.C.C. § 1-201(35) defines "representative" as including "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."

419(3) applies only when a collecting bank acts as a true agent.²⁰ The courts that espouse this view assert that this agency status exists only when the collecting bank sells negotiable bearer instruments for its principal. Section 3-419(3) is held inapplicable to ordinary bank collection transactions; therefore, it affords no protection when a bank pays on a forged indorsement.

In spite of the generally critical evaluation of these three theories by legal writers,²¹ recent judicial opinions have done little to clarify the issue or to revise the earlier approaches to the problem. The courts, in effect, have continued to ignore the defense without fully discussing the consequences of their actions on the U.C.C. itself.

Illustrative of the cases that have merely cited and affirmed earlier judicial authority on this question are *Tubin v. Rabin*²² and *Grieshaber v. Michigan National Bank of Detroit*.²³ In *Tubin* the District Court for the Northern District of Texas said, "This section [3-419(3)] of the Code is not applicable to the transaction involved here . . . [I]t must be presumed that the . . . Legislature in adopting both Sections 3-419(1)(c) and 3-419(3) intended a *reasonable* result . . . Section 3-419(3) . . . is concerned with an entirely different transaction than the typical 'honoring a check' transaction."²⁴ Similarly, the Michigan Court of Common Pleas in *Grieshaber* concluded that section 3-419(3) does not provide a new defense to collecting banks. The court held, in effect, that collecting banks were protected by section 3-419(3) only when they acted in a true representative capacity for the innocent transferee of bearer instruments. The court maintained that the section does not apply to the usual bank collection transaction because there is no true agency by the bank:

[T]he court is well satisfied that the present controversy is occasioned by nothing more than imprecise draftsmanship and that, when the slightest examination is made beneath the surface of the words of the subsection, it is evident that the purpose of mentioning collecting and depository banks therein is to identify them as being included among those who are protected when they act as representatives, not to prescribe that collecting and depository banks are necessarily representatives.²⁵

Thus, judicial interpretation of section 3-419(3) has remained unsatisfactory because the courts have continued to disregard the Code on the basis of theories that are at best inadequate. None of the approaches espoused by the courts withstand careful analysis. Resort to a routine finding that when a collecting bank pays on a forged indorsement it does not act within the reasonable commercial standards required by section 3-419(3) is an unsatisfactory solution to the question of the collecting bank's liability. Although there are situations in

20 *Tubin v. Rabin*, 389 F. Supp. 787 (N.D. Tex. 1974); *Grieshaber v. Michigan National Bank of Detroit*, Mich. C.P., City of Detroit, 18 U.C.C. Rep. 1248 (1976); *Ervin v. Dauphin Deposit Trust Co.*, 84 Dauph. 280, 38 Pa. D. & C.2d 473 (1965).

21 See note 13 *supra*.

22 389 F. Supp. 787 (N.D. Tex. 1974). The case involved a bank which accepted a cashier's check for deposit on the basis of a forged indorsement.

23 *Grieshaber v. Michigan National Bank of Detroit*, Mich. C.P., City of Detroit, 18 U.C.C. Rep. 1248 (1976).

24 389 F. Supp. at 789 (emphasis added).

25 18 U.C.C. Rep. at 1256.

which a bank will not have acted reasonably when it pays on a forged indorsement, the typical situation in which the bank is duped by a clever forger should not be considered commercially unreasonable *per se*. In these common situations,

it would be a sham to fasten liability on the defendant banks, which operate in a world of electronic impulses and encoded integers, on the basis of the eyeball to eyeball mercantile confrontations of halcyon days. Minute examination of checks for forgeries is an old banker's tale; two hundred years after *Price v. Neal*, bankers do not purport to be graphologists.²⁶

Likewise, the "proceeds" test for routinely invalidating the defense is unsatisfactory. This analysis relies upon the imposition of a constructive trust to allow the payee to trace the proceeds of his check into the bank's hands.²⁷ Such reliance is misplaced in the normal forged indorsement situation, however, because a constructive trust generally will be imposed to protect a particular creditor only when an improper act of the debtor, such as fraud, induces the extension of credit and other creditors are likely to benefit as a result of the wrongful act, as in the case of an insolvent bank.²⁸ Utilization of the proceeds theory is thus an imaginative, although inappropriate, construction of section 3-419(3) language which effectively maintains the collecting bank's pre-Code status of liability.

The main criticism of the "representative" theory is that it narrows the scope of section 3-419(3) too greatly. As one commentator has noted, restricting the defense to collecting banks acting as agents in the sale of negotiable bearer instruments "reflects an unwarranted concern with the designation of the bank either as an agent acting for its transferor or as the purchaser of the item from the transferor. Concern with this technicality is clearly against the tenor of the U.C.C."²⁹

Thus, none of these analytical approaches really supports the result reached but in light of the policy considerations for allowing the payee direct suit against the collecting bank, these theories have nevertheless been maintained. As one commentator summarized: "Although we deplore that mentality which leads a court to think it is completely free to disregard legislative language we appreciate the strength of the policy arguments against the restrictions that the bankers presumably wrote into 3-419(3), and if we were in the legislature we would urge its modification."³⁰ Not content to wait for legislative relief, the courts have fashioned their own judicial remedies to this problem by construing the statute narrowly and technically.

26 *Perini Corp. v. First National Bank of Habersham County*, 553 F.2d 398, 420 (5th Cir.), *reh. denied*, 557 F.2d 823 (5th Cir. 1977). *Price v. Neal*, 3 Burr. 1354 (1762), held that money paid against an item on which the drawer's signature was forged could not be recovered by the drawee from anyone who had received the payment without knowledge of the forgery.

27 *Cooper v. Union Bank*, 507 P.2d at 615-16.

28 5 SCOTT ON TRUSTS, §§ 528, 529 (3d ed. 1967).

29 Comment, 74 COLUM. L. REV. 104, 109 (1974). U.C.C. § 4-201 provides that a collecting bank is presumed to be an agent of the owner regardless of the form of the indorsement.

30 WHITE & SUMMERS, *supra* note 5, at 505.

III. The Scope of the Defense

The note suggests that the courts have not completely disregarded legislative language, however, and that upon close examination of the provisions and explanatory Comments of U.C.C. Articles 3 and 4, one can glean the true scope of section 3-419(3). The section does not require modification, but merely needs to be read in context with the rest of the Code.

The "representative" theory comes closest to enunciating the scope of section 3-419(3). Its drawback, however, as with the other two theories is that it ignores Comment 6 to section 3-419, which states in pertinent part that "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."³¹

Both the courts and the commentators have been remiss in their neglect of this clear statement of the section's intent and effect. In this regard, although the "representative" theory based on agency principles should not be abandoned, it is necessary to examine the U.C.C. to reevaluate the parameters of a collecting bank's actions as a "representative."

A. "Representative" Defined

As defined in the Code, "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."³² The Comment to this definition says simply but significantly that the definition is "New."³³ Thus, the scope and operation of the term must be ascertained from statutory language and usage. There is no indication that the term applies to banks generally. In accordance with the principle of *ejusdem generis*, the clause "or any other person empowered to act for another" must be read in light of the specific terms that precede it in the definition, all of which indicate an agency relationship between the person empowered to act and his principal.

In the whole of U.C.C. Articles 3 and 4, only three sections incorporate "representative." Section 3-403 states in pertinent part that "a signature may be made by an agent or other representative."³⁴ Here the statutory language is equivocal, but the Comments following the section cite the Code definition of "representative" and then discuss the agency principles of express, implied, and apparent authority. Examples illustrating the operation of the section deal with, *inter alia*, "Arthur Adams, Agent."³⁵

31 U.C.C. § 3-419, Comment 6 states:

The 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.

32 U.C.C. § 1-201 (35).

33 U.C.C. §§ 1-201, Comment 35.

34 U.C.C. § 3-403(1) states: "A signature may be made by an agent or other representative, and his authority to make it may be established as in other cases of representation. No particular form of appointment is necessary to establish such authority."

35 U.C.C. § 3-403, Comments 1, 3.

Section 3-419(3) uses the phrase "representative, including a depository or collecting bank." This language is ambiguous, and the Comments do little to clarify the meaning of the term, other than to state that the representative is not liable to his "principal."³⁶

Finally, section 3-508(6) speaks in terms of the representative of a party's estate, and subsection (7) of that provision addresses itself to the personal representative of a dead or incompetent party. Both instances refer to true agency situations.³⁷ In short, at no point in Article 3 or 4 does the Code give any indication that "representative" is broader in scope than traditional agency relationships.

B. Collecting Bank as Agent

It remains to examine the Code to establish the circumstances in which a collecting bank is deemed to be an agent/representative. The logical starting point is section 4-201(1).³⁸ This section applies to almost every item moving through banks for the purpose of presentment, payment, or collection.³⁹ Both the statutory language and the explanatory Comments are explicit with regard to a collecting bank's agency status: unless there is a contrary intent clearly evidenced, the status of a collecting bank is that of an agent for the owner of the item. This presumption of agency "applies regardless of the form of the indorsement."⁴⁰

There is, however, a major limitation on the rule of prima facie agency status. At some point in the bank collection process the agency status of the collecting bank changes to that of a debtor of its customer. In accordance with

36 U.C.C. § 3-419, Comment 5.

37 U.C.C. §§ 3-508(6), 3-508(7). It should be noted that U.C.C. § 3-508(1) uses the language "agent or bank" giving notice to his "principal or customer" (emphasis added). This seems to be a clear indication that a bank is not normally considered an agent. When this language is juxtaposed with the § 3-419(3) language "representative, including a . . . collecting bank" (emphasis added), the latter phrase seems to indicate that a collecting bank will be protected only when it is functioning as a representative; that is, only when it has an agency relationship with its customer.

38 U.C.C. § 4-201(1) states:

Unless a contrary intent clearly appears and prior to the time that a settlement given by a collecting bank for any item is or becomes final (subsection (3) of Section 4-211 and Sections 4-212 and 4-213) the bank is an agent or sub-agent of the owner of the item and any settlement given for the item is provisional. This provision applies regardless of the form of the indorsement or lack of indorsement and even though credit given for the item is subject to immediate withdrawal as of right or is in fact withdrawn; but the continuance of ownership of an item by its owner and any rights of the owner to proceeds of the item are subject to rights of a collecting bank such as those resulting from outstanding advances of the item and valid rights of set-off. When an item is handled by banks for purposes of presentment, payment and collection, the relevant provisions of this Article apply even though action of parties clearly establishes that a particular bank has purchased the item and is the owner of it.

39 U.C.C. § 4-201, Comment 1 states in part:

The general approach of Article 4, similar to that of other articles, is to provide, within reasonable limits, rules or answers to major problems known to exist in the bank collection process without regard to questions of status and ownership but to keep general principles such as status and ownership available to cover residual areas not covered by specific rules. In line with this approach, the last sentence of subsection (1) says in effect that Article 4 applies to practically every item moving through banks for the purpose of presentment, payment or collection.

40 U.C.C. § 4-201, Comment 3 states: "The prima facie agency status of collecting banks is consistent with prevailing law and practice today."

section 4-201(1), that change occurs at "the time settlement given by a collecting bank for an item is or becomes final." At this point the collection is completed and "all agency aspects are terminated and the identity of the item has become completely merged in bank accounts, that of the customer with the depository bank and that of one bank with another."⁴¹

Thus section 4-201 makes the pertinent provisions of Article 4 applicable to substantially all items handled by banks in the collection process, recognizes the prima facie status of banks as agents, and states the appropriate time when this agency status terminates. In so doing, it controls the scope of the defense given to collecting banks under section 3-419(3).

The key to the collecting bank's change of status is clearly the time when settlement given by it for an item becomes final. It is therefore necessary to determine at what point this occurs.

Section 4-213⁴² sets forth the general guidelines that establish the definition and effect of a final payment by a payor bank. The time at which the bank makes final payment is significant because final payment has a direct relationship to the final settlement of the item by the collecting bank. Subsection (1) of section 3-213 lists the events that constitute final payment. Generally it will be accomplished by the mere passage of time in accordance with section 4-

41 U.C.C. § 4-201, Comment 4. U.C.C. § 4-104(j) defines "settle" to mean "to pay in cash, by clearing house settlement, in a charge or credit or by remittance, or otherwise as instructed. A settlement may be either provisional or final."

42 U.C.C. § 4-213 states:

(1) An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

- (a) paid the item in cash; or
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement; or
- (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement.

Upon a final payment under subparagraphs (b), (c) or (d) the payor bank shall be accountable for the amount of the item.

(2) If provisional settlement for an item between the presenting and payor banks is made through a clearing house or by debits or credits in an account between them, then to the extent that provisional debits or credits for the item are entered in accounts between the presenting and payor banks or between the presenting and successive prior collecting banks seriatim, they become final upon final payment of the item by the payor bank.

(3) If a collecting bank receives a settlement for an item which is or becomes final (subsection (3) of Section 4—211, subsection (2) of Section 4—213) the bank is accountable to its customer for the amount of the item and any provisional credit given for the item in an account with its customer becomes final.

(4) Subject to any right of the bank to apply the credit to an obligation of the customer, credit given by a bank for an item in an account with its customer becomes available for withdrawal as of right

- (a) in any case where the bank has received a provisional settlement for the item,—when such settlement becomes final and the bank has had a reasonable time to learn that the settlement is final;
- (b) in any case where the bank is both a depository bank and a payor bank and the item is finally paid,—at the opening of the bank's second banking day following receipt of the item.

(5) A deposit of money in a bank is final when made but, subject to any right of the bank to apply the deposit to an obligation of the customer, the deposit becomes available for withdrawal as of right at the opening of the bank's next banking day following receipt of the deposit.

213(1)(d); that is, upon expiration of the payor bank's "midnight deadline."⁴³ This deadline will not operate, however, if the payor bank completes its "process of posting"⁴⁴ prior to the expiration of the deadline. Although the time of final payment may vary, the effect does not: upon final payment "the payor bank shall be accountable for the amount of the item."⁴⁵ This accountability is that of strict liability to the true owner.⁴⁶ Subsection (2) expressly states that when the item is finally paid in accordance with subsection (1), the final payment automatically without further action "firms up" the provisional credits made for the item and makes these credits final settlements.⁴⁷ Subsection (3) states that when the collecting bank's settlement thus becomes final, the bank is accountable to its customer for the amount of the item.⁴⁸ At this point, its agency status terminates and it becomes a debtor of its customer.

Thus, when all banks in the collection stream have operated in the normal fashion of giving one another provisional credits, the final payment of the item solidifies all the credits down the stream and the funds are said to be transmitted instantly through these banks and into the hands of the collecting bank. In effect, final payment *is* final settlement. Because it is not possible for the collecting bank to know when this instantaneous collection of funds has occurred, the customer is not given the right to withdraw the funds until the collecting bank has had a reasonable time to learn that settlement is final.⁴⁹

If, however, the item is accounted for without the use of provisional credits, final payment by the payor bank does not necessarily result in simultaneous final settlement in the case of all prior parties. When, for example, one or more of the banks account for the item with a remittance draft,⁵⁰ the next prior bank does not receive final settlement for the item until the remittance draft itself is paid.⁵¹ This type of transaction is referred to as a "straight non-cash collection," and its use results in a time lag between final payment by the payor bank and final settlement by the collecting bank.⁵²

It should be noted, however, that in the majority of cases banks make provisional settlement for items when they are first received and then await determination as to whether the items will be finally paid. In these cases provisional

43 See §§ 4-213 (1)(c), 4-301. U.C.C. § 4-104(1)(h) defines "midnight deadline" as "midnight on [the bank's] next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later."

44 For a discussion of the process of posting, see WHITE & SUMMERS, *supra* note 5, at 534; HAWKLAND, *supra* note 13, at 429-31.

45 U.C.C. § 4-213(1).

46 See note 8 *supra*.

47 See U.C.C. § 4-213, Comment 8.

48 U.C.C. § 4-213, Comment 9.

49 See HAWKLAND, *supra* note 13, at 418, 429-35. Even though the collecting bank permits the depositor, as a matter of convenience and customer relations, to withdraw the funds represented by the uncollected item the relationship is still regarded as one of agent-principal and not as one of debtor-creditor. See also U.C.C. § 4-213, Comment 9.

50 Remittance drafts are used when one collecting bank does not have an account with another. It is therefore unable to settle the item by giving a provisional credit. Rather, it must send a remittance draft drawn on a third bank in which both collecting banks have an account. See HAWKLAND, *supra* note 13, at 432.

51 See U.C.C. §§ 4-211(3), 4-201, Comment 4.

52 U.C.C. § 4-201, Comment 4. See §§ 4-211(3), 4-213(3), which define the time of final settlement with regard to straight non-cash collections.

53 See U.C.C. § 4-212, Comment 1.

credits are used and the items are referred to as "cash items."⁵³

In summary, then, section 4-213(1) provides that an item is finally paid when the payor bank takes certain action with respect to that item. This final payment may or may not result in a simultaneous final settlement for the item *vis-à-vis* the collecting bank. If provisional credits and debits have been utilized, final settlement is simultaneous with final payment. If such credits have not been used, the collecting bank's final settlement does not become final until some time later.⁵⁴

The Code is clear on the status of the collecting bank during the interim, if any, between final payment and final settlement: the collecting bank retains its status as agent and as a consequence the owner retains his status as principal.⁵⁵ Thus, during this period the collecting bank falls within the Code's concept of "representative" and is therefore immune from suit by the payee in accordance with section 3-419(3), provided it uses good faith and acts in accordance with reasonable commercial standards. It is to this interim period that Comment 6 to section 3-419 is addressed. When the payor bank makes final payment on a forged indorsement it becomes liable to the payee. The collecting bank is protected from the payee until it loses its agency status. Because it has breached its warranties by paying on the forged indorsement, however, the collecting bank is immediately liable to the payor bank for the amount of the payor bank's loss.

Thus, section 3-419(3) was designed to encompass two separate situations in its protection of collecting banks. The first situation involves collecting banks when they act as agents in dealing with bearer paper. It is to this narrow area of bank activity alone that courts utilizing the "representative" theory have limited the scope of section 3-419(3). Comment 5 explains this defense by stating that section 3-419(3) is intended to adopt the current rule of decisions that holds a representative not liable to his principal for a good faith conversion of a negotiable instrument.⁵⁶ As one commentator has summarized the scope of this defense:

Additional research will disclose a series of pre-Code decisions applying a rule not unlike section 3-419(3)—but to a quite different set of facts. In those cases, the court was called upon to determine the conversion liability of a broker or bank which disposes of stolen bearer paper for its principal, who is generally the good faith transferee of the stolen instrument. Under those circumstances, the courts limited the agent's liability to the original owner to whatever proceeds remained in the agent's hands.⁵⁷

In addition to this narrow application of section 3-419(3), the defense protects the collecting bank during the time before final payment is made and in the interim, if any, between final payment and final settlement. This period of liability only for breach of warranty to the payor bank comports with the language of Comment 6, which heretofore has been virtually ignored. No real hardship is afforded the payee, however, because as soon as settlement becomes

⁵⁴ See note 54 *supra*.

⁵⁵ U.C.C. § 4-201, Comment 5.

⁵⁶ U.C.C. § 3-419, Comment 5.

⁵⁷ Dugan, *Stolen Checks—the Payee's Predicament*, 53 B.U.L. REV. 955, 974 (1973).

final, the collecting bank loses its agency status and consequently its immunity from direct suit by the payee.⁵⁸

This interim period may be important to the collecting bank because it allows the bank a period of grace during which it has an opportunity to correct its mistake. It is probably true that "bankers' . . . hands were . . . at work in the drafting of 3-419(3)."⁵⁹ Although a complete revision of the common law with regard to the long-established principle of a collecting bank's liability for payment on a forged instrument was an unrealistic undertaking for these drafter-bankers, they did succeed in codifying the extant common law defense to conversion of negotiable bearer instruments. In addition, they provided themselves with a general period of immunity to attempt to salvage an unfortunate situation as much as possible.

There is no pre-Code rule of law that provided a defense to a collecting bank on the facts presented in the hypothetical given at the beginning of this note, and the mere fact that the section was intended to codify an extant rule of law is persuasive evidence that it did not create a completely new defense. Had a more radical departure from the common law been intended or attempted, the explanatory Comments following section 3-419(3) would have clearly defined the extent of departure from prior law and the justifications for that departure.

In addition, had the drafters of the Code intended to depart from this established rule of pre-Code law, it is reasonable to expect that the statutory language of the section itself would have manifested that intent explicitly. As presently drafted, subsection (3) reads "a representative, including a . . . collecting bank." This language is ambiguous and can reasonably be interpreted to mean that a collecting bank is protected by the section only when it acts in a representative capacity. By simply changing the section to read "a representative *and* a . . . collecting bank" this ambiguity would have been eliminated. Thus, by substituting "and" for "including," the section would have clearly distinguished the operation of the representative from the operation of the bank and allowed the defense to cover each separate entity without restriction.

IV. Section 3-419(3) in Operation

Assuming that the drawee bank has discovered the forgery and therefore has

58 5 SCOTT ON TRUSTS §§ 534, 540 (3d ed. 1967) states:

If commercial paper is deposited with a bank for collection, although the bank presumptively receives it and holds it as agent or trustee or bailee until collection, it presumptively becomes a debtor to the depositor after it has collected. . . . A bank, however, in making collections is presumptively entitled to use the proceeds as its own. This is the regular custom of banks and indeed they could hardly do business any other way.

. . . .
Where the bank has mingled cash of the claimant with its own cash, it is perfectly well settled that the right of the claimant to follow his money is not lost. The mere fact that the cash of the claimant is indistinguishably mingled with the cash of the bank does not cut off the claimant's interest, but he acquires an equitable lien upon the whole of the mingled cash in the bank. This is in accordance with the general rule as to the effect of mingling funds. It is immaterial that withdrawals have been made from the cash and additions of the bank's own money have been made, so long as the amount of cash on hand is not diminished below the amount of the claimant's money which has been mingled in the fund.

59 WHITE & SUMMERS, *supra* note 5, at 505.

not made final payment, the payee has no direct action against the collecting bank because it retains its agency status and is protected by section 3-419(3). This presents no hardship to the payee, however, because under these circumstances he has a cause of action against the drawer in accordance with section 3-804⁶⁰ of the Code. The drawer has lost nothing because the payor bank has not debited his account. He still owes the payee on the underlying obligation. Thus, when he draws a new check for the payee he is merely discharging his original debt. No one except the forger (who is now insolvent or cannot be found) has been unjustly enriched, and the loss falls where it properly should—on the first responsible person who took the paper from the forger, the collecting bank. The collecting bank has already paid the forger; now, when the drawer's new check comes through the collection stream it must pay again, this time to the true payee. As can be seen, this process operates completely within the ambit of the U.C.C.

Assuming that the payor bank has already made final payment and the transaction involves non-cash collections such that there will be a time interval between final payment and final settlement of the item, the Code allows the parties' own remedy to take effect. Section 4-211(3)⁶¹ provides that the risk of non-payment on the remittance instrument is placed on the owner of the item and not on the collecting bank.⁶² The terms of payment of the instrument would probably have been agreed upon between the parties prior to their use of such instrument.⁶³ Thus, the effect of this Code provision is merely to allow the terms of such agreement to operate as the parties intended.

If the payor bank has not made final payment but does not detect the

60 U.C.C. § 3-804 provides that "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 upon due proof of his ownership."

61 U.C.C. § 4-211(3) states:

(3) A settlement for an item by means of a remittance instrument or authorization to charge is or becomes a final settlement as to both the person making and the person receiving the settlement

- (a) if the remittance instrument or authorization to charge is of a kind approved by subsection (1) or has not been authorized by the person receiving the settlement and in either case the person receiving the settlement acts seasonably before its midnight deadline in presenting, forwarding for collection or paying the instrument or authorization,—at the time the remittance instrument or authorization is finally paid by the payor by which it is payable;
- (b) if the person receiving the settlement has authorized remittance by a non-bank check or obligation or by a cashier's check or similar primary obligation of or a check upon the payor or other remitting bank which is not of a kind approved by subsection (1) (b),—at the time of the receipt of such remittance check or obligation; or
- (c) if in a case not covered by sub-paragraphs (a) or (b) the person receiving the settlement fails to seasonably present, forward for collection, pay or return a remittance instrument or authorization to it to charge before its midnight deadline,—at such midnight deadline.

62 See § 4-211, Comments 1, 7. See also Comment 5, which states that § 4-211 is limited to those situations where a collecting or payor bank or a non-bank payor receives an item and accounts for it by "remitting" or "sending back" something for the item, usually some form of a remittance instrument, order or authorization. Some specific rules are needed for remittance cases because of time required to process the remittance instrument.

63 See U.C.C. § 4-211, Comment 7, which states that "if the person receiving the settlement has authorized remittance by certain specified media . . . the settlement becomes final at the time of receipt of such check or obligation. In this event the person receiving the settlement assumes the risk that the remittance instrument is not itself paid."

forgery, and the forger-customer has cashed the check or obtained a provisional credit against which the bank allows him to draw before settlement becomes final, section 3-419(3) operates to protect the collecting bank (assuming good faith and reasonable commercial standards); but it operates only as long as the collecting bank retains its "representative" status. As soon as final settlement occurs, the collecting bank loses the shield of section 3-419(3) and becomes accountable to the payee.⁶⁴

If the forgery is not detected until after final payment has been made, and if provisional credits were used which were not drawn against until after settlement became final, the warranty provisions of the Code operate to hold the collecting bank ultimately liable in the event the payee sues the payor bank. The payee can sue the collecting bank directly, however, because final settlement will be effected simultaneously with final payment; thus, the collecting bank will no longer be a "representative" and section 3-419(3) will no longer operate to immunize the bank from direct suit. Since the Code is silent as to the collecting bank's liability to the payee in the ordinary bank collection transaction, section 1-103⁶⁵ provides that the common law of banking shall govern. The collecting bank is held liable to the payee.⁶⁶

V. Conclusion

As evidenced by the definitions and use of the terms in the U.C.C., "representative" is meant by the drafters to encompass true agency situations only. The scope of those situations which involve collecting banks is contained in Articles 3 and 4 of the Code. Examination of these articles reveals that the Code incorporates without change the common law position that a collecting bank or other agent is not liable to his principal when dealing with negotiable bearer instruments. In addition, the Code makes clear that until such time as any provisional settlement given by a collecting bank becomes final, the collecting bank in its normal course of business maintains an agency status with its customer. It is to these two situations that the defense of section 3-419(3) applies, provided the bank acts in good faith and in accordance with reasonable commercial standards.

The section does not necessarily need to be redrafted; rather, as is true with most of the Code provisions, it must be read in the context of the common law that preceded it and the other related Code sections that define its scope and operation. Read in isolation, section 3-419(3) can be seen to change radically the common law of banking without adequate justification or explanation by the drafters. Read in context, however, it merely codifies prior law and provides collecting banks a reasonable time period free from direct suit by the payee.

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⁶⁴ See note 58 *supra*.

⁶⁵ U.C.C. § 1-103 states that "unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions."

⁶⁶ See note 8 *supra*.