Depositary Bank Liability Under § 3-419(3) Of The Uniform Commercial Code
DEPOSITARY BANK LIABILITY UNDER § 3-419(3) OF THE UNIFORM COMMERCIAL CODE

The exigencies of financial affairs have historically necessitated the use of various forms of commercial paper for the efficient consummation of most business transactions. In particular, the almost universal usage of checks has been prompted by their convenience for discharging monetary obligations. However, abusive practices have accompanied the check phenomenon, creating perplexing legal problems. One particularly troublesome area has been that of determining the rights and remedies that should be afforded the true owner of a check when the check is collected on an unauthorized endorsement for the benefit of one who has improperly come into its possession.

Prior to the adoption of the Uniform Commercial Code (UCC) by the states, the true payee of an order instrument had an undisputed right to recover the money properly due him from at least four parties.

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1Commercial paper is a term of art which includes "drafts," "checks," "certificates of deposits," and "notes." Uniform Commercial Code [hereinafter UCC] § 3-104. Commercial paper is to be distinguished from money, documents of title, and investment securities. Id. § 3-103.

2The negotiable instrument evolved in direct response to the need by the commercial community for a method to transact business over great distances without the risk of carrying or transporting money. See J. Holder, The History of Negotiable Instruments in English Law 1-3 (1955). The bank check, a form of negotiable instrument, is the natural outgrowth of the development of banking itself. The phenomenal growth of the bank check as a medium of exchange is evidenced by its efficient performance today as the vital conduit for conducting the commerce of the country. See H. Bailey, Brady on Bank Checks 1-3 (4th ed. 1969).

3In 1962, the estimated volume of checks was approaching 14.5 billion which amounted to 4.7 trillion dollars. O'Malley, Common Check Frauds and the Uniform Commercial Code, 23 Rutgers L. Rev. 189, 190 n.9 (1969). Forecasters predicted that this volume would reach twenty-two billion checks by 1970. Farnsworth, A General Survey of Article 3 and an Example of Two Aspects of Codification, 44 Texas L. Rev. 645, 652 n.63 (1966). It is estimated that checks are used in ninety-five percent of all business transactions. Vergari, In re Articles 3, 4, and 5, 28 Temp. L. Q. 529, 538 (1955).

4A check is one of many forms a negotiable instrument may take. Specifically, a check is a negotiable instrument drawn on a bank which is payable on demand. UCC § 3-104(1) and (2)(b).

5Collection is the process of sending a check through normal banking channels for final payment by the drawer's bank. The collection process is governed by Article 4 of the UCC. See UCC § 4-101 and Comment.

6Unauthorized endorsements, which include forged endorsements, are those made without actual, implied or apparent authority. UCC § 1-201(43).

7A check is payable to order when by its terms it is made payable to a particular person. Id. § 3-110.
who had dealt with the instrument. Although there was an enormous amount of disagreement among the jurisdictions as to the particular theories of recovery, nearly all courts recognized the right of the payee to recover from a depositary bank that took the check for collection. The bank was generally liable to the true owner under either a tort theory for conversion of the check or a contract theory.

Generally, the right of a true owner of an instrument to recover was founded in § 23 of the Negotiable Instruments Law [hereinafter NIL]. Since under § 23 the party who received the proceeds of the forged check had no right to them, the true payee could sue one of three parties in addition to the forger himself; the drawer of the check, the payor bank which paid the check over the unauthorized endorsement, or the bank that cashed or agreed to collect the check and received the proceeds from the payor bank. Against the drawer of the check the cause of action was generally recognized as one on the underlying obligation for which the check was given, since the genuine payee had never received any money. See, e.g., Hart v. Moore, 171 Miss. 838, 158 So. 490 (1935); Siegel v. Kovinsky, 93 Misc. 541, 157 N.Y.S. 340 (Sup. Ct.), aff'd mem., 174 A.D. 864, 159 N.Y.S. 1142 (1916); Shepard & Morse Lumber Co. v. Eldridge, 171 Mass. 516, 51 N.E. 9 (1898). But where the check was stolen from the mails or otherwise diverted prior to the payee's physical receipt, in some jurisdictions he was unable to recover from the drawer. See, e.g., Graves v. American Exch. Bank, 17 N.Y. 205 (1858).


The genuine payee's right to recover from a depositary or collecting bank was generally upheld, although on different theories. Notes 10-11 infra.

See the theories discussed at note 8 supra.

for money had and received.\textsuperscript{11}

Section 3-419(3) of the UCC seemingly altered this pre-UCC status of depositary bank liability.\textsuperscript{12} On its face, the statute provides an absolute defense to the depositary bank that acts reasonably and in good faith, except to the extent of the check proceeds which may still be in its hands:

Subject to the provisions of this Act concerning restrictive endorsements 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


\textsuperscript{12}The following are the state statutes containing the language of Uniform Commercial Code § 3-419(3): ALA. CODE tit. 7A, § 3-419(3) (1966); ALASKA STAT. § 45.05.356(3) (1964); ARIZ. REV. STAT. § 44.3556 (3) (1967); ARK. STAT. ANN. § 85-3-419(3) (1961); CAL. COMM. CODE § 3419(3) (West 1964); COLO. REV. STAT. ANN. § 155-3-419(3) (1963); CONN. GEN. STAT. REV. § 42a-3-419(3) (1960); DEL. CODE ANN. tit. 5A, § 3-419(3) (Spec. UCC Pamphlet 1970); D.C. CODE ANN. § 28-3-419(3) (1967); FLA. STAT. ANN. § 673.3-419(3) (1966); GA. CODE ANN. § 109A-3-419(3) (1962); HAWAII REV. STAT. § 490-3-419(3) (1968); IDAHO CODE § 28-3-419(3) (1967); ILL. REV. STAT. ch. 26, § 3-419(3) (1971); IND. CODE § 26-1-3-419(3) (1971); IOWA CODE § 554.3419(3) (1971); KAN. STAT. ANN. § 84-3-419(3) (1965); KY. REV. STAT. § 355.3-419(3) (1971); ME. REV. STAT. ANN. tit. II, § 3-419(3) (1964); MD. ANN. CODE art. 95B, § 3-419(3) (1963); MASS. GEN. LAWS ANN. ch. 106, § 3-419(3) (1963); MICH. STAT. ANN. § 19.3419(3) (Rev. Vol. 1964); MINN. STAT. § 336.3-419(3) (1969); MISS. CODE ANN. § 41A:3-419(3) (Spec. UCC Supp. 1967); Mo. REV. STAT. § 400.3-419(3) (Supp. 1967); MONT. REV. CODES ANN. § 87A-3-419(3) (1964); NEB. REV. STAT. § 90-3-419(3) (Supp. 1969); NEV. REV. STAT. § 104.3419(3) (1971); N.H. REV. STAT. ANN. § 382-A:3-419(3) (1961); N.J. REV. STAT. § 12A:3-419(3) (1962); N.M. STAT. ANN. § 50A-3-419(3) (1962); N.Y. U.C.C. § 3-419(3) (McKinney 1964); N.C. GEN. STAT. § 25-3-419(3) (Repl. Vol. 1965); N.D. CENT. CODE § 41-03-56 (1965); OHIO REV. CODE ANN. § 1303.55(c) (Page 1964); OKLA. STAT. ANN. tit. 12A, § 3-419(3) (1963); ORE. REV. STAT. § 73.4190(3) (1963); PA. STAT. ANN. tit. 12A, § 3-419(3) (1970); R.I. GEN. LAWS ANN. § 6A-3-419(3) (1961); S.C. CODE ANN. § 10.3-419(3) (1962); S.D. CODE § 57-3-4 (1969); TENN. CODE ANN. § 47-3-419(3) (Repl. Vol. 1964); TEX. BUS. & COM. CODE § 3-419(3) (1968); UTAH CODE ANN. § 70A-3-419(3) (Repl. Vol. 1968); VT. STAT. ANN. tit. 9A, § 3-419(3) (1966); VA. CODE ANN. § 8.3-419(3) (1965); WASH. REV. CODE ANN. § 62A.3-419(3) (Supp. 1970); W. VA. CODE ANN. § 46-3-419(a) (1966); WIS. STAT. § 403.419(3) (1969); WYO. STAT. ANN. 34-3-419(3) (Cum. Supp. 1971). None of the jurisdictions listed above has adopted UCC § 3-419(3) in a form different than the official code.
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 its hands.\(^\text{13}\)

Since in most instances a forger would have cashed the check or withdrawn the proceeds of the check if deposited prior to the true owner's suit, commentators felt that the § 3-419(3) defense would totally absolve the depositary bank from any liability to the true owner.\(^\text{14}\)

The judicial reaction to this apparent alteration of pre-UCC depositary bank liability has generally been a refusal to recognize the § 3-419(3) defense.\(^\text{15}\) A Pennsylvania trail judge applying the UCC in

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\(^{13}\)UCC § 3-419(3) (emphasis added).


\(^{15}\)The majority of cases that have specifically considered the applicability of § 3-419(3) has denied its defense on several grounds: (1) Ervin v. Dauphin Deposit Trust Co., 84 Dauph. 280, 38 Pa. D. & C.2d 473, 3 UCC Rep. Serv. 311 (1965) (depositary bank not acting as "representative"); (2) Cooper v. Union Bank, 9 Cal.3d 123, 507 P.2d 609, 107 Cal. Rptr. 1 (1973) (depositary bank still held proceeds); (3) Federal Deposit Ins. Corp. v. Marine Nat'l Bank, 431 F.2d 341 (5th Cir. 1970); 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); Belmar Trucking Corp. v. American Trust Co., 65 Misc.2d 31, 316 N.Y.S.2d 247 (Sup. Ct. 1970); Montgomery v. First Nat'l Bank, 96 Ore. Adv. Sh. 1258 (Sup. Ct. 1973) (depositary bank did not deal with true owner's instrument in a commercially reasonable manner and, therefore, proceeds defense was not applicable); (4) Mississippi Bank & Trust Co. v. County Supplies and Diesel Servs., Inc., 253 So.2d 828 (Miss. 1971) (depositary bank held jointly and severally liable with payor bank and held solely liable to payor bank via cross-claim).
Ervin v. Dauphin Deposit and Trust Co.\textsuperscript{16} held a depositary bank liable despite the fact that the bank had acted reasonably and had cashed the checks for the forger. More recently, in Cooper v. Union Bank,\textsuperscript{17} the California Supreme Court sitting en banc adopted an interpretation of the statutory term "proceeds" which effectively eliminated the availability of the defense. Since the propriety of the Ervin and Cooper decisions may well determine the future viability of § 3-419(3), a detailed analysis of their rationale is necessary. However, before an accurate conclusion as to the true import of these decisions can be made, the language of § 3-419(3) must be examined against the background of the decisions which established the liability of depositary banks prior to the UCC.\textsuperscript{18} Additionally, since the Official Comment to § 3-419(3)\textsuperscript{19} indicates that the subsection was intended to adopt the reasoning of pre-UCC decisions which dealt with the liability in conversion of brokers selling stolen negotiable instruments, a full understanding of pre-UCC broker liability\textsuperscript{20} is imperative.

Under the Negotiable Instruments Law (NIL) both brokers and depositary banks were generally liable to a true owner when an instrument was dealt with over a forged endorsement. A broker, as an agent for his customer was liable in conversion to a true owner as was his principal,\textsuperscript{21} since he stood in the shoes of his customer when he sold personal property. The broker was not protected from liability by the mere fact that he acted on behalf of his principal and that he reasonably, although mistakenly, believed that his principal had been lawfully in possession of the property.\textsuperscript{22} Because a forged endorsement transferred absolutely no rights to the endorsee,\textsuperscript{23} a customer had no power to transfer a fraudulently endorsed negotiable instrument to his broker for disposition,\textsuperscript{24} and the broker derived no

\textsuperscript{17} Cal.2d 123, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).
\textsuperscript{18} See notes 33-47 infra and accompanying text for discussion of pre-UCC depositary bank liability in conversion and otherwise.
\textsuperscript{19} UCC § 3-419(3), Comment 5.
\textsuperscript{20} See notes 21-32 infra and accompanying text for discussion of pre-UCC broker liability for conversion.
\textsuperscript{21} RESTATEMENT (SECOND) OF AGENCY § 349 (1957).
\textsuperscript{22} Id.
\textsuperscript{23} NIL § 23 provided that a forged or unauthorized endorsement was "wholly inoperative" and, therefore, created no rights in the endorsee.
\textsuperscript{24} Since a forged endorsement was "wholly inoperative" the principal who wrongfully took possession of the instrument without the payee's endorsement took no title to the instrument and, therefore, had no power to transfer title. See NIL § 23.
power to convey good title. Accordingly, a broker who innocently sold a negotiable instrument over a forged endorsement was fully liable in conversion to a true owner, even though the proceeds may have been remitted to the customer.

Despite this general doctrine on agent liability, the courts developed an exception for an agent who dealt with negotiable securities in bearer form. When a broker sold stolen bearer bonds and remitted the proceeds of the sale to his principal in good faith, the courts refused to find the broker liable in conversion to the true owner. The judicial justification for this exception was essentially two-fold. First, since the bonds circulated like money and title passed by delivery alone, the broker was held to have little or no means of ascertaining any outstanding rights of the true owner. Second, because the bonds were in bearer form and a bona fide purchaser from the agent acquired a valid title and was protected from suit in conversion, the courts reasoned that the agent, as the innocent conduit of valid title,

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25 An agent derives his power from his principal. If the principal could not convey title, then his agent would never have that right. Restatement (Second) of Agency § 12 (1957).

26 No pre-UCC cases specifically considering the liability of a broker for the conversion of a negotiable instrument over a forged endorsement have come to the attention of this writer. However, since a negotiable instrument constitutes personal property, the law with respect to the conversion of personal property is applicable to all negotiable instruments. Since in the case of forged endorsements a potential converter such as a broker acting as an agent of a wrongdoer would have no title to the instrument, an act of sale inconsistent with the true owner's rights would constitute conversion. See Restatement (Second) of Torts §§ 223, 241 (1965).


28 In First Nat'l Bank v. Goldberg, 340 Pa. 337, 17 A2d 377, 378-79 (1941), a Pennsylvania court aptly described what the good faith standard required:

To defeat the rights of one dealing with negotiable securities it is not enough to show that he took them under circumstances which ought to excite the suspicion of a prudent man and cause him to make inquiry, but that he had actual knowledge of an infirmity or defect, or of such facts that his failure to make further inquiry would indicate a deliberate desire on his part to evade knowledge because of a belief, or fear that investigation would disclose a vice in the transaction.

For a comparison of the pre-UCC good faith standard with the commercial reasonableness standard which the UCC has imposed to protect agents in Articles 3 and 8, see note 50 infra.

should also be afforded such protection.\textsuperscript{30} The exception, although very narrow,\textsuperscript{31} recognized the need to enhance the ready transferability of bearer bonds.\textsuperscript{32}

The pre-UCC liability of depositary banks was distinct from the unique treatment extended to brokers dealing with negotiable bearer bonds. Just as the innocent agent who sold stolen personal property was generally liable to its true owner in conversion, a depositary bank in the absence of negligence, laches or estoppel was liable to the payee whose endorsement was forged.\textsuperscript{33} Despite the near uniform acceptance of the premise that liability existed in the absence of a specific defense, there was some difference in the legal justification behind that premise. As mentioned earlier, there were two theories of recovery: one in tort for conversion of the true owner's property\textsuperscript{34} and one in contract for money had and received.\textsuperscript{35}

Cases which permitted recovery under the tort theory reasoned that the depositary bank in receiving a check for collection obtained

\textsuperscript{31}The defense of good faith was allowed only to the broker who sold investment securities while in bearer form. Nevertheless, the specific court decisions espousing the rule framed it so as to imply that the defense was available when dealing with all forms of negotiable instruments. See cases cited at note 28 supra. Certainly a security could be negotiable and yet not be in bearer form. See NIL § 1. Since the justification for the special rule of liability developed for the dealer in bearer bonds would be inapposite where endorsements are necessary to transfer valid title, it seems that despite the language of the various court decisions, the rule only applied to securities which were in bearer form.
\textsuperscript{32}In Gruntal v. National Sur. Co., 254 N.Y. 468, 173 N.E. 682, 684, 246 N.Y.S. Appdx. 468, 470 (1930), the leading case on the conversion of bearer bonds by an agent, the court indicated that public policy simply did not require the imposition of a harsh rule of liability on an innocent seller of bearer bonds. The court recognized that these bonds were readily transferable and should continue to be so without placing too great a risk on the parties who deal with them.
\textsuperscript{33}See cases at notes 10-11 supra.
\textsuperscript{34}For cases allowing recovery in tort for conversion, see note 10 supra. The measure of damages under the tort theory was prima facie the face value of the instrument as opposed to the remedy for an action in contract which was the proceeds of the check or the amount of money collected by the depositary bank on the instrument. This formal distinction in remedies proved crucial when a defendant could show that for some reason the drawer's obligation to pay was valueless and therefore the instrument worthless, i.e., an insolvent drawer.

A second important aspect of the distinction between the tort and contract theories of recovery was the determination of when a true owner's action might be barred by the statute of limitations. The actions in conversion and for money had and received were unequivocally governed by the tort and contract statutes of limitations, respectively. See Mackey-Woodard, Inc. v. Citizens State Bank, 197 Kan. 536, 419 P.2d 847 (1966).
\textsuperscript{35}For cases allowing recovery for money had and received, see note 11 supra.
no title to the check if the individual depositing it had none. Since
the validity of the check, the scope of the order to pay, and the payee
himself were fixed at the initial preparation of the instrument, it was
presumed that the payee was the true owner of the paper. By collect-
ing the check and crediting the amount to the depositor, the bank
necessarily assumed dominion over the instrument inconsistent with
the payee’s control of his own property and therefore converted the
instrument. The damages for the conversion of a negotiable instru-
ment were prima facie its face value. 38

Many jurisdictions also afforded the true owner a right to recover
from the depositary bank in contract for money had and received. 37
Under this theory of recovery, when a depositary bank had collected
a check over a forged endorsement, the courts reasoned that the bank
held the proceeds of the collection in the same way for the payee as
it had originally held the check, 33 and that this implied relationship
created an obligation on the part of the bank to pay the proceeds only
to the true owner. 39 However, a necessary pre-requisite to the courts’
implying this promise to pay was the payee’s ratification of the collec-
tion of the check by the depositary bank. 40 Since a payor bank could
only pay out its depositor’s money in accordance with the depositor’s
direction or order, 41 the payee could not claim that the proceeds col-
lected by the depositary bank were properly his unless he ratified the

38 A description of the legal elements of the tort recovery can be found in the
following cases: Aetna Cas. & Sur. Co. v. Lindell Trust Co., 348 S.W.2d 558 (Mo. Ct.
App. 1924); Security Fence Co. v. Manchester Fed. Sav. & Loan Ass’n, 101 N.H. 190, 136
A.2d 910 (1957); Hillsley v. State Bank, 17 App. Div. 2d 686, 230 N.Y.S.2d 531 (1962);
Moch Co. v. Security Bank, 176 App. Div. 842, 163 N.Y.S. 277 (1917); California
39 See cases at note 11 supra.
40 Mackey-Woodard, Inc. v. Citizens State Bank, 197 Kan. 536, 419 P.2d 847,
853 (1966). It was the breach of this obligation which gave rise to the money had and
received cause of action.
41 See note 38 supra.
42 Mackey-Woodard, Inc. v. Citizens State Bank, 197 Kan. 536, 419 P.2d 847, 853
(1966). Ratification is one of the characteristic rights that a principal may exercise in
respect of the actions of his agent. See RESTATEMENT (SECOND) OF AGENCY, § 82 (1957).
In an action for money had and received, the act of bringing suit against the depositary
bank was deemed the act of ratification. 419 P.2d at 854 (1966).
See W. BRITTON, BILLS AND NOTES §§ 142, 147 (2d ed. 1961).
collection from the payor. Having ratified the collection, yet having been wrongfully denied the proceeds by the payment to the forger, the payee was afforded the right to recover damages from the depositary bank in the amount of the proceeds without regard to good faith, notice, knowledge or duty of inquiry. The bank was fully liable even though it may have parted with the money it collected.

The result under both the tort and the contract theories of recovery was identical for the depositary bank: full liability without any defenses founded in good faith or the absence of proceeds. Depositary banks were treated as any agent would have been treated who mistakenly, although innocently, converted the personal property of another. The unique rule of nonliability which protected the broker who sold stolen bearer bonds was justifiably not extended beyond its narrow coverage since the particular considerations which persuaded courts to insulate the seller of bearer bonds from liability in conversion were inapposite where a forged endorsement was involved.

When the language of UCC § 3-419(3) is analyzed in light of these established judicial policies which formed the background against which the subsection was formulated, the apparent alteration of pre-UCC depositary bank liability manifests itself. The statute seemingly requires that when a depositary bank acts honestly and in a com-

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1Mackey-Woodard, Inc. v. Citizens State Bank, 197 Kan. 536, 419 P. 2d 847, 853 (1966). The act of bringing suit against the depositary bank meant that upon the payee's recovery he was pro tanto estopped from suit against the drawee or the drawer. Id. Since the collection became proper via ratification, the drawee's payment to the depositary bank was deemed proper.

2The payee could ratify the collection of the check without ratifying the improper payment of the proceeds to the forger. 419 P.2d at 855.

3Id. at 853.

4Id. at 853-54. Specifically, the Kansas court in Mackey-Woodard stated: "It is no defense to a collecting bank that it has fully paid over and accounted for the proceeds of a check, which it collected from the drawee bank, to the forger or unauthorized indorser without knowledge or suspicion of the forgery or unauthorized indorsement in a suit by the payee for money had and received." Id. at 854.

5Compare text accompanying notes 21-26 supra with text accompanying notes 33-45 supra.

6See text accompanying notes 27-32 supra.

7Section 3-419(3) applies to "representatives." By definition an agent is a representative. UCC § 1-201(35). According to § 4-201 of the UCC and the comment thereunder a depositary bank is an agent of the owner of the item which has been presented for collection. Id. § 4-201(1) and Comment 1. Regardless of whether the depositary bank cashes the check for an individual or credits an account before collection, the settlement given is provisional and the bank is an agent until final settlement. Id. §§ 4-104(j), 4-201(1) and Comment 1. It seems clear, therefore, that even absent the language "including depositary and collecting banks" a depositary bank would nevertheless qualify as a "representative" and be entitled to the § 3-419(3) defense.

8Honesty in fact is required by § 3-419(3) in order to have access to the defense
mercially reasonable manner, but no longer has the proceeds of the instrument in its hands, it should not be liable “in conversion or otherwise” to the true owner. While the care exercised by a bank and the location of the proceeds of the check were totally irrelevant to the determination of a depositary bank’s liability to a true owner under pre-UCC judicial doctrine, § 3-419(3) made these two elements the prerequisites for an absolute defense to liability. In that respect, the drafters vastly expanded the availability of a defense which had previously been allowed only the broker dealing with bearer bonds. In light of the unique characteristics of the bearer bond which traditionally justified relaxation of the general rules of broker liability, it is not clear why the drafters chose to expand the availability of the defense to all representatives dealing with any form of commercial paper over a forged endorsement. The legislative history to § 3-419(3) offers little explanation, and the only apparent justification would

provided therein. The subsection requires that the bank act in “good faith” which via UCC § 1-201(19) means honesty in fact.

Section 3-419(3) states that the bank must act “in accordance with the reasonable commercial standards applicable to the business of such representative.” UCC § 3-419(3). The Official Comment to § 3-419(3) implies that the subsection is intended to adopt the pre-UCC rule of decisions which insulated brokers dealing in good faith with negotiable securities. See cases cited at note 27 supra. Although the standard of good faith was more difficult to meet under the Nil than the honesty in fact test for good faith found at UCC § 1-201(19), it would appear that the overall standard of care required under § 3-419(3) is far more stringent than any standard of care set under pre-UCC judicial doctrine. See note 28 supra. The UCC standard of care has been labelled as “shifting and unpredictable.” Britton, Defenses, Claims Of Ownership And Equities—A Comparision Of The Provisions Of The Negotiable Instruments Law With Corresponding Provisions Of Article Three Of The Proposed Commercial Code, 7 Hast. L.J. 1, 46 (1955). The adoption of the commercially reasonable test unquestionably introduces an objective standard of care which must be met by any party attempting to utilize the § 3-419(3) defense. Post-UCC judicial decisions have construed it to be just that. See, e.g., 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); Belmar Trucking Corp. v. American Trust Co., 65 Misc.2d 31, 316 N.Y.S.2d 247 (Sup. Ct. 1970).

The honest and commercially reasonable depositary bank is expressly held liable under § 3-419(3) only to the extent of the “proceeds remaining in [its] hands.” The drafters quite inappropriately provided no definitions which offer any help in defining what this key phrase actually means. It is this portion of § 3-419(3) which was construed in Cooper v. Union Bank, 9 Cal.3d 123 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

The phrase “or otherwise” implies that all theories of recovery which applied under pre-UCC legal doctrine shall continue to apply, subject to the § 3-419(3) defense. See, e.g., United States Portland Cement Co. v. United States Nat’l Bank, 61 Colo. 334, 157 P. 202, 203 (1916); National Union Bank v. Miller Rubber Co., 148 Md. 449, 129 A. 688, 690 (1925). See also notes 44-45 and accompanying text supra.

Official Comment 5 to § 3-419 provides the entire legislative background for § 3-419(3). The comment is misleading at best. The only accurate claim is that § 3-419(3)
appear to be that the provision was the result of a general effort by the drafters of the UCC to encourage the transferability of commercial paper by offering banks greater protection.\(^5\)

Suits directly against depositary banks by owners of checks paid over forged endorsements have been few since the adoption of the UCC by the states.\(^6\) Possibly, potential litigants have been discouraged from direct suit against the depositary bank because of the increased protection seemingly afforded the bank by § 3-419(3). However, as mentioned above, both the Pennsylvania court in *Ervin v. Dauphin Deposit & Trust Co.*\(^7\) and the California court in *Cooper v. Union Bank*\(^8\) have severely threatened the future vitality of this insulation from direct suit embodied in § 3-419(3). Both courts unexpectedly interpreted the language of the subsection so as to justify findings that § 3-419(3) did not alter pre-UCC depositary bank liability. The propriety of these decisions must be examined in order to determine whether they provide a sound legal basis upon which future litigants can seek to avoid the § 3-419(3) defense.

The *Ervin* decision, which was rendered in a judgment on the pleadings, represents the earliest reported case construing the language of § 3-419(3). In *Ervin* an employee took checks payable to his employer's order to defendant bank where they were cashed over the employer's forged endorsement and later collected from the payor.

\(^{is new.}\) The indication from the comment is that the pre-UCC broker cases, which § 3-419(3) is said to have followed, allowed a good faith defense for agents dealing with all forms of negotiable instruments. A proper analysis of the rule of decisions adopted by § 3-419(3), however, indicates that the defense was applicable only to the agent selling investment securities in bearer form. See text accompanying notes 27-32 *supra*.

A proper legislative comment would have more fully disclosed the vast expansion of the good faith defense beyond the narrow scope of its pre-UCC coverage.

\(^{\text{5\text{a}}}\) For an excellent discussion of the allocation of losses on forged checks under the NIL and the Uniform Commercial Code and the various aspects of Articles 3 and 4 which represented an effort by the drafters to protect banks dealing with commercial paper, see Comment, *Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 *Yale L.J.* 417 (1953). The apparent rationale of increased protection for banks is that it would serve to expedite the collection process and therefore enhance the circulation and transferability of commercial paper. See Miller and Crea, *The Uniform Commercial Code: Effect on the Law of Negotiable Instruments in New York*, 30 *Brooklyn L. Rev.* 204, 258 (1963).

\(^{\text{5\text{b}}}\) Apparently, only one decision involving § 3-419(3) has actually protected a depositary bank from liability. See Messeroff v. Kantor, 261 So.2d 553 (Fla. App. 1972). For a list of cases which have held depositary banks liable in conversion despite § 3-419(3), see note 15 *supra*.


The employer, as the true owner of the instruments, sued the defendant bank in contract for money had and received. The defendant bank interposed § 3-419(3) in defense to this suit and demurred to the true owner's complaint. Notwithstanding the language of § 3-419(3), the court overruled the defendant's demurrer, holding that the defense was not applicable.

In overruling the depositary bank's demurrer, the court made several observations concerning the § 3-419(3) defense. The court recognized that the statute included depositary banks within its broader concept of "representative," yet proceeded to hold that the "clear meaning" of the subsection was to include them only when acting as a "representative." Citing § 1-201(35) of the UCC wherein the term "representative" is defined, the court concluded that "[t]he entire subsection [§ 3-419(3)] speaks of something other than the negotiating or the honoring of a check when it refers to the representative having 'dealt with an instrument or its proceeds on behalf of one who was not the true owner.'" Apparently relying on the Official Comment to § 3-419(3), the court ruled that the subsection referred only to the type of transaction involved in the pre-UCC cases where a broker selling bearer bonds was afforded the defense similar to that embodied in § 3-419(3). Having concluded that the subsection was inapplicable, the court held the bank subject to the pre-UCC rules of liability.

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5See text accompanying notes 37-45 supra for a discussion of this pre-UCC contract theory of recovery.

63 UCC REP. SERV. at 318.

61Id.

53 UCC REP. SERV. at 318. The court also formulated an alternate theory for overruling the defendant bank's demurrer. Since the bank had cashed the checks over the forged endorsement, the court reasoned that the bank constituted a purchaser and therefore still held the proceeds of the checks in its hands. When the bank purchased the checks it did so with its own money and, therefore, the proceeds subsequently collected from the payor bank were the check's proceeds, and belonged to the true owner. Id.

There is considerable support for the court's proposition that a cashing bank constitutes a purchaser—support derived from pre-UCC as well as post-UCC judicial decisions. Compare Kaufman v. State Sav. Bank, 151 Mich. 65, 114 N.W. 863 (1908), with Harry H. White Lumber Co. v. Crocker-Citizens Nat'l Bank, 263 Cal. App.2d 268, 61 Cal. Rptr. 381 (1967). See also H. BAILEY, BRADY ON BANK CHECKS, § 15.14, at 499-500 (4th ed. 1969). However, it would appear that courts which continue to distinguish between the cashing bank and the bank that merely credits an account are doing so in disregard of the provisions of Article 4. Section 4-201 of the UCC affirmatively establishes that a bank is an agent for collection and all settlements given are provisional until final settlement is made by the payor bank. In defining what constitutes a settlement the UCC is absolutely clear that it may be a payment in cash or by credit.
The *Ervin* decision cannot stand on its statutory analysis, and its rationale should be of little precedential value. The basic failure in the court’s reasoning derives from its total disregard for the statutorily defined status of depositary banks as agents while collecting negotiable instruments.\(^6\) The court’s principal justification for denying the defense to the bank was that when the drafters provided the defense to depositary banks *dealing* with instruments while *acting* as agents, they did not envisage the negotiation of checks as constituting such activity.\(^6\) There is no legislative history which would support such a contention.\(^6\) Rather, the language of § 4-201 of the UCC seems to establish without question that § 3-419(3) was designed precisely to cover the depositary bank which, while an agent for collection, makes a provisional settlement\(^7\) over a forged endorsement. Consequently, when the *Ervin* court held that the defendant depositary bank did not act in a representative capacity when it collected the check over the forged endorsement, it adopted a position directly in conflict with the language of § 4-201 of the UCC. That conflict must be resolved in favor of the subsection and the statutory construction utilized in *Ervin*, therefore, should have little effect on future litigation under § 3-419(3).\(^6\)

As did the Pennsylvania court in *Ervin*, the California Supreme Court in *Cooper v. Union Bank* severely restricted the availability of the § 3-419(3) defense to depositary banks, in effect making it inapplicable unless the owner is barred by a defense such as negligence.\(^6\) In *Cooper* the plaintiff was an attorney who had in his employment

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UCC § 4-104(j). When a depositary bank cashes a check, under the UCC that bank merely makes a provisional cash settlement and becomes an agent for collection. *Id.* § 4-201. Against the background of the UCC concept of bank settlements and the more precise provisions of § 4-201, different treatment for the cashing bank vis-à-vis a bank that credits an account is tenuous at best.

\(^6\) UCC § 4-201 and Comment 2.

\(^7\) UCC Rep. Serv. at 318.

"The Official Comment indicates an obvious intent on the part of the drafters to treat banks collecting checks as agents. See UCC § 4-201, Comment 1. The Official Comment to § 3-419(3) provides absolutely no basis from which to infer that this agency status is not applicable when the depositary bank is sued in conversion.

"Settlement is defined at § 4-104(j) of the UCC. A provisional settlement is one that is made immediately upon presentment of an item for collection and becomes final only after final settlement by the payor of the instrument. See UCC § 4-201.

"The *Ervin* case has received considerable attention from commentators and the consensus is that the court's statutory analysis was wholly inaccurate. *See*, *e.g.*, H. BAILEY, BRADY ON CHECKS § 15.14, at 496-501 (4th ed. 1969); J. WHITE AND R. SUMMERS, UNIFORM COMMERCIAL CODE § 15-14, at 505 (1972).

\(^6\) A negligent payee is barred from recovery under the UCC; he is precluded from
a woman whose duties were to act as his personal secretary and bookkeeper. During a period of approximately a year and one-half beginning in December of 1965, plaintiff's secretary purloined twenty-nine checks intended for her employer and forged the necessary endorsements. She cashed some of these checks at the defendant banks while depositing others to her personal accounts at the same banks. The entire amount of such deposits was subsequently withdrawn by the forger prior to discovery of the unauthorized endorsements. All of the checks were collected from the payor banks.

The plaintiff brought suit against the defendant depositary banks in conversion\textsuperscript{20} to recover the amounts of the instruments handled by them on the forged endorsements. With respect to a majority of these checks the court held that because of § 3-404 of the UCC, the plaintiff's negligent supervision of his secretary and his books of account precluded his claim that the endorsements were unauthorized.\textsuperscript{21} However, with regard to those instruments where the plaintiff was allowed to assert the impropriety of the endorsement, the court rejected the

claiming that the forged endorsement is unauthorized. See UCC § 3-404(1) and Comment 4.

\textsuperscript{20}The California court stated that the plaintiff's suit was one in conversion, implying that the theory of suit was founded in tort law. 507 P.2d at 612. However, the court in its analysis utilized ratification concepts which were characteristic of only pre-UCC contract theory of recovery. \textit{Id.} at 613-14. A plausible explanation for the court's utilization of ratification where the plaintiff's suit was in conversion lies in the fact that the "proceeds" language of § 3-419(3) demands reliance on ratification. See text accompanying note 92 infra.

\textsuperscript{21}There is a great disparity between the treatment given the negligence of the payee at the trial level and at the supreme court level. The holding of the trial court is discussed at great length in the intermediate appellate court decision (103 Cal. Rptr. 610) which was vacated by the supreme court.

There were essentially four groups of checks stolen by the payee's employee: (1) fourteen rent checks payable to payee as representative for a real property investment group of which he was a member; (2) six checks for interest payments on an account which the payee maintained in his capacity as receiver for the Orange County Superior Court; (3) eight checks payable to an elderly female client whose financial affairs were managed by the plaintiff; and (4) a single check payable to plaintiff for legal services. The plaintiff's employee purloined the checks in the following manner: Group 1 checks (from December 1965 until June 1966 took the monthly rent checks and cashed them at defendant Union Bank; from July 1966 to January 1967 took the next seven rent checks and deposited them to an account at defendant Crocker Bank); Group 2 checks (cashed three at Union Bank in October and December of 1965 and April of 1966; thereafter, cashed or deposited three at Crocker); Group 3 checks (from October 1966 to June 1967 the eight checks were deposited at Crocker); and Group 4 check (cashed at Union in February 1967).

The superior court and the intermediate appellate court held that the negligence
availability of any defense under § 3-419(3) since the defendant was held to have retained the proceeds of the checks in its hands.\textsuperscript{72}

The Cooper court proceeded through three stages of analysis in order to hold the depositary bank liable under the language of § 3-419(3). First, through application of the pre-UCC doctrine of ratification\textsuperscript{73} the court established that the proceeds of the checks in question had been received by the depositary bank.\textsuperscript{74} However, in order to meet the precise requirement of the subsection, the court had to find that these same proceeds were still in the hands of the bank at the time the owner filed his suit in conversion. To do so, the court entered upon its second stage of analysis. Relying on both pre-UCC judicial doctrine\textsuperscript{75} and the UCC itself,\textsuperscript{76} the court held that upon receipt of the check proceeds the bank became the debtor of the true owner. As a debtor, the bank was entitled to mingle the check proceeds with its own.\textsuperscript{77} Therefore, it became necessary for the court to find a way for the plaintiff to identify his proceeds among those of the bank in

of the plaintiff would bar recovery only on the Group 1 checks deposited after April 1, 1966. See 103 Cal. Rptr. at 614-16. On the other hand, without explanation the supreme court held that negligence was a bar to plaintiff's action on all the checks dealt with after April 1, 1966. See 507 P.2d at 618, 622. This is a totally unjustified disparity. The supreme court either interpreted the trial court's finding of negligence improperly or engaged in its own fact-finding mission. Either action is inexcusable.\textsuperscript{75}507 P.2d at 615-16. Because the trial court had found that the defendant had acted in good faith and with reasonable care, the only way by which the California court could hold the depositary bank liable under § 3-419(3) was to show that the check proceeds were still in its hands.

\textsuperscript{76}See notes 40-42 and accompanying text \textit{supra} for discussion of the ratification doctrine.

\textsuperscript{77}507 P.2d at 614.

\textsuperscript{78}Under the NIL theory of recovery for money had and received, if the payee ratified the bank's collection of the proceeds, the bank became liable to the payee as a debtor. See notes 37-45 and accompanying text \textit{supra} for a discussion of this pre-UCC theory of recovery.

\textsuperscript{79}Relying on UCC § 4-213(3) and the comments thereunder, the Cooper court held that the UCC supported the bank's status as a debtor upon final settlement. 507 P.2d at 615. Specifically, because § 4-213(3) made a collecting bank accountable to its customer for "the amount of the item" rather than for its proceeds, a conclusion that the UCC anticipated the continuation of a bank's pre-UCC liability as a debtor to the true owner of a check seemed justified. The Official Comment to § 4-213 only served to lend further weight to the court's conclusion: "When this credit given by it [the bank] so becomes final, in the usual case its agency status terminates and it becomes a debtor to its customer for the amount of the item." UCC § 4-213, Comment 9 (emphasis added).

\textsuperscript{80}See 507 P.2d at 614 n.8, citing A. ScoTr, Trusts § 634, at 3712-18 (3d ed. 1967) [hereinafter cited as ScoTr, in order to establish that the bank, as a debtor, was entitled to use the proceeds as its own. This is the regular custom of banks and indeed it would seem that a bank could hardly function in any other way.
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general. The court met this challenge and essentially concluded its
analysis through the imposition of a constructive trust, an equitable
documentary which in a banking context allows a true owner of a check
to trace his proceeds though commingled with those of his debtor,
provided that debtor has sufficient funds to meet the claim. Since
in Cooper the funds of the bank exceeded the amount of the true
owner's claim, the court held that the plaintiff could trace the pro-
ceeds into the hands of the bank and thus avoid the § 3-419(3) de-
fense. 5

Through the first two stages of its analysis the Cooper decision
seems to be founded on sound legal principles. Ratification was an
established pre-UCC theory of recovery for a true owner against a
depository bank, and nothing in § 3-419(3) implies that its rationale
has been rejected. 6 The California court's description of the payee-
depository bank relationship as that type of relationship which exists
between a creditor and his debtor is also a sound legal position under
the UCC. 7 It is only at the third and final stage of its analysis—the
imposition of the constructive trust—that serious possibilities of im-
propriety appear.

In utilizing a constructive trust to allow the plaintiff to trace
proceeds into the hands of the bank, the court specifically relied on
the tracing rights which a proper claimant may exercise against an
insolvent bank in order to rise above the bank's general creditors.
Such reliance seems to have been misplaced, since the bank was not
insolvent and none of the grounds upon which a court generally de-
pends for its equitable powers to protect a particular creditor was
present. 8 It would have been more proper for the Cooper court to

5 507 P. 2d at 615.
6 Scott § 540.
7 507 P.2d at 615-16. The court attempted to reinforce its conclusion that the
defendant did not part with the proceeds of the check by looking to an additional
aspect of Article 3. From the distinctive use of the term "proceeds" in § 3-419(3), as
opposed to the term "for value" which establishes holder in due course status for a
bank under UCC § 3-302, the court reasoned that § 3-419(3) was not meant to protect
the depositary bank merely because it may have given value to the forger. 507 P.2d at
616. This argument is not persuasive in a conversion context. Holder in due course lan-
guage, even by analogy, would seem wholly inapplicable where forged endorsements
are involved since the party taking from the forger cannot become a "holder." See UCC
§§ 1-201(20), 3-201, 3-404.
8 Subsection 3-419(3) states that the depositary bank shall not be liable to a true
owner "in conversion or otherwise." Clearly, that language recognizes the distinct
theories of suit which existed before the UCC and anticipates their continued viability
under the UCC, subject, of course, to the § 3-419(3) defense.
9 Note 76 supra.

Generally, a constructive trust will be imposed to protect a particular creditor
draw its discussion of tracing rights from the equitable doctrines related to the conversion of personal property.4 An innocent converter who transforms a true owner's property into a new "product" acquires legal title to the property.5 Co-extensive with this legal title, however, is an equitable duty to convey the new "product" to the true owner,6 who enforces his equitable rights against the innocent converter through the imposition of an equitable lien.7 If the converter mingles the new "product," which often is in the form of cash proceeds, with his own funds, the equitable lien affords the owner the right to trace his cash "product" within those funds.8 Recovery is allowed provided the converter's funds are equal to or in excess of the amount of the owner's claim.9 The Cooper court's discussion of tracing rights thus seems accurate, but only in light of the equitable lien theory of relief.

Despite the propriety of tracing under equitable lien theory when conversion occurs, an inherent inconsistency appears in the Cooper court's analysis. This inconsistency derives from the doctrine of ratification which, as the court properly recognized, was so vital to the plaintiff's recovery from the bank under § 3-419(3). Ratification provided the means to establish that the proceeds of the check were received by the depositary bank. Yet, it also simultaneously transformed the wrongful collection of the check into a proper act.10 When the Cooper court imposed the trust, it apparently overlooked this important effect of ratification. Because the payee ratified the exchange of the check for its proceeds, he should no longer have been entitled to claim that the bank converted the check. Absent conver-

4The tracing principles that are applicable to the conversion of personal property are identical to those discussed by the court. Compare Scott §§ 508.1, 515 with § 540. However, when a converter does not act wilfully, a court can only properly invoke an equitable lien for the true owner. Id. § 509. The difference between the equitable lien and the constructive trust discussed by the court is simply that the latter forces the wrongdoer to account for all profits derived by the wrongful act. Id. § 462. The former is only enforced to the extent of the value of the owner's property that was lost. Id. § 463.

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sion by the bank, the true owner should not have been able to invoke the equitable power of the court and should have been relegated to the legal remedies of a creditor against his debtor. Those legal remedies have never included a right on the part of the creditor to trace his proceeds as was allowed by the *Cooper* court.\(^9\)

As long as ratification is an essential part of a true owner's theory of recovery, it would seem that tracing principles would not be applicable. Under pre-UCC judicial doctrine ratification was not necessary to the genuine payee's suit in tort for conversion.\(^9\) Therefore, the question must be raised as to the propriety of equitable relief as granted in *Cooper* in the absence of ratification. The answer lies quite simply in the fact that the language of § 3-419(3) demands an examination into the location of proceeds. Under the statute a depositary bank can only be liable to the extent of any proceeds in its hands. Since ratification is the only apparent method by which to establish the receipt of proceeds by the depositary bank when a conversion has occurred, the wording of § 3-419(3) mandates its use. Thus, the wholesale necessity of ratification theory would seem to preclude the application of equitable tracing principles as attempted by the California court.

What the *Cooper* decision emphatically illustrates is the total absence in Article 3 or elsewhere in the UCC of an accurate definition of the meaning of the § 3-419(3) phrase "proceeds remaining in [its] hands."\(^3\) The non-existence of such a definition provided the court with the opportunity to utilize a totally unexpected sort of legal analysis in order to satisfy the requirement of the subsection and to hold the bank liable. To the extent that it would serve to clarify the meaning of § 3-419(3), a statutory definition would be helpful. However, in the absence of such a definition there would appear to be a logical source from which to derive an accurate understanding of the phrase: the pre-UCC rule of decisions which § 3-419(3) is stated to have adopted.\(^9\)

\(^9\)If the exchange of the check for proceeds is ratified and therefore not wrongful, no equitable duty to convey those proceeds arises. A bank is entitled to use the proceeds as its own since it is the debtor of the true owner and commits no wrong by doing so. *Scott* § 525. The bank's obligation to account to the true owner for the amount of the proceeds is an obligation as a debtor and provides no basis for the imposition of a constructive trust or equitable lien. *Id.* at § 534.

\(^3\)The only definition in the UCC is located at § 9-306(1): "'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." In the context of determining the meaning of the § 3-419(3) defense, a definition designed for application to security interests is not very helpful.

\(^9\)Official Comment 5 to UCC § 3-419(3) states in pertinent part:
Gruntal v. National Surety Co.,\textsuperscript{95} is characteristic of the pre-UCC broker liability cases upon which § 3-419(3) is claimed to be based. Although the basic justification for the exceptional defense allowed the broker derived from the bearer nature of the bonds that were sold, the New York court additionally stated that the defense should apply only when the broker had paid the purchase money over to his principal.\textsuperscript{96} The basic thrust of the decision was that a broker who in good faith sold bearer bonds should not sustain a financial loss if the bonds are discovered to be stolen.\textsuperscript{97} It seems logical that the drafters of § 3-419(3) intended to protect the depositary bank as against a true owner in the same manner when they limited the bank's liability to the amount of "proceeds remaining in [its] hands."

Why the drafters chose to utilize the word "proceeds" to convey this protection to depositary banks poses an additional question. As discussed previously, pre-UCC depositary bank liability to a true owner was determined without regard to the location of proceeds. Many of the courts applying the NIL\textsuperscript{98} stated this rule of liability in a manner which incorporated the concept of "proceeds," holding that "it [was] no defense to [the depositary] bank that it [had] fully paid over and accounted for the proceeds of [the] check . . . to the forger . . . ."\textsuperscript{99} It would seem proper to assume that the drafters of § 3-419(3) had this substantial body of pre-UCC law in mind when they chose to utilize identical language in the subsection. Therefore, the drafters' use of the term proceeds seems merely to have been responsive to the terminology incorporated in this body of law that preceded § 3-419(3).

Subsection 3 is intended to adopt the rule of decisions which has held that a representative, such as a broker or depositary bank, who deals with a negotiable instrument for his principal in good faith is not liable to the true owner for conversion of the instrument or otherwise, except that he may be compelled to turn over to the true owner the instrument itself or any proceeds of the instrument remaining in his hands.

\textsuperscript{95}254 N.Y. 468, 173 N.E. 682, 246 N.Y.S. Appdx. 468 (1930). Gruntal is cited in the Official Comment to § 8-318 as the basis for the good faith defense provided the broker who sells investment securities on behalf of his principal. It is generally considered a leading case illustrating the justification for the exceptional pre-UCC treatment afforded the seller of bearer bonds. See 2 N.Y. LAW REVISION COMMISSION STUDY OF THE UNIFORM COMMERCIAL CODE 1081-82 (1955).

\textsuperscript{96}173 N.E. at 684.

\textsuperscript{97}Id.

\textsuperscript{98}See cases at note 53 supra.

\textsuperscript{99}Mackey-Woodard, Inc. v. Citizens State Bank, 197 Kan. 536, 419 P.2d 847, 854 (1966) (emphasis added). The full passage of this quotation can be found at note 45 supra.
In light of the improper invocation of constructive trust doctrine by the California court and the presence of what would appear to be a logical source from which the court could have ascertained the meaning of the "proceeds" language utilized in § 3-419(3), Cooper v. Union Bank, just as the Ervin decision, should not seriously affect the future status of § 3-419(3). Both decisions involve strained statutory analysis. The courts imaginatively, although inappropriately, adopted constructions of § 3-419(3) which in effect maintained the pre-UCC status quo for depositary bank liability in conversion to a true owner. In light of the seemingly obvious intent of § 3-419(3) to protect depositary banks and thereby substantially disrupt the status quo, the question must be raised as to why the two state courts in question chose to construe the statute as they did. In both decisions an appealing justification has been offered—to avoid circuity of action and promote justice.¹⁰⁰

Traditionally, as alternatives to his rights against the depositary bank, a true owner of a forged instrument has had the right to recover in conversion against the drawee bank¹⁰¹ or on the underlying contractual obligation against the drawer of the check.¹⁰² The UCC has maintained these two rights of action for the genuine payee.¹⁰³ Additionally, the UCC has adopted the pre-UCC policy which ultimately placed the loss for a forged endorsement on the party to whom the forger transferred the check.¹⁰⁴ Thus, despite § 3-419(3), in most cases the depositary bank will bear the loss incurred by the typical inability to recover from the forger himself. Because of this loss allocation under the UCC and the usual geographic proximity of the depositary bank to the true owner, there are appealing reasons for disregarding the defense provided by § 3-419(3). These policy considerations were well recognized prior to the UCC¹⁰⁵ and do tend to raise substantial questions about the propriety of the § 3-419(3) defense.

Yet it is not clear that there are no valid reasons for requiring the true payee to pursue the more traditional route of suit against the drawer or the drawee bank. One possible detrimental result of a direct

¹⁰⁰See Ervin, 3 UCC REP. SERV. at 318-19, and Cooper, 507 P.2d at 617.
¹⁰¹See cases at note 8 supra.
¹⁰²See id.
¹⁰³The true owner's right of action against the drawer is preserved by the fact that the drawer's underlying obligation to pay is not discharged when the check is paid over a forged endorsement. See UCC §§ 3-603, 3-802. The payee's rights against the drawee bank are preserved at § 3-419(1)(c) and (2).
¹⁰⁴The loss on a forged endorsement is transferred back to the party who took from the forger via the transfer warranties of § 3-417 and § 4-207 of the UCC.
suit by a payee against a depositary bank is that in allocating the loss from the forged endorsement it potentially allows for the circumvention of a possibly negligent act by a drawer. When a payee institutes a direct suit against a depositary bank, thus by-passing the drawer, it may be indicative of an attempt on the part of the payee to get his money without placing the loss on the party with whom he has done business, a course of action which could have jeopardized future business dealings with the negligent drawer. There is no method readily apparent under the UCC whereby the depositary bank could then force this loss onto the drawer, where it would lie were the payee forced to utilize the traditional means of suit. It is an established policy of the UCC that a depositary bank should bear the loss incident to the collection of a check over a forged endorsement only when both the payee and the drawer are free from any negligence that may have caused the unauthorized signature. Section 3-419(3), by for-
ing a payee to seek recovery from the drawer or the drawee bank, seems to ensure that result.10

The possible misallocation of loss which can exist if the payee is allowed his direct suit against the depositary bank merely serves to illustrate the risks involved when a court decides to disregard a statute in order to enforce a policy of judicial economy and fairness. The ultimate results reached in Ervin or Cooper may have been just in light of the particular facts presented in each case.11 Yet a court, which sets out in a case of first impression to consider a new statutory provision, has a duty to pay proper deference to the legislative function. By disregarding the meaning of a statutory provision, which seemingly becomes obvious when examined against the background of the judicial doctrines which preceded it, a court disregards that duty.

What the future holds for the protection offered depositary banks under § 3-419(3) will eventually be determined by the precedential value afforded the Ervin and Cooper decisions. Certainly the courts cannot be blamed for their apparent frustration with the manner in which the drafter chose to alter a substantial body of pre-UCC judicial doctrine. The Official Comment to § 3-419(3) is wholly inadequate in that it fails to offer a satisfactory justification for the change. However, if courts in the future examine the pre-UCC judicial decisions on the liability of agents and depositary banks, the language of § 3-419(3) will assume a clarity which cannot be misconstrued; i.e., that the depositary bank is to be protected from liability under § 3-419(3) just as the seller of bearer bonds was protected under the NIL. Admittedly, this interpretation of the § 3-419(3) defense raises serious questions of public policy and justice. In light of these serious problems, both Ervin and Cooper are appealing. Yet the seeming

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10Were the courts in Cooper and Ervin able to develop a basis upon which the depositary bank could force the loss onto the negligent drawer, the policy arguments underlying their rejection of the § 3-419(3) defense would have increased merit. See note 107 supra for some plausible suggestions. Certainly, the desire to avoid circuitry of action has been instrumental in the increased judicial recognition of the drawer's direct suit against the depositary bank when the drawer has settled with the payee on the underlying obligation. In doing so, however, the courts have been careful to provide the depositary banks with any defenses the drawee bank may have asserted against the drawer. See cases at note 109 supra.

11Absent negligence on the part of the drawer, the direct suit by the payee seems to be both efficient and fair.