NYU.C.C. § 3-206: Depository Bank Prohibited from Attaining Holder in Due Course Status When It Pays Inconsistently with a Restrictive Indorsement the Bank Itself Supplied

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refusing to contradict the plain language of the statute.

Donald M. Miehls

Article 3—Commercial Paper

_N.Y.U.C.C. § 3-206(3): Depositary bank prohibited from attaining holder in due course status when it pays inconsistently with a restrictive indorsement the bank itself supplied_

Under the Uniform Commercial Code (UCC),\textsuperscript{120} a depositary bank\textsuperscript{121} may acquire holder in due course status\textsuperscript{122} if it establishes:


\textsuperscript{121}See N.Y.U.C.C. § 4-105(a) (McKinney 1964). A depositary bank is “the first bank to which an item is transferred for collection even though it is also the payor bank.” Id.

\textsuperscript{122}See id. § 3-302(1). To be considered a holder in due course, a transferee must demonstrate his status as a holder, see, e.g., United Overseas Bank v. Veneers, Inc., 375 F. Supp. 596, 602 (D. Md. 1973); National Bank of N. Am. v. Flushing Nat'l Bank, 72 App. Div. 2d 538, 538, 421 N.Y.S.2d 602 (1st Dep't 1979), and that the instrument was a negotiable one, see, e.g., Geiger Fin. Co. v. Graham, 123 Ga. App. 771, 772, 182 S.E.2d 521, 523 (1971); N.Y.U.C.C. § 3-102(1)(e) (McKinney 1964). In addition, the transferee must establish that he took the instrument: “for value; and . . . in good faith; and . . . without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.” N.Y.U.C.C. § 3-305(1)-(2) (McKinney 1964). Thus, a holder in due course takes free from “personal” defenses, see H. BAILEY, BRADY ON BANK CHECKS § 9.13, at 6 (5th ed. Supp. 1983), such as failure of consideration, see, e.g., Chemical Bank v. Haskell, 51 N.Y.2d 85, 91, 411 N.E.2d 1339, 1341, 423 N.Y.S.2d 478, 480 (1980), fraud in the inducement, see, e.g., Federal Deposit Ins. Corp. v. Kassel, 72 App. Div. 2d 787, 788, 421 N.Y.S.2d 609, 610-11 (2d Dep't 1979), conditional delivery, see, e.g., Worthy v. First State Bank, 573 S.W.2d 279, 281 (Tex. Civ. App. 1978), and breach of fiduciary duty, see, e.g., Chemical Bank, 51 N.Y.2d at 91, 411
Ordinarily, in order to qualify as a holder, a transferee must take an instrument that is indorsed. A bank, however, is permit-

See supra notes 122-24. The three categories of indorsements identified in the UCC are special, blank, and restrictive. See N.Y.U.C.C. §§ 3-204 to -205 (McKinney 1964). A special indorsement indicates with particularity the person to whom the instrument is payable. Id. § 3-204(1). A blank indorsement does not identify any person as the indorsee and is payable to the bearer. Id. § 3-204(2). A restrictive indorsement is defined as follows:

An indorsement is restrictive which either
ted under the UCC to supply a missing indorsement,129 and even, in some cases, to attain the status of a holder in due course when an instrument has been taken without an indorsement.130 Recently, however, in Marine Midland Bank, N.A. v. Price, Miller, Evans & Flowers,131 the Court of Appeals held that under the UCC, a depositary bank was precluded from acquiring holder in due course status when the bank paid inconsistently on a restrictive indorsement which the bank itself had supplied.132

In Marine Midland, the defendant law firm drew two checks and delivered them to the payee, Leo Proctor Construction Co. (Proctor), as progress payments for construction work performed.133 An employee of Proctor presented the checks, without indorsement, to the plaintiff bank, requesting that the plaintiff transfer the funds represented by the checks to an account maintained by Proctor in an out-of-state bank.134 The plaintiff accepted

(a) is conditional; or
(b) purports to prohibit further transfer of the instrument; or
(c) includes the words "for collection," "for deposit," "pay any bank," or like terms signifying a purpose of deposit or collection; or
(d) otherwise states that it is for the benefit or use of the indorser or of another person.

Id. § 3-205(1) (emphasis added).

129 See id. § 4-205. Section 4-205(1) of the UCC authorizes a depositary bank that "has taken an item for collection . . . [to] supply any indorsement of the customer which is necessary to title. . . ." Id.


132 Id. at 227-28, 441 N.E.2d 1087, 455 N.Y.S.2d at 569.

133 See id. § 4-205. Section 4-205(1) of the UCC authorizes a depositary bank that "has taken an item for collection . . . [to] supply any indorsement of the customer which is necessary to title. . . ." Id.

134 Id. at 222-23, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566. The defendant represented its clients on construction contracts entered into with Proctor. Id. at 222, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566. A trust account was maintained by the defendant for its clients in connection with the construction projects. Id. at 223, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566. The two checks at issue were drawn by the defendant on this trust account as progress payments to Proctor for work completed on the project. Id. at 222-23, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566. On six prior occasions, Proctor presented the progress payment checks to the plaintiff bank and requested that the funds be wired to one of Proctor's bank accounts in either Texas or Oklahoma. Id., 441 N.E.2d at 1085, 455 N.Y.S.2d at 567. Of these checks, only one was presented without an indorsement.
the checks and stamped them "credited to the account of the payee herein named Marine Midland Chautaqua National Bank," and transferred the funds as requested by Proctor.\textsuperscript{135} Proctor did not, however, maintain an account in the plaintiff bank.\textsuperscript{136}

Upon receiving notice of Proctor's default on the construction contract, the defendant stopped payment on the checks.\textsuperscript{137} Unable to recover the funds from Proctor, which had filed a petition in bankruptcy, the plaintiff bank brought an action against the drawer law firm after the firm refused the plaintiff's demand for payment.\textsuperscript{138} The plaintiff asserted that its status as a holder in due course of the checks precluded the drawer's defense of lack of consideration.\textsuperscript{139} The Appellate Division, Fourth Department, on an accelerated judgment, held\textsuperscript{140} that as a depositary bank the plaintiff was capable of providing the indorsement necessary to establish itself as a holder in due course.\textsuperscript{141}

On appeal, the Court of Appeals reversed.\textsuperscript{142} Writing for a unanimous Court,\textsuperscript{143} Judge Wachtler first addressed the plaintiff's

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\textsuperscript{1} [Note: Footnotes are provided for reference]

\textsuperscript{135} 57 N.Y.2d at 223, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566.

\textsuperscript{136} Id. Although Proctor did not maintain an account with the plaintiff bank, the plaintiff did cash payroll checks drawn on accounts maintained by Proctor in the other banks in Texas and Oklahoma. Id. at 224, 441 N.E.2d at 1085, 455 N.Y.S.2d at 567.

\textsuperscript{137} Id. at 223, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566.

\textsuperscript{138} Id.

\textsuperscript{139} Id. at 224, 441 N.E.2d at 1085, 455 N.Y.S.2d at 567; see supra note 122.

\textsuperscript{140} 57 N.Y.2d at 222 n.1, 441 N.E.2d at 1084 n.1, 455 N.Y.S.2d at 566 n.1. The case was heard directly by the appellate division pursuant to section 3222 of the CPLR. Id.; see CPLR 3222(a), (b)(3) (1970). Under these provisions parties may submit an agreed statement of the facts and stipulate either the appellate division, special term, or a particular judge or referee (upon consent) to hear and decide the case. See CPLR 3222(a), (b)(3), commentary at 1081, 1085 (1970).

\textsuperscript{141} 57 N.Y.2d at 222, 441 N.E.2d at 1084, 455 N.Y.S.2d at 566. The appellate division majority noted that section 4-205(1) of the UCC permits a depositary bank to provide any necessary indorsement of its customer. Marine Midland Bank, N.A. v. Price, Miller, Evans & Flowers, 85 App. Div. 2d 903, 904, 446 N.Y.S.2d 797, 799 (4th Dep't 1981), rev'd, 57 N.Y.2d 220, 441 N.E.2d 1083, 455 N.Y.S.2d 565 (1982). The court found that although the payee did not have an account in the plaintiff bank, it was not precluded from being a "customer" of the bank. Id. Thus, the court reasoned that the plaintiff was a holder, and, having satisfied the other requirements, was a holder in due course. Id.

Judges Callahan and Schnepf dissented, contending that section 4-205 of the UCC was designed only to facilitate the collection process and did not affect the bank's status as a holder. Id. at 905, 446 N.Y.S.2d at 800 (Callahan and Schnepf, JJ., dissenting). Moreover, the dissent maintained that the plaintiff bank supplied "an inappropriate indorsement" and that such an indorsement could not be used to attain holder in due course status. Id.

\textsuperscript{142} 57 N.Y.2d at 228, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569.

\textsuperscript{143} Chief Judge Cooke and Judges Jasen, Gabrielli, Jones, Fuchsberg and Meyer joined
status as a holder. The Court noted that although UCC section 4-205(1) permits a depositary bank to supply a customer's indorsement, the definition of customer includes those maintaining accounts in the bank, as well as those for whom the bank "has agreed to collect items." Thus, Judge Wachtler reasoned, the plaintiff bank was not precluded from supplying its own indorsement merely because the payee did not maintain an account with it.

More specifically, the Court found that the legend stamped by the bank on the reverse side of the check was in fact an indorsement.

Turning to the holder in due course criteria, the Court concluded that the plaintiff did not meet the requirement of taking the instruments for value, and thus, was not a holder in due course. Judge Wachtler reasoned that the plaintiff, by transferring the funds to another bank, had acted inconsistently with the restrictive indorsement it had itself provided. The result, held the Court, was that the bank did not give value, since under section 3-206 of the UCC a transferee becomes a holder for value only to the extent that he acts consistently with a restrictive indorsement. Finally, the Court rejected the plaintiff's contention that a

in Judge Wachtler's opinion.

144 57 N.Y.2d at 224-27, 441 N.E.2d at 1085-86, 455 N.Y.S.2d at 567-68; see supra notes 123 & 128-30 and accompanying text.

145 57 N.Y.2d at 225, 441 N.E.2d at 1085, 455 N.Y.S.2d at 567; see N.Y.U.C.C. § 4-205(1) (McKinney 1964); supra note 129 and accompanying text.

146 57 N.Y.2d at 226, 441 N.E.2d at 1086, 455 N.Y.S.2d at 568; N.Y.U.C.C. § 4-104(1)(e) (McKinney 1964).

147 57 N.Y.2d at 225, 441 N.E.2d at 1086, 455 N.Y.S.2d at 568.

148 Id. at 226, 441 N.E.2d at 1086, 455 N.Y.S.2d at 568. The Court noted that the UCC "expressly provides that 'a statement placed on the item by the depositary bank to the effect that the item was deposited by a customer or credited to his account is effective as the customer's indorsement . . . . '" Id. (quoting N.Y.U.C.C. § 4-205(1) (McKinney 1964)). Indeed, it is recognized that the bank practice of stamping similar legends "is specifically made effective as the customer's indorsement." B. CLARK & A. SQUILLANTE, THE LAW OF BANK DEPOSITS, COLLECTION, AND CREDIT CARDS 90 (1970).

149 57 N.Y.2d at 227-28, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569; see supra note 125 and accompanying text.

150 57 N.Y.2d at 227, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569. The indorsement stamped on the checks indicated that the funds represented by the checks were to be credited to the payee's account in the plaintiff bank. See supra text accompanying note 135. Thus, the plaintiff, by transferring the funds to the payee's account in another bank, acted inconsistently with the indorsement. 57 N.Y.2d at 227, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569. Notably, it was impossible for the plaintiff bank to act consistently with the indorsement since the payee did not maintain an account in the plaintiff bank. See supra text accompanying note 136.

151 57 N.Y.2d at 227-28, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569. Section 3-206(3) of
depository bank need not comply with the terms of an indorsement, since it is not obligated, in the first instance, to provide one when the instrument is presented by the named payee. Judge Wachtler, noting that some courts have labeled an indorsement a meaningless formality, held nonetheless that "sound banking practices" justify the requirement that a depositary bank supply an indorsement in order to attain the status of a holder in due course.

It is submitted that the Marine Midland Court properly construed sections 4-205(1) and 3-206(3) of the UCC, and has delineated clearly the indorsement requirements for depositary banks. It appears that the Court's holding was prompted by a desire to repudiate definitively the Bowling Green decision, in which the First Circuit liberally construed section 4-205(1), holding that to satisfy holder in due course requirements, "a bank which takes an item for collection from a customer who was himself a holder need not establish that it took the item by negotiation." The Bowling Green case has been extensively criticized, in particular for basing its holding upon the presumption that section 4-205(1) preempts the article 3 requirement that a holder take an instrument by negotiation in order to be a holder in due course. While the bank-

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the UCC provides:

Except for an intermediary bank, any transferee under an indorsement which is conditional or includes the words "for collection," "for deposit," "pay any bank," or like terms . . . must pay or apply any value given by him for or on the security of the instrument consistently with the indorsement and to the extent that he does so he becomes a holder for value. In addition such transferee is a holder in due course if he otherwise complies with the requirements of Section 3-302 on what constitutes a holder in due course.

N.Y.U.C.C. § 3-206(3) (McKinney 1964) (citation omitted) (emphasis added).

182 57 N.Y.2d at 228, 441 N.E.2d at 1087, 445 N.Y.S.2d at 569.
183 Id.
185 See, e.g., United Overseas Bank v. Veneers, Inc., 375 F. Supp. 596, 603-04 (D. Md. 1974); 2 F. HART & W. WILLIER, supra note 122, § 11.02, at 11-7. The Bowling Green conclusion, that because a transferee is granted all rights of a transferor under § 3-201, the bank would be a holder simply by virtue of taking the item from a holder, see 425 F.2d at 84, has been discredited, both for "misreading and misunderstanding" section 3-201, see 2 F. HART & W. WILLIER, supra note 122, § 11.02, at 11-12, and for being irreconcilable with precedent, see Security Pac. Nat'l Bank v. Chess, 58 Cal. App. 3d 555, 556-56, 649 Cal. Rptr. 852, 858-59 (1976). Indeed, it has been observed that "[t]he fatal flaw in the court's argument in this respect is its failure to distinguish status from rights; while the [b]ank acquired, from [the payee's] transfer of the check, the rights of a holder, it did not become a holder for the purpose of meeting the holder in due course requirements." Comment, Bowling Green: The Bank as a Holder in Due Course, 71 COLUM. L. REV. 302, 310 (1971) (emphasis in original).
ing provisions of article 4 take precedence over the article 3 commercial paper provisions they do so only to the extent that the two articles conflict.\textsuperscript{156} Clearly, section 4-205(1) may be read consistently with the requirement for negotiation, since section 4-205(1) permits banks to provide the indorsement necessary for negotiation.\textsuperscript{157} Thus, the better view is that a depositary bank must take an instrument by negotiation, but it may supply the indorsement necessary for negotiation.\textsuperscript{158} The \textit{Marine Midland} Court has adopted this view and taken it one step further by requiring a depositary bank, in order to become a holder for value, to comply with the requirements of section 3-206(3) that a transferee pay consistently with a restrictive endorsement.\textsuperscript{159}

Further, it is suggested that the \textit{Marine Midland} approach is commendable because it leads to the free flow of negotiable instruments. Indeed, by providing depositary banks that have taken undorsed instruments with concrete rules for attaining holder in due course status, the \textit{Marine Midland} holding enhances predictability.\textsuperscript{160} The Court only requires that a depositary bank either

\textsuperscript{156} See N.Y.U.C.C. § 4-201(1) (McKinney 1964).


\textsuperscript{159} See 57 N.Y.2d at 227, 441 N.E.2d at 1087, 441 N.Y.S.2d at 569. Apparently, the Court of Appeals has refused to permit banks to disregard the article 3 criteria for holder in due course status, see supra text accompanying notes 123-27, but will grant banks special status under article 4 in meeting the article 3 requirements. Thus, a bank may use bank credit to fulfill the requirement that the instrument be taken for value, see First Nat'l City Bank v. Skedelski, 17 U.C.C. Rep. Serv. (Callaghan) 803, 804 (N.Y. Sup. Ct. N.Y. County 1975); N.Y.U.C.C. §§ 4-208 to -209 (McKinney 1964), or as in the instant case, a depositary bank may supply a missing indorsement in order to establish that it has taken the instrument by negotiation, see 57 N.Y.2d at 226, 441 N.E.2d at 1086, 455 N.Y.S.2d at 568.

\textsuperscript{160} See infra note 161 and accompanying text. It should be noted that Judge Wachtler's construction of sections 4-205(1) and 3-206(3) appears to promote the underlying purpose of the restrictive indorsement requirements—insuring that the conditions of transfer are enforced, see Underpinning & Found. Constructors, Inc. v. Chase Manhattan Bank, N.A., 61 App. Div. 2d 628, 630, 403 N.Y.S.2d 501, 502 (1st Dep't 1978), by compelling banks to supply a written indorsement and act according to the terms of the indorsement so supplied. In addition, Judge Wachtler's adherence to the technical requirements of the UCC comports with the view that holder in due course status should not be granted lightly, see, e.g., Perini Corp. v. First Nat'l Bank, 553 F.2d 398, 418 (5th Cir. 1977), and is in accord with precedent, see Marine Midland Bank v. Graybar Elec. Co., 41 N.Y.2d 703, 709-10, 363 N.E.2d 1139, 1143-44, 395 N.Y.S.2d 403, 407 (1977) (depositary bank which indorsed a check was a holder under section 4-205(1)); Underpinning & Found. Constructors, Inc. v. Chase Manhattan Bank, N.A., 61 App. Div. 2d 628, 630-31, 403 N.Y.S.2d 501, 502 (1st Dep't 1978) (depositary
refuse to accept an unindorsed item, or supply the proper indorsement if the bank accepts the instrument. Not only are bank tellers aware of the intended transaction, but it is also common banking practice to instruct tellers to request indorsements before accepting any instrument.

Although the First Circuit in Bowling Green doubted whether a bank's holder in due course status should depend upon "whether a clerk employed the appropriate stamp," Marine Midland's persuasive answer would be that it is hardly inequitable "to penalize the bank when it fails to perform such a simple act."

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DEVELOPMENTS IN NEW YORK LAW

Search warrant may be issued to compel a suspect to supply a blood sample prior to arrest, provided probable cause exists and there is both a clear indication that relevant material evidence will be found and a safe, reliable means of obtaining the sample.

The propriety of seizing physical or nontestimonial evidence from suspects in criminal investigations is an issue having substantial constitutional implications. Indeed, the fourth amendment

bank liable to drawer for loss resulting from payment inconsistent with restrictive indorsement).

161 See 57 N.Y.2d at 227-28, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569.

162 It is clear that the teller involved in the Marine Midland case, by taking the checks for the express purpose of transferring them to another bank, was conscious of the special nature of the transaction. Thus, it is submitted that it would not have been unduly burdensome on the bank for the teller to provide an indorsement reflecting the special nature of the transaction.

163 See D. GERMAN & J. GERMAN, The Bank Teller's Handbook: How to Build your Bankability 134 (rev. ed. 1980) (teller is responsible for proper indorsement of every check); T. QUINN, QUINN'S UCC COMMENTARY AND LAW DIGEST § 4-205[A], at S4-25 (Supp. 1982) ("the teller's first instinct [to get indorsements] is the only safe rule"); Bell, The Depositary Bank as a Holder in Due Course: A Case Study, 8 IDAHO L. REV. 1, 30 n.122 ("tellers always make you indorse, whether needed for negotiation or not").

164 Bowling Green, 425 F.2d at 84.

165 57 N.Y.2d at 228, 441 N.E.2d at 1087, 455 N.Y.S.2d at 569 (quoting B. CLARK & A. SQUILLANTE, supra note 148, at 189).

166 See, e.g., Davis v. Mississippi, 394 U.S. 721, 726-27 (1969); United States v. Harris, 457 F.2d 1317, 1323 (8th Cir. 1972), cert. denied, 412 U.S. 927 (1973). The fourth amendment provides: The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants