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N.Y.U.C.C. §§ 3-206, -405: Drawer Has Cause of Action Against Depositary Bank for Failure to Act in Accordance with a Restrictive Indorsement

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in accord with the intended reading of EPTL § 5-4.3. When the legislature first enacted the wrongful death statute\textsuperscript{170} it was free to place restrictions on the right to recover.\textsuperscript{171} Moreover, judicial interpretation of “pecuniary injuries” to exclude loss of society and consortium has not prompted legislative response, suggesting a reluctance to broaden the elements of recovery in wrongful death actions. It is submitted that if change in the traditional New York rule is to occur, it should come from the legislature.

Elaine Robinson McHale

**Uniform Commercial Code**

*N.Y.U.C.C. § 3-206, -405:* Drawer has cause of action against depositary bank for failure to act in accordance with a restrictive indorsement

The Uniform Commercial Code (UCC) contains various provisions which seek both to foster the negotiability of commercial paper\textsuperscript{172} and to place the risk of loss of the party who should most appropriately bear it.\textsuperscript{173} Thus, under the “imposter rule” of section

\textsuperscript{170} The constitutional limitations on the legislature’s right to limit recoverable damages under the wrongful death statute were not adopted until 1894. See note 149 supra.


\textsuperscript{172} Section 3-104(1) lists the prerequisites of negotiability. The instrument must be signed by the maker or drawer, promise unconditionally the payment in money of a sum certain on demand or at a definite time, and be payable to order or to bearer. These prerequisites are discussed in detail elsewhere in the Code. See N.Y.U.C.C. §§ 3-105 to -107, -109, -112 to -114 (McKinney 1964).

\textsuperscript{173} Section 3-406, for example, provides that the party whose negligence “substantially” contributes to the alteration of an instrument or to the unauthorized affixing of a signature thereon shall, if the drawee pays in good faith, bear the burden of the resulting loss. Section 3-418 codifies the rule of Price v. Neal, 97 Eng. Rep. 871 (1762), which held that money paid out by an innocent drawer on an instrument bearing a forged signature may not be recovered from a holder in due course or an innocent purchaser who is able to show detrimental reliance. Section 3-419 delineates the circumstances whereby an instrument is deemed converted and allocates liability therefor. Subsection 3 limits the conversion liability of depositary and other collecting banks to the infrequent instances when the bank holds the proceeds of an instrument, fails to act in good faith or in accordance with reasonable commercial standards, or
3-405, where an employee furnishes his employer, as drawer, with the name of a payee, intending the payee to have no interest in the instrument, the employee's unauthorized indorsement is deemed effective for purposes of negotiation.\(^{174}\) Since the drawer is deemed to be in a better position than the drawee to prevent such forgeries, the risk of loss is placed on the drawer.\(^{175}\) Similarly, section 3-206, which recognizes that the collection of commercial paper would be impeded were all banks in the collection process\(^{176}\) required to investigate restrictive indorsements\(^{177}\) other than those of their immediate transferor, imposes a duty of inquiry solely on depository banks.\(^{178}\)

In Underpinning & Foundation Constructors, Inc. v. Chase cashes a check over a restrictive indorsement. See J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE, 504-05 (West 1972) [hereinafter cited as WHITE & SUMMERS], and the cases cited therein for a critique of § 3-419(3)'s solicitousness of the financial resources of banks.

\(^{174}\) N.Y.U.C.C. § 3-405 (McKinney 1964) provides, in pertinent part, that "[a]n indorsement by any person in the name of a named payee is effective if . . . an agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest." Section 3-405 is the exception to the general rule that payment on an unauthorized or forged indorsement is equivalent to conversion of the instrument.

\(^{175}\) The Official Comment to N.Y.U.C.C. § 3-405 states:

The principle followed is that the loss should fall upon the employer as a risk of his business enterprise rather than upon the subsequent holder or drawee. The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or, if he is not, is at least in a better position to cover the loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.

\(^{176}\) Banks in the collection process include the depositary bank, which is "the first bank to which an item is transferred for collection even though it is also the payor bank," N.Y.U.C.C. § 4-105(a) (McKinney 1964), the payor bank, which is "a bank by which an item is payable as drawn or accepted," id. § 4-105(b) (McKinney 1964), and the intermediary bank, which is "any bank to which an item is transferred in course of collection except the depositary or payor bank," id. § 4-105(c) (McKinney 1964).

\(^{177}\) An indorsement is restrictive which either

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

\(^{178}\) Section 3-206(2) provides:
Manhattan Bank N.A., the Appellate Division, First Department, recently had occasion to consider an unusual instance involving the interplay of the imposter rule and section 3-206 and held that a drawer has a cause of action against a depositary bank which neglects to apply proceeds of restrictively indorsed checks according to their tenor.

Underpinning & Foundation Constructors, Inc., relying on false invoices prepared by an employee, drew ten checks to the order of vendors and suppliers from which it customarily made purchases. The employee then restrictively indorsed the checks to the named payees and presented them for deposit in accounts maintained by the employee at the Bank of New York (BNY). Despite the restrictive indorsements, BNY accepted the checks and credited the accounts of the employee. Underpinning brought suit alleging that in failing to apply the proceeds of the checks consistently with the

An intermediary bank, or a payor bank which is not the depositary bank, is neither given notice nor otherwise affected by a restrictive indorsement of any person except the bank's immediate transferor or the person presenting for payment.

N.Y.U.C.C. § 3-206(2) (McKinney 1964).

The drafters' intent that restrictive indorsements be given effect as against depositary banks is further evidenced by § 3-603(1)(b), which provides that a depositary bank which pays or satisfies a holder in contravention of a restrictive indorsement is not discharged from liability on the instrument. N.Y.U.C.C. § 3-603(1)(b) (McKinney 1964).

Moreover, § 3-419(3) imposes liability for conversion upon a depositary bank which fails to pay or apply the proceeds of a restrictively indorsed instrument in accordance with the indorsement. The theory is that, in light of the immense volume of checks handled by banks in the chain of collection, only the depositary bank should be expected to examine the checks for irregularities. As stated in the Official Comment to § 3-206, intermediary banks, and payor banks which are not depositary banks, "ordinarily handle instruments, especially checks, in bulk and have no practicable opportunity to consider the effect of restrictive indorsements." N.Y.U.C.C. § 3-206, Official Comment 3 (McKinney 1964); see White & Summers, supra note 173, at 499-509.


180 Id. at 630-31, 403 N.Y.S.2d at 503.
181 Id. at 629, 403 N.Y.S.2d at 501.
182 Id. It is not clear from the court's summary of the facts why the checks had been restrictively indorsed.
183 Id. at 629, 403 N.Y.S.2d at 501-02.
restrictive indorsements, BNY breached the standard of care imposed on depositary banks by section 3-206.\(^{184}\) BNY’s motion to dismiss for failure to state a cause of action was denied by the Supreme Court, New York County.\(^{185}\)

On appeal, a divided appellate division affirmed the lower court’s ruling, holding that the depositary bank’s duty of care ran to the drawer of the restrictively indorsed checks.\(^{186}\) Writing for the majority,\(^{187}\) Justice Yesawich noted that while intermediary collecting banks generally are not subject to liability for failing to inquire when presented with an instrument containing a restrictive indorsement, both the common law and section 3-206 impose such liability on depositary banks.\(^{188}\) Reasoning that the absence of privity of contract should not bar a direct action by a drawer against a depositary bank which fails to inquire when presented with a restrictive indorsement,\(^{189}\) the court concluded that “the beneficiary of a depositary bank’s duty to make that inquiry is any party harmed by the bank’s failure to do so.”\(^{190}\)

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\(^{184}\) Id. Underpinning also alleged that BNY’s failure to inquire when presented with the checks for deposit constituted gross negligence. Id.

\(^{185}\) Id., 403 N.Y.S.2d at 502.

\(^{186}\) Id. at 630-31, 403 N.Y.S.2d at 503.

\(^{187}\) Justice Birns joined Justice Yesawich in the majority opinion. Justice Sandler concurred in a separate opinion.

\(^{188}\) 61 App. Div. 2d at 630, 403 N.Y.S.2d at 502.

\(^{189}\) In rejecting the contention that the absence of privity of contract precludes a cause of action by the drawer, the court spoke in terms of broad tort liability attaching to the negligent depositary bank and found a duty running to those whose injury was proximately caused by the defendant’s act. Id. at 631, 403 N.Y.S.2d at 503. The law in New York has been that no privity of contract exists between the drawer of a check and the collecting bank. The Court of Appeals has held that “a collecting bank is merely an agent for the purpose of collecting from the drawee bank the proceeds of the check delivered to it.” Henderson v. Lincoln Rochester Trust Co., 303 N.Y. 27, 33, 100 N.E.2d 117, 120 (1938). Applying this reasoning, where a check has been paid on a forged indorsement the drawer’s remedy lies in an action against the drawee bank, which in turn may seek indemnification from the collecting bank. See note 190 infra. Similarly, in the landmark case of Stone & Webster Eng. Corp. v. First Nat’l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962), the Supreme Judicial Court of Massachusetts held that a drawer may not sue a depositary bank in conversion for cashing and passing on a check which was stolen from the drawer. This view is premised on the grounds that a drawer has no “valuable rights” in an undelivered check, that the drawee bank is in a better position than the depositary bank to assert against the drawer the defense of negligence and, that there is no privity of contract between the drawer and the depositary bank.

Dissenting at length,\textsuperscript{191} Justice Lupiano observed that no cause of action accrues in favor of a drawer against a depositary bank which collects on a check bearing the forged indorsement of the payee.\textsuperscript{192} The dissent noted that such actions are precluded due to the absence of privity between the parties.\textsuperscript{193} Generally, Justice Lupiano reasoned, a depositary bank’s liability for paying on a forged indorsement is limited to either the wronged payee\textsuperscript{194} or the drawee

\footnotesize{(mem.); Low v. Merchants Nat’l Bank & Trust Co., 24 App. Div. 2d 322, 323-24, 266 N.Y.S.2d 74, 75-76 (3d Dep’t 1966); Chartered Bank v. American Trust Co., 48 Misc. 2d 314, 316-17, 264 N.Y.S.2d 656, 659 (Sup. Ct. N.Y. County 1965); Aritor Corp. v. Chase Manhattan Bank, 39 Misc. 2d 427, 428, 240 N.Y.S.2d 615, 616 (Sup. Ct. N.Y. County 1963). The Underpinning court distinguished Low v. Merchants Nat’l Bank & Trust Co., 24 App. Div. 2d 322, 266 N.Y.S.2d 74 (3d Dep’t 1966), which involved a suit by a drawer against a depositary bank for crediting an account, other than that of the named payee, with the proceeds of restrictively indorsed checks. 61 App. Div. 2d at 631, 403 N.Y.S.2d at 503. The Low court held that since no privity of contract existed between the drawer and the collecting bank, the plaintiff’s action, if any, lay against the drawee bank. See note 189 supra. In the Low situation, either the drawee bank or the payee has an action against the collecting bank. 24 App. Div. 2d at 324, 266 N.Y.S.2d at 76 (citing Henderson v. Lincoln Rochester Trust Co., 303 N.Y. 27, 100 N.E.2d 117 (1951); Soma v. Handrulis, 277 N.Y. 223, 14 N.E.2d 46 (1938); City of New York v. Bronx County Trust Co., 261 N.Y. 64, 184 N.E. 495 (1933)). For a description of the warranties made by customers and collecting banks when transferring or presenting items, see note 195 infra. The Underpinning court distinguished Low on the grounds that the latter case was not argued on the basis of § 3-206. 61 App. Div. 2d at 631, 403 N.Y.S.2d at 503. In a concurring opinion, Justice Sandler stressed the Code’s treatment of the duty of depositary banks with respect to restrictive indorsements. 61 App. Div. 2d at 631-32, 403 N.Y.S.2d at 503-04 (Sandler, J., concurring). The impact of § 3-206 in preserving the depositary bank’s duty of inquiry, see note 178 supra, coupled with the bank’s liability in conversion for failure to pay a restrictively indorsed instrument according to its tenor, see N.Y.U.C.C. § 3-419(3), (4) (McKinney 1964), seemed to Justice Sandler to import a lack of intent on the part of the Code’s draftsmen to deny to the drawer an action against the depositary bank. 61 App. Div. 2d at 632, 403 N.Y.S.2d at 504 (Sandler, J., concurring). Section 3-419 (4) provides:

An intermediary bank or payor bank which is not a depositary bank is not liable in conversion solely by reason of the fact that proceeds of an item indorsed restrictively are not paid or applied consistently with the restrictive indorsement of an indorser other than its immediate transferor.


No section of the Uniform Commercial Code specifically requires an indorsee-bank to examine the [restrictive indorsement] and to ensure that its payment is not inconsistent therewith; nor does any provision set forth any liability on the part of a bank for payment inconsistent with a restrictive indorsement. But . . . such duty and resulting liability for the failure to carry out such duty can be fairly inferred from a number of Code sections.

\textsuperscript{191} Presiding Justice Murphy concurred in the dissenting opinion of Justice Lupiano.

\textsuperscript{192} 61 App. Div. 2d at 634-35, 403 N.Y.S.2d at 504-05 (Lupiano, J., dissenting); see note 190 supra.

\textsuperscript{193} 61 App. Div. 2d at 634-35, 403 N.Y.S.2d at 504-05 (Lupiano, J., dissenting); see Henderson v. Lincoln Rochester Trust Co., 303 N.Y. at 33, 100 N.E.2d at 120.

bank. In the instant case, however, no action would accrue in favor of the named payee since it was not intended to have any interest in the instrument. More importantly since the imposter rule shields the drawee bank from liability to the drawer, the former would suffer no loss for which it could seek indemnification from the depositary bank. Thus, notwithstanding the provisions of section 3-206, the possibility of section 3-405 barring an action by the plaintiff against the drawee bank, declared the dissent, does not justify sustaining an action against the depositary bank. Such a result was thought to be contrary both to the rule governing forged indorsement cases and to the intent of the UCC’s draftsmen in placing the risk of loss on the drawer of the instrument under section 3-405.

It appears that the Underpinning majority erred in restricting its inquiry to the question whether section 3-206 was drafted with an eye towards affording the drawer a remedy against the depositary bank. Generally, the only occasion when the drawer would seek to bring an action against the depositary bank would be when the imposter rule operates to bar a successful suit against the drawee bank. The critical question, which was not acknowledged by the Underpinning majority, is whether the loss which the imposter rule allocates to the drawer should be shifted to the depositary bank by virtue of section 3-206.

In imposing liability on the depositary bank, the Underpinning court failed to consider the shifting of loss which the imposter rule mandates. A forged indorsement “is wholly inoperative as that of the person whose name is signed” and if a bank pays on such an instrument it is liable in conversion. Under the imposter rule of section 3-405, however, where an employee of the drawer causes an instrument to be made payable to a payee, intending such payee to have no interest in the instrument, the imposter rule seems clearly applicable. Although never discussed by the majority, this was believed by the dissent to form the unspoken predicate for the court’s holding. See N.Y.U.C.C. § 3-404(1) (McKinney 1964); see note 3 supra.
ment made by the employee in the payee's name is effective.\textsuperscript{201} Thus, if a bank pays on such an instrument it is not liable in conversion since the employer is made to bear the risk of loss.\textsuperscript{202} In Underpinning, the employee did not merely indorse the instrument in the payee's name; rather, he restrictively indorsed it. This event, although sufficient in the court's view to give the drawer a cause of action against the depositary bank, should not alter the legal result obtaining from the imposter rule. Since section 3-405 was drafted with the object of imposing risk of loss upon the drawer,\textsuperscript{203} the Underpinning result is inconsistent with the intent of the drafters of the Code.

Bruce A. Antonelli

Developments in New York Practice

Declaration against penal interest held inadmissible against defendant in criminal action

In People v. Brown,\textsuperscript{204} the Court of Appeals expanded the declaration against interest exception to include a declaration against penal interest offered by a defendant in a criminal case.\textsuperscript{205} The

\textsuperscript{201} N.Y.U.C.C. § 3-405 (McKinney 1964); see notes 174-75 supra.

\textsuperscript{202} N.Y.U.C.C. § 3-405 (McKinney 1964). An argument might be made, however, that even where the imposter rule applies, if a bank acts contrary to reasonable commercial practices and pays inconsistently with the terms of a restrictive indorsement, the drawer should be allowed to assert such negligence and shift the loss to the payor bank. Under §§ 3-406 and 4-406, if both the bank and its customer are shown to have been negligent with respect to instruments which have been altered or signed without authorization, the resulting loss is borne by the bank. N.Y.U.C.C. §§ 3-406, 4-406 (McKinney 1964); see White & Summers, supra note 173, at 548-49.

\textsuperscript{203} See R. Anderson, supra note 174, §§ 3-405:6, 505:3.


\textsuperscript{205} It had been the settled rule in New York that the declaration against interest exception only included declarations against one's pecuniary or proprietary interest. See, e.g., Kittredge v. Grannis, 244 N.Y. 168, 175-76, 155 N.E. 88, 90 (1926); Ellwanger v. Whitefold, 15 App. Div. 2d 898, 898-99, 225 N.Y.S.2d 734, 735 (1st Dep't 1962) (per curiam), aff'd mem., 12 N.Y.2d 1037, 190 N.E.2d 24, 239 N.Y.S.2d 680 (1963). See generally W. Richardson, Evidence §§ 255-266 (10th ed. J. Prince 1973); see also People v. Sullivan, 43 App. Div. 2d 55, 349 N.Y.S.2d 702 (1st Dep't 1973) (per curiam). Professor Wigmore persuasively urged American courts to "discard this barbarous doctrine [precluding the admission of declarations against penal interest], which would refuse to let an innocent accused vindicate himself even by producing to the tribunal a perfectly authenticated written confession, made on the very gallows, by the true culprit now beyond the reach of justice . . . ." 5 J. Wigmore, Evidence § 1477, at 290 (3d ed. 1940).

In the Brown case, the defendant was on trial for murder and asserted that he had killed the victim in self-defense. 26 N.Y.2d at 90, 257 N.E.2d at 16, 308 N.Y.S.2d at 825. Although