Cooper v. Union Bank California Protects the True Owner against a Forged Indorsement Despite Uniform Commercial Code Section 3-419(3)

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COOPER v UNION BANK. CALIFORNIA PROTECTS THE TRUE OWNER AGAINST A FORGED ENDORSEMENT DESPITE UNIFORM COMMERCIAL CODE SECTION 3-419(3)

In any event, I would say that this was one of those areas in which no three people could lead you out of the confusion that you must now be in, and that if you have a problem like this, the law is very unclear.

E. Allan Farnsworth

In Cooper v Union Bank California has reaffirmed its traditional rule that a collecting bank is liable to the true owner of a

1. ALI, ADVANCED ALI-ABA COURSE OF STUDY ON BANKING AND SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 57 (1968) [hereinafter cited as ALI-ABA COURSE OF STUDY].

2. 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973). The opinion was written by Mr. Justice Mosk for a unanimous court.

3. Definition of a few terms will aid in understanding the issues discussed. The definitions are taken from the Uniform Commercial Code, CAL. COMM. CODE § 4105 (West 1964).

"Depositary bank"—the first bank to which an item is transferred for collection even though it is also the payor bank.

"Payor bank"—a bank by which an item is payable as drawn or accepted.

"Intermediary bank"—any bank to which an item is transferred in course of collection except the depositary or payor bank.

"Collecting bank"—any bank handling the item for collection except the payor bank.

"Presenting bank"—any bank presenting an item except a payor bank.

"Remitting bank"—any payor or intermediary bank remitting for an item.

From the above definitions it can be seen that the categories of banks set out are not all mutually exclusive. For example, a payor can also be a depositary, but a payor cannot be a collecting bank. An intermediary is always a collecting bank, but cannot be either a depositary or payor. A collecting bank may be either a depositary or intermediary. (Consideration of the two additional categories, "presenting bank" and "remitting bank" is not necessary in the context of this note.) Any given bank will be one of these four possible combinations, in the context of a single transaction: depositary-collecting bank, depositary-payor bank, non-depository payor bank, intermediary-collecting bank.

In addition, the following terms are generally defined:

"Payee"—party to whom item is made payable.

"Drawee bank"—the bank upon which the item is drawn.

"Drawer"—the party that draws the item.

"Order instrument"—an instrument made payable to the order of a specified person, negotiable only by delivery with indorsement. See UNIFORM COMMERCIAL CODE §§ 3-110, 3-202(1).

4. "True owner" is the original payee of the check, or any subsequent indorsee prior to the forgery who may assert a claim for conversion of the instrument.
check if it remits funds on a forged indorsement. The only defense the bank may assert is that the true owner is estopped from pleading the forgery by his negligence. In so holding, California has rejected the nearly unanimous assumption in other jurisdictions and in commentary that the bank's liability may, in certain cases, be limited by Uniform Commercial Code section 3-419(3) to the amounts received by it on collection of the check which it has not yet remitted to its transferor.

Section 3-419(3) reads:

Subject to the provisions of this Act concerning restrictive indorsements 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 such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.

Prior to Cooper, all the leading commentary, and dicta in every reported case involving section 3-419 had interpreted the subsection as absolving a collecting bank from liability to the true owner of a check, in remitting funds over a forged indorsement, if it had (1) acted in good faith, (2) acted in accord with reasonable commercial standards, and (3) paid out all the proceeds of the check to the forger or subsequent indorsee. These three criteria, collectively, have become known as the "defense" of section 3-419(3). Only one case, Ervin v. Dauphin Deposit Trust Co., had held to the contrary, that the presumed "defense" never applies to a collecting bank remitting funds on a forged indorsement. The California Supreme Court in Cooper thus becomes the first high court in the forty-nine states which have adopted the Code to offer a definitive ruling on this subsection. Cooper will very likely provoke a spate of adverse criticism for its in-

5. "Forgery" in the context of this note means any unauthorized signature, as defined in Uniform Commercial Code § 1-201(43): "'Unauthorized' signature or indorsement means one made without actual, implied or apparent authority and includes a forgery." The significance of an unauthorized signature is set forth in Uniform Commercial Code § 3-404(1): "Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it..." The forged signature of the indorser is of primary interest in this note and should be distinguished from the forged signature of the drawer. Payment by any bank on a forged indorsement constitutes a conversion of the instrument under Uniform Commercial Code § 3-419(1)(c).

6. For a discussion of this proviso, see note 40 infra.


8. See, e.g., commentary cited in note 30 infra.

terpretation of 3-419(3). Some of the criticism will be merited, for some of the court's reasoning is not as clearly and directly expressed as it could be. On the whole, however, the decision can be defended in view of both the subsection itself and its comments—especially the California comments.

In order to understand the policy which the section sets forth, and subsequently to evaluate the holding in Cooper, it is first necessary to understand the pre-Code liability which the common law placed on collecting and depositary banks and the liability it placed on a broker-agent for conversion. It will be shown that section 3-419-(3) combines elements of these two doctrines to reach an ambiguous result. Cooper found the combination confusing and attempted to clarify the section's meaning insofar as the section bears on the problem of collecting bank liability in conversion.

Common Law Bases of Liability

Common Law Liability of Collecting Banks

Professor Friedrich Kessler has summed up the historical attitude of the Anglo-American common law toward liability for forged indorsements in the following short paragraph:

[T]he protection given to the true owner of an order instrument against the loss of the instrument by reason of a forgery of his signature is complete. He may proceed either against the subsequent purchaser who has collected the proceeds, or against the acceptor and, possibly, even against the drawee who has paid the instrument to the wrong party, or finally, in case of dishonor, against prior secondary parties. It is obvious that the American rule is designed to place the ultimate liability upon the purchaser from the forger.10

This Anglo-American attitude is in sharp contrast with the position taken by the continental law, which exonerates the transferee holding the instrument in good faith and without gross negligence11 and thereby shifts the burden of loss to the true owner.

The common law placed liability on the collecting bank under several different theories:12 (1) in assumpsit, for money had and received, (2) in conversion, (3) an election between assumption and conversion, (4) strict liability, and (5) unjust enrichment. The action most commonly used in California has been that of assumpsit.13

10. Kessler, Forged Indorsements, 47 YALE L.J. 863, 880 (1938) [hereinafter cited as Kessler]. This article is cited in Cooper, 9 Cal. 3d at 376, 507 P.2d at 613, 107 Cal. Rptr. at 5. It appears that the court has looked closely at Professor Kessler's comparative study of the policies underlying the continental and common law approaches to forged indorsements.
11. Kessler, supra note 10, at 863-64.
13. E.g., Morgan v. Morgan, 220 Cal. App. 2d 665, 34 Cal. Rptr. 82 (1963);
Briefly, the theory is this: when the true owner sues the collecting bank, he ratifies the collection of the proceeds of the item by the collecting bank from the payor bank, but does not ratify the payment by the collecting bank to the forger. The true owner then holds the collecting bank accountable for the funds it has received from the payor bank and wrongly paid out to the forger. Typical of the rigidity of the common law approach is the following language from a Colorado case, cited by the California District Court of Appeals:

[T]he payee can recover from a bank which accepted [the checks] from the forger and collected them from the drawee bank, as for moneys had and received, even though it has fully paid over and accounted for the same to the forger without knowledge or suspicion of the forgery.

Occasionally, the common law rule was phrased in terms of absolute liability; for example, "[o]ne who acts upon the indorsement of negotiable paper must ascertain its genuineness at his peril." The liability was generally not so absolute as this language suggests, however. The transferee could assert some defenses, including the negligence of the payee, to bar recovery. These defenses always required a showing of some culpability on the part of the true owner, in contrast to the simpler, stronger defense given by the continental law to the transferee: good faith, absence of gross negligence.

The common law also allowed any transferee of an instrument bearing a forged indorsement to recover from his immediate transferor; a payor or intermediary bank could recover from a prior intermediary or depositary bank on the standard guarantee of prior indorsements or otherwise recovered under the common law theory of payment by mistake. The depositary bank could, in turn, recover under the


14. This is the "ratification" theory which was followed by the court in Cooper. See text accompanying notes 52-55 infra for a more complete discussion of this theory.


18. See Annot., 87 A.L.R.2d 638 (1963) (Payee's prior negligence facilitating forging of indorsement as precluding recovery from bank paying check); Annot., 39 A.L.R.2d 641 (1955) (When depositor-drawer of check is "precluded", under Negotiable Instruments Law, § 23, from setting up forgery of indorsement or want of authority against drawee bank).

warranty from the forger if it could find him.\textsuperscript{20} The practical result was to place final liability on the depositary bank, which was better able to institute procedures to ascertain the genuineness of an indorsement than other parties because of the directness of its contact with the forger.\textsuperscript{21}

\textbf{Common Law Liability of a Broker-Agent for Conversion}

The second of the two common law doctrines which appear to be incorporated into section 3-419(3) is the common law liability of an agent (representative) for the torts of his principal. The general rule is that the innocent agent is liable for conversion when he disposes of goods for his principal, even though the agent has acted in good faith and no longer exercises control over the converted goods.\textsuperscript{22} The common law extended a special exemption from liability in conversion to a broker who dealt with stolen negotiable bonds or securities on behalf of his principal, remitting all the proceeds from the sale of the paper to this principal. For example, the Massachusetts case of \textit{Pratt v. Higginson},\textsuperscript{23} citing an earlier case of \textit{Spooner v. Holmes},\textsuperscript{24} exempted members of a banking-brokerage firm who had in good faith and without notice disposed of United States bonds for a thief, remitting the proceeds to the thief. Later cases adopted the exemption,\textsuperscript{25} absolving the innocent representative. This standard for behavior is similar to the defense allowed to the transferee of a forged indorsement under the continental rule—good faith action without gross negligence.

These broker cases are subject to two different interpretations with regard to the possible scope of the exemption granted. The first and generally accepted interpretation is that the exemption from liability in conversion is limited to circumstances in which the broker

\begin{itemize}
\item \textsuperscript{20}To simplify discussion of bank liability for forged indorsements, it is assumed throughout this note that the forger deals directly with the depositary bank. In situations where the forger deals with an innocent second party, who in turn transfers the check to the depositary, the warranty still applies as against the innocent customer, and liability ultimately rests with the customer if the forger cannot be reached. \textsc{Uniform Commercial Code} §§ 3-417 & 4-207 provide the warranties on presentment or transfer extended by any person or collecting bank.
\item \textsuperscript{21}"[A] elaborate protection for the true owner, with exceptions in only a limited number of instances, has been built upon a philosophy designed to place ultimate liability upon the purchaser who took from the forger." Kessler, \textit{supra} note 10, at 872.
\item \textsuperscript{22}W. Prosser, \textsc{Law of Torts} 84-86 (4th ed. 1971); \textsc{Restatement (Second) of Agency} § 349 (1958); \textsc{Restatement (Second) of Torts} § 233 (1965).
\item \textsuperscript{23}230 Mass. 256, 119 N.E. 661 (1918).
\item \textsuperscript{24}102 Mass. 503 (1869).
\end{itemize}
markets only bearer paper. The *Restatement (Second) of Torts* defines and delimits the broker exemption in terms of the "holder in due course" doctrine.\(^{26}\) According to the comments and illustrations to section 233(4) the broker would not be protected under common law if he innocently received and sold negotiable instruments bearing forged indorsements.\(^{27}\) The *Restatement (Second) of Agency* takes a similar position.\(^{28}\) Under the second interpretation the cases should be read more broadly to grant the exception whenever a broker markets any negotiable instrument. The argument for a broader interpretation is this: Although all the instruments involved in these broker cases were bearer bonds or securities, negotiable by delivery alone without indorsement, the rationale for the exemption does not turn on whether the instrument converted was an order instrument or a bearer instrument. The rationale for the exemption is

\[\text{\footnotesize 26. Restatement (Second) of Torts \S 233(4) (1965): "The statement in Subsection (1) [that one who as agent of another person disposes of a chattel is liable for a conversion to another who, as against his principal, is entitled to the immediate possession of the chattel] is not applicable to an agent or servant who disposes of current money, or a document negotiable by common law or by statute, pursuant to a transaction by which the transferee becomes a holder in due course of such money or document, unless the agent or servant knows or has reason to know that his principal or master does not have authority so to dispose of it." For the requirements of becoming a holder in due course, see Uniform Commercial Code §§ 3-302 to 3-305.}
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\[\text{\footnotesize 27. Restatement (Second) of Torts \S 233(4), Comments d & e, Illustrations 5 & 6 (1965) reads:}
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\[\text{\footnotesize "d. The statement in this Subsection is applicable only when the transferee receives the instrument under circumstances which make him a holder in due course. If, for any reason, the transferee fails to obtain title to the instrument, the agent or servant who negotiates it either by indorsement or delivery is subject to liability to the person entitled to the immediate possession of the instrument for its conversion. Illustrations:}
\]

\[\text{\footnotesize 5. A employs B, his broker, to sell certain bonds payable to bearer. B sells the bonds to C, and delivers them pursuant to the sale. C knows that A has stolen the bonds from D, but B is ignorant of this fact. B is subject to liability to D.}
\]

\[\text{\footnotesize 6. A employs B, his broker to sell certain bonds payable to order. B sells the bonds to C, and delivers them pursuant to the sale. Both B and C are ignorant of the fact that A had stolen the bonds and forged the name of D, the last indorsee. B is subject to liability to D.}
\]

\[\text{\footnotesize e. Rationale. The statement in Subsection (4) is consistent with the policy of the Uniform Negotiable Instruments Act, the Uniform Bills of Lading Act, the Uniform Warehouse Receipts Act and the Uniform Commercial Code. The policy of all of this legislation is directed toward insuring the marketability of the documents in question by protecting one who obtains them as a holder in due course. The rule stated in this Section enhances the marketability and the easy exchange of credits by affording a similar protection to those who deal with negotiable securities on behalf of a principal."}
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to enhance the marketability of negotiable bonds and securities, and the more inclusive term "negotiable instrument" is often used in these cases, instead of the narrower one, "bearer instrument." Read restrictively, the cases exempt only brokers dealing with bearer paper; read more broadly, the cases would exempt the broker to preserve his role as marketing agent for order as well as bearer paper, and the exemption could therefore extend to protect the broker who dealt with order paper bearing forged indorsements. The difference in the two interpretations becomes significant when one attempts to analyze section 3-419(3) in terms of the broker exemption.

A comparison of the broker-agent rule with the common law rule on the liability of collecting banks for forged indorsements shows two distinctly different concepts operating. The true owner of a marketable negotiable instrument had his rights subordinated to the innocent broker-agent who dealt with the instrument, but the true owner of an order check had rights superior to any bank which took the check for collection, absent negligence on the owner's part.

Section 3-419: the pre-Cooper Analysis

At the time Cooper reached the California Supreme Court the consensus among legal scholars, with support in dicta from the courts,

29. E.g., First Nat'l Bank v. Goldberg, 340 Pa. 337, 343, 17 A.2d 377, 380 (1941): "The purpose of the Negotiable Instruments Law is to enhance the marketability of such securities and to allow bankers, brokers, and people generally to trade in them with confidence. That object would be defeated if liability were to be imposed upon one who, mistakenly but in good faith, deals with negotiable instruments on the assumption that they belong to the person who employs him to effect their sale through ordinary market channels."

30. E.g., ALI ABA COURSE OF STUDY, supra note 1, at 56-57. Mr. Leary concluded that § 3419(3) would protect a depositary if it took the check for collection and gave the transferor a provisional credit, but would not protect the depositary or collecting bank if the transferor received cash for the check, for in the latter case the bank pays out its own money to purchase the check and does not act as a representative for collection.

H. BAILEY, THE LAW OF BANK CHECKS § 15.14, at 499 (4th ed. 1969) (footnotes omitted). "The Code would appear to [provide] that a depositary or collecting bank which collected a check on a forged indorsement and remitted the proceeds to its prior transferor is not liable in conversion to the true owner."

8 CAL. JUR. 2d, Bills & Notes § 260, at 487 (1968) (footnotes omitted). "[§ 3419(3)] should have the effect of excluding from liability to the payee a bank cashing or collecting a check bearing a forged payee's indorsement, where no proceeds of the check remain in the bank's possession, and where the bank has dealt with the forger in a 'commercially reasonable' manner."

B. CLARK & A. SQUILLANTE, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS 144 (1970). "[A] collecting bank which does not 'cash' the check is protected from a conversion action by § 3-419(3), which recognizes that such a bank is a mere agent handling the check for its principal. . . . A strong argument can be made that a bank which 'cashes' a check, [however, should not be allowed to assert
was that the collecting bank had been given a new, strong defense in
the defense of § 3-419(3)]."

2 F. Hart & W. Willier, Commercial Paper under the Uniform Commercial Code § 12.38[3], at 12-142 (1972). "[A bank which cashes a check] would not be exempt in any way from liability. . . . In strictly collection cases, the issue resolves itself into whether the bank paid the instrument in good faith and in accordance with reasonable commercial standards."

J. White & R. Summers, Handbook of the Law under the Uniform Commercial Code 502 (1972) [hereinafter cited as White & Summers]. "For reasons not too clear to us the draftsmen have attempted to free depository banks from conversion liability in a substantial number of cases. . . . [If the forger deposits the check in his own account, and does not withdraw it,] the depository bank still has the 'proceeds' and will be liable. To the extent it pays cash over the counter to the thief it has no proceeds."

White, Some Petty Complaints About Article Three, 65 Mich. L. Rev. 1315, 1333 n.58 (1967). "[B]anks in the collecting chain will usually have no liability for dealing with a stolen check [citation omitted]; there is some doubt, however, as to whether 'representative' includes [those] who simply cash a check over a forged instrument or whether the term is limited to banks in the chain of payment."

Note, Allocation of Losses from Check Forgeries under the Law of Negotiable Instruments and the Uniform Commercial Code, 62 Yale L.J. 417, 471 (1953). "[§ 3-419(3)] gives a collecting bank who exercises reasonable care a defense against the payee for the amount of any proceeds not remaining in the bank's hands."

FDIC v. Marine Nat'l Bank, 431 F.2d 341, 344 (5th Cir. 1970). The court assumes the defense is available, but not in the case at bar, since by the bank's own admission it had failed to comply with its own commercial standards.

Allied Concord Fin. Corp. v. Bank of America, 275 Cal. App. 2d 1, 8, 80 Cal. Rptr. 622, 626 (1969) (dictum). "[I]f a collecting or depository bank has proceeds of a forgery in its possession under section 3419(3) it may become liable to the true owner . . . for the amount of proceeds remaining in its hands." (Drawer was not allowed to bring an action directly against collecting bank.)

Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 6, 184 N.E.2d 358, 361 (1962) (dictum). "[W]e assume that the collecting bank may be liable in conversion to a proper party, subject to defenses, including that in § 3-419(3)." (Court denied drawer the right to bring action directly against collecting bank.)

Salsman v. National Community Bank, 102 N.J. Super. 482, 493, 246 A.2d 162, 168 (L. Div. 1968), aff'd 105 N.J. Super. 164, 251 A.2d 460 (App. Div. 1969). "[§ 3-419(3)] clearly implies the liability of a depository or collecting bank in conversion when it deals with an instrument or its proceeds on behalf of one who is not the true owner, where the bank does not act in accordance with 'reasonable commercial standards.'" (Recovery allowed, since defendant bank had not acted in accordance with these standards.)

Belmar Trucking Corp. v. American Trust Co., 316 N.Y.S.2d 247, 251, 253 (N.Y. Civ. Ct. 1970). "[§ 3-419(3)], which is new, is an exculpatory proviso, relieving a depository or collecting bank from liability in the event that it acts 'in good faith and in accordance with the reasonable commercial standards applicable to the business' of the bank. . . . The full measure of the collecting bank's relief from responsibility [under § 3-419(3)] is set forth in the language. . . ." (Collecting bank held liable because it had violated reasonable commercial standards.)

In none of the above cases was the court faced with a collecting bank which had acted in accord with reasonable commercial standards. The assumed "defense" was therefore never applied to relieve any collecting bank from liability to the true owner.
section 3-419(3). One case had held to the contrary,\textsuperscript{32} and at least one commentator had raised serious questions as to the meaning of the section.\textsuperscript{33} The consensus was this: section 3-419, correctly interpreted, gives the true owner the right to sue the payor in conversion for paying on a forged indorsement, and at the same time mitigates the common law liability of the collecting bank to the true owner where the bank has acted in good faith, without negligence (in accord with reasonable commercial standards), and where the bank no longer retains the proceeds of the check. In a sense, a standard for liability similar to that of the continental law, modified by the proceeds provision, would replace the common law liability of collecting banks. The right to recover from the collecting bank would be preserved under the Code's warranty\textsuperscript{34} provisions so that a payor found liable in conversion to the true owner could recoup the loss it had sustained in remitting the proceeds to the collecting bank.\textsuperscript{35} The net result of this rearrangement of liabilities would be to limit the true owner's cause of action to the payor bank; ultimate liability would still remain upon the depositary-collecting bank for breach of warranty of the indorsement. The collecting bank would be freed from any simultaneous liability to the payee in conversion and to the payor in warranty.

It is possible to analyze section 3-419(3) into its component parts based on the common law and to see how the section could be interpreted as broadening the common law broker exemption and as extending it to new parties in arriving at the scheme of liabilities as set forth immediately above. The official comment to section 3-419-(3) states that its purpose is

\textsuperscript{32} Ervin v. Dauphin Deposit Trust Co., 38 Pa. D. & C.2d 473 (C.P. Dauphin Co. 1965). \textit{Ervin} reached the same conclusion as does \textit{Cooper}, that § 3-419(3) does not allow the collecting bank a defense. The fact situation is similar to that in \textit{Cooper}. See text accompanying notes 68, 74 & 75 \textit{infra} and note 68 \textit{infra} for comparison of the two cases and commentary on \textit{Ervin}.

\textsuperscript{33} \textit{See} Britton, \textit{Defenses, Claims of Ownership and Equities—A Comparison of the Provisions of the Negotiable Instruments Law with Corresponding Provisions of Article 3 of the Proposed Commercial Code}, 7 HASTINGS L.J. 1, 45-46 (1955). Professor Britton points out a number of confusing ambiguities in the wording of the section and foreshadows the difficulty of interpreting the term "proceeds:"

"[W]ho is the 'true owner'? Is this a reference to the 'true owner' of the instrument or the 'true owner' of the proceeds? They are not the same. The drawee is the 'true owner' of the proceeds and the holder is the 'true owner' of the check.

"It is not apparent why the unusual phrasing—'A representative, including a depositary or collecting bank'—is used in the section. The problem concerns the liability of the person who got the money under the forged indorsement from the drawee. This could be the forger, or a purchaser from the forger or someone who collects in behalf of the forger, or other purchaser or an agent thereof. This idea could be more simply and more clearly expressed than it is."

\textsuperscript{34} \textit{Uniform Commercial Code} § 4-207.

\textsuperscript{35} \textit{Id.} § 3-419, Comment 6, indicates that this liability is to be preserved.
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. The provisions of subsection (3) are, however, subject to the provisions of this Act concerning restrictive indorsements.

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The first sentence of the comment could be interpreted as an indication that the drafters intended to grant the broker-agent exemption, in some form or another, to despository and collecting banks. The question then arises whether the drafters in adopting the rule of the broker-agent decisions and extending it to collecting banks, intended to use a broad interpretation of the rule to apply the exemption to all negotiable instruments. Further, and more importantly, did the drafters mean to extend the rule to collecting banks dealing with order instruments in the normal check collection process as well as in the role of broker? The answers to these questions are not clear from the first sentence of the comment.

The second sentence of the comment, however, seems to give a better answer to the question as to whether order paper is meant to be included in the exemption. Here, as well as in section 3-419(3) itself, the drafters make clear that the exemption granted is subject to the restrictive indorsement provisions in the Code. It would make no sense to include a restrictive indorsement exception to the exemption if the exemption itself did not deal with indorsements. Following this line of argument the explanation for this exception would be that depositary and collecting banks are not liable in conversion to the true owner (if they act in good faith, in accord with reasonable commercial standards, and retain no proceeds) unless they remit the funds

36. Id., Comment 5.
37. See text accompanying notes 22-25 supra.
39. Cf. UNIFORM COMMERCIAL CODE § 8-318, which extends a similarly broad exemption to agents and bailees who innocently deal with converted securities on behalf of a principal. Although the comment to § 8-318 indicates that the rule of Gruntal v. National Sur. Co., 254 N.Y. 468, 173 N.E. 682 (1930) is being followed, the Code exemption is clearly broader than is indicated in the case. See also UNIFORM COMMERCIAL CODE § 7-404, which exempts an innocent bailee from liability for good faith delivery pursuant to the terms of a document of title.
40. These provisions are found in UNIFORM COMMERCIAL CODE §§ 3-205, 3-206, & 3-419(4). A common example of a restrictive indorsement is "for deposit only." The effect of these provisions is to hold the first taker (e.g., depositary bank) absolutely liable to the indorser if it does not follow the instructions of the restrictive indorsement, but to relieve subsequent transferees or indorsees from liability for conversion in the event the first taker does not apply the funds consistently with the restrictive indorsement.
as immediate transferees in disobedience to an express restrictive indorsement. For example: forger steals a check made out to Corporation X, indorses the check with the Corporation's "for deposit only" stamp, signs his own name under the corporation indorsement, and requests cash from the teller of a depositary-collecting bank. If the teller gives him the cash, the bank will be liable to the true owner (Corporation X) in conversion, since it cannot assert the "defense" of section 3-419(3) in disobedience of the restrictive indorsement. If the exemption were meant to apply only in the case of bearer paper, there would be no need to limit the exemption by the restrictive indorsement proviso.

A liberal reading of the broker cases and the inclusion of the restrictive indorsement proviso in section 3-419(3) both support the argument that the exemption granted must include order paper. The question remains as to whether collecting banks are exempt in the ordinary check collection transaction. The majority interpretation assumes that they are, although this would entail a substantial departure from the common law of commercial paper, as we have seen. Cooper holds that they are not exempt.

Cooper v. Union Bank

Bernice Ruff was employed as secretary and bookkeeper by Joseph Stell. Over a period of eighteen months, Miss Ruff appropriated twenty-nine checks intended for Stell either personally or in his business capacity, forged his indorsement on them, and cashed some of the checks either at Union Bank or at Crocker Citizens National Bank (depositary-collecting banks). She also cashed two of the checks directly at the payor bank, Crocker, which became a payor-depositary for those transactions. She deposited the rest to her personal account at Crocker and later withdrew the entire amount of these deposits before the forgeries were discovered. Some of the checks were forwarded to and paid by Crocker, Security First National Bank and First Western Bank and Trust Company (payor banks); others were paid by banks not parties to the action (also payor banks).

Stell and his partners brought an action in conversion against the depositary-collecting banks and payor banks, under the Uniform Commercial Code, section 3-419(1)(c). The trial court found that Stell

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41. Stell’s theory of recovery was this: the collecting banks converted the check by paying on a forged indorsement, under CAL. COMM. CODE § 3419(1)(c) (West 1964), and did not act in accordance with reasonable commercial standards, and could not therefore assert the “defense” of § 3419(3); or, alternatively, the payor banks converted the checks and were not shielded by § 3419(3), which is limited by its terms to “depositary and collecting banks.” See Brief for Appellant, Cooper v. Union Bank, 103 Cal. Rptr. 610 (1972), rev’d in part, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973) [hereinafter cited as Brief for Appellant].
was negligent in failing to discover Ruff's misdeeds after six months time and therefore was estopped from asserting these later forgeries against both the collecting and payor banks. (When Stell hired Ruff, he knew she was insolvent because of gambling losses. He subsequently did not adequately supervise her bookkeeping.) With regard to the forgeries which took place in the first six months, the trial court found that all the banks had acted in good faith and in accord with reasonable commercial standards, and were therefore shielded from liability under section 3-419(3) because they had remitted all the proceeds to Ruff. The payor banks were also extended the immunity because the court concluded they had also acted as representatives within the meaning of the statute. 42

In affirming the trial court's action, the court of appeals carefully reviewed the evidence which showed adherence to "reasonable commercial standards," and concluded that in every respect the banks had acted reasonably under the circumstances. 43 It then approved the use of the "defense" in section 3-419(3), absolving the banks from liability. The court did not question the existence of such a defense, nor did the plaintiff-appellant challenge this assumption in his argument, except in one short citation 44 to Ervin v. Dauphin Deposit Trust Co. 45 as maverick authority.

In reviewing the case, the California Supreme Court upheld the finding of negligence, denying recovery on all checks misappropriated after the six month period. 46 However, it allowed recovery from the depositary-collecting banks on the earlier checks by denying the availability of section 3-419(3) as a defense to the collecting banks with regard to the checks transferred to them for deposit as well as those cashed, since in both cases the bank had retained the proceeds. 47 The

42. This result, if affirmed, would have left the hapless true owner without any remedy against the banks whatsoever.

43. "The bank's duty is not an absolute one of discovering a forgery, it is a duty to take precautions which might disclose the forgery and which are reasonable under the circumstances." 103 Cal. Rptr. at 616.

44. Brief for Appellant, supra note 41, at 7.


46. 9 Cal. 3d at 383, 507 P.2d at 618, 107 Cal. Rptr. at 10. The court did not reach the question of the payor banks' liability, since the checks at issue in the action against the payor banks (as non-depository payors) had been forged after the six month period and Stell was therefore precluded by his negligence from asserting these forgeries under § 3406. Id. at 385, 507 P.2d at 620, 107 Cal. Rptr. at 10. Since the negligence defense of § 3406 is limited by its terms to payor banks, the court used the common law estoppel doctrine (see text accompanying note 18 supra) as applied through § 3404(1) (see note 5 supra) to allow the collecting banks the negligence defense.

47. The commentators are divided as to when the bank retains proceeds upon cashing a check. For example, Mr. Leary posits that when a bank cashes a check over the counter, it pays out its own money and collects the proceeds later; it there-
court reasoned on five grounds. (1) The collecting banks retained the proceeds of the forged checks, remitting instead their own funds to the transferor in cash or deposit credit. (2) A collecting bank does not act as a true agent throughout the ordinary bank collecting transaction, since its agency status ends on final settlement of the item, and it becomes a debtor of the transferor. Section 3-419(3) is addressed, not to this kind of transaction, but to the true agency situation. (3) Pre-Code law had held collecting banks liable to the true owner in similar fact situations. Since liability ultimately rests with the depositary-collecting bank under the warranty provision of the Code, the legislature could not have intended an “uneconomical circuit of action” contrary to the Code’s purpose to simplify the commercial law, and did not intend to deprive the true owner of his action directly against the collecting bank. The effect of such a defense would be to free the collecting bank of responsibility, requiring the true owner to bear the loss because of the expense in bringing multiple suits against payor banks, in situations like Cooper. The legislature could not have intended such an unjust result. (4) California comments to the Code indicate that section 3-419(3) is consistent with prior California law, and that no drastic change from the former strict liability was contemplated by the legislature. (5) Official Code comment indicates that the section was not intended to be applied to the ordinary bank collection transaction, but was designed to mitigate liability in conversion for brokers and agents who market negotiable instruments in good faith and remit the proceeds to their customers. The reasoning in Cooper may be summarized into three main lines: analysis of the term

fore always retains the proceeds of such checks and cannot assert the “defense” of section 3-419(3). Professor Farnsworth contends the “defense” is unavailable because the bank in cashing the check has purchased the instrument, and is therefore not a representative. ALI—ABA COURSE OF STUDY, supra note 1, at 56-57. Professors White and Summers argue that to the extent the bank pays cash to the forger it retains no proceeds. WHITE & SUMMERS, supra note 30, at 502. Cooper specifically rejects any distinction between checks cashed and checks deposited in ascertaining the liability of the collecting bank. 9 Cal. 3d at 380 n.12, 507 P.2d at 616 n.12, 107 Cal. Rptr. at 8 n.12.

48. UNIFORM COMMERCIAL CODE § 4-207, “Warranties of Customer and Collecting Bank on Transfer or Presentment of Items . . . .” Under these provisions the liability for wrongful payment will ultimately fall on the depositary-collecting bank in situations like Cooper, even if the bank is not sued directly by the true owner in conversion. Under the warranty provision, a collecting bank warrants the validity of a prior indorsement upon transferring the check to the payor bank, and is liable to the payor bank for breach of this warranty if the prior indorsement is shown to be forged. If the true owner sues the payor bank under § 3-419(1)(c) in conversion, the payor bank will in turn sue the collecting bank under § 4-207 for breach of warranty, and the depositary-collecting bank will ultimately bear the loss, if the warranty claims are made in a timely manner (§ 4-207(4) ) (assuming, of course, the forger cannot be reached).
“proceeds,” analysis of the relationship of the collecting bank to the transferor, whether agent or debtor, and inquiry into legislative intent.

Proceeds

The term “proceeds” is not defined either generally in Article 1 of the Uniform Commercial Code, nor in the context of commercial paper and banking transactions (Articles 3 and 4). “Proceeds” is defined, however, in terms of security interests in personalty in Article 9. Article 3 incorporates certain definitions from Article 4 into its definitions, as well as all the Article 1 definitions (which are of general applicability throughout the Code), but it does not include the Article 9 definition of proceeds. To be consistent with the definitional scheme, the definition in section 9-306(1) should not be applied in the context of commercial paper and the court has not done so. Still, this definition does indicate that at least in terms of secured transactions under the Code, “proceeds” covers a broad spectrum and tends to include any equivalent amount of personalty received by a party to a transaction in exchange for other personalty. The definition in Black's Law Dictionary includes the general phrase “value of property sold or converted into money or other property.”

Cooper arrives at a much narrower definition, in the context of liability for forged indorsements. The court takes as its premise the pre-Code bank collection theory that the proceeds of a check are only those funds which are paid out of a drawer's account in accord with his directions. It then applies this theory to the Code scheme for collection of order paper, in the following way: a check drawn payable to "bearer" or to "cash" needs no indorsement, and is negotiated by delivery alone. A check drawn to "the order of" requires both delivery and an indorsement by the payee for negotiation in compliance


"'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds. Insurance payable by reason of loss or damage to the collateral is proceeds, except to the extent that it is payable to a person other than a party to the security agreement. Money, checks, deposit accounts, and the like are 'cash proceeds.' All other proceeds are 'non-cash proceeds.'"


51. Black's Law Dictionary 1369 (rev. 4th ed. 1968) defines "proceeds" as "[i]ssues; income; yield; receipts; produce; money or articles or other thing of value arising or obtained by the sale of property; the sum, amount, or value of property sold or converted into money or into other property."

52. 9 Cal. 3d at 376-77, 507 P.2d at 613, 107 Cal. Rptr. at 5.

53. Uniform Commercial Code § 1-201(5): "'Bearer' means the person in possession of an instrument, document of title, or security payable to bearer or indorsed in blank."

54. Id. § 3-202(1).

55. Id.
with the directions of the drawer. If the drawee bank pays an order check on a forged indorsement, it has not followed the instructions of the drawer, and may not charge the drawer's account for the amount.\(^\text{56}\) It remits its own funds, and the proceeds stay in the drawer's account. The liability of a collecting bank for conversion of the proceeds arises, according to the common law, when the true owner brings an action against it. This action is deemed to be a ratification by the true owner of the collection, and the payor-drawee may then charge the drawer's account; the collecting bank, however, retains the proceeds, having remitted its own funds to the forger, for the true owner has not ratified the payment to the forger. Since the collecting bank retains the proceeds, it cannot assert the "defense" of section 3-419(3).

**Circularity of the "Proceeds" Argument**

The court's attempt to define section 3-419(3) "proceeds" in terms of the common law ratification theory in order to resolve the issue of a collecting bank's liability is, unfortunately, an exercise in circular reasoning. This, in itself, does not condemn the decision, but it does force one to look more closely at the opinion to see what the court is really attempting to say. The circularity of the proceeds argument will be examined in order to assess the effects of this faulty reasoning on the holding as a whole.

Consider what happens to the proceeds chronologically, according to the ratification theory, from the time the forger transfers the check to the depositary for deposit to his account. **Phase I.** The depositary gives the forger's account a provisional credit for the amount and presents the check to the drawee for payment. The drawee-payor debits the account of the drawer and forwards the amount of the check to the depositary bank (clearing house credits are used in most transactions). At this time of final settlement, the depositor firms up the credit given to the forger, and becomes the debtor of the forger for the amount, free to use the amount collected as its own. At this point, however, the "proceeds" have never really left the drawer's account, since the drawee has paid the wrong person. **Phase II.** The forger withdraws his deposit accounts and leaves town. The true owner discovers the forgery and sues the depositary bank. At this point, according to the ratification theory, what the depositary bank received is now the proceeds, which it holds for the true owner. But why are the proceeds now held in a discrete quantity for the true owner, instead of being mingled with the depositary's other funds, as they were before the forgery was discovered? The court answers this query by the constructive trust theory which allows the tracing of mingled funds.\(^\text{57}\)

\(^{56}\) Id. § 4-401.

\(^{57}\) 9 Cal. 3d at 379, 507 P.2d at 615, 107 Cal. Rptr. at 7-8.
This is tantamount to saying that the collecting bank always retains the proceeds because the court will impose a constructive trust on its assets in the amount of the original proceeds of the check, and will then call this amount the proceeds.

The only way to understand the proceeds argument is to see it as an attempt to interpret section 3-419(3) in light of the fiction of constructive ratification of the collection of the proceeds. Since the ratification theory always places the common law liability on the collecting bank, it is fundamentally irreconcilable with the majority interpretation of the section, and any analysis of "proceeds" in terms of ratification will always impose liability on the collecting bank, absent negligence on the part of the true owner. The proceeds argument is therefore circular, because its premise is its conclusion. The entire proceeds analysis can be reduced to the following summary:

1. Is the collecting bank liable under section 3-419?
2. Yes, but only if it retains the proceeds of the check.
3. What are proceeds?
4. Proceeds, according to the common law, are funds constructively retained by a collecting bank when it remits on a forged indorsement and is sued by the true owner.
5. Since this bank remitted funds on a forged indorsement, and was sued by the true owner, it must have retained the proceeds.
6. Therefore the bank is liable.

Professor Julius Stone, in his construct of "legal categories of illusory reference," calls this type of reasoning "concealed circular reference," since "the vacuity is concealed by referring for the solution to a mere reformulation of the question itself." (The legal "category" in this instance is "proceeds.") In assessing the implications of discovering such an argument in a case, Professor Stone acknowledges that the circular category "is strictly incapable of yielding any result," yet he shows how to profit from the discovery:

In all such cases the present submission is not that the court's decision is meaningless or even unsound . . . [but] simply that if the legal category is meaningless from which the courts purport to deduce their decision, the real ground of decision must be other than this.

The use of the common law definition of proceeds in Cooper to interpret section 3-419(3) is an example of the use of a legal category of "concealed circular reference." Considered alone, it cannot meaningfully support the court's holding. The failure of the proceeds

59. Id. at 258.
60. Id.
61. Id. at 246 (footnotes omitted).
argument points out the need to look elsewhere than the word "proceeds" for a satisfactory interpretation of the section. Fortunately, the court does not rely solely on a definition of proceeds for its holding. Its analysis of the relation of collecting banks to transferor and, more importantly, its inquiry into legislative intent, brief as it is, furnish solid grounds for the decision.

Agency Status of Collecting Bank Not Retained

The court in Cooper seeks support for the thesis that section 3-419(3) should not apply to a collecting bank in the ordinary check collection process in Jennings v. United States Fidelity & Guaranty Co. Here, Mr. Justice Cardozo discusses "proceeds" in terms of general collection theory and analyzes the rights that various parties may assert over funds in the chain of the collection process. Cooper cites Jennings only for the imprimatur it placed on the theory that in the ordinary check collection transaction, upon final settlement of an item, a collecting bank's agency status ends and it thereafter remits its own funds as debtor to its customer and not as agent, whether it pays out cash or credits the payee's deposit account.

While borrowing Justice Cardozo's summary of the relevant common law may lend some prestige to the court's argument, the same common law theory can be found embodied in the Code itself. Section 4-201, entitled "Presumption and Duration of Agency Status of Collecting Banks..." enacts the common law presumption that absent a clear, contrary intent the collecting bank is an agent of the owner of the item. The official comments indicate that this agency terminates upon final settlement of the item. (Cooper recognizes that this provision is in accord with Cardozo's view.) The comments show an acceptance by the Code of the principle that in a routine check collection transaction the collecting bank acts as debtor in remitting the amount of the check to its creditor-customer.

This additional analysis by the court is an attempt to show that section 3-419(3) should not be construed to exempt collecting banks

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63. 9 Cal. 3d at 378, 507 P.2d at 614, 107 Cal. Rptr. at 6.
64. UNIFORM COMMERCIAL CODE § 4-201(1).
65. Id. § 4-201, Comment 4. Settlement is final when the collecting bank receives final credit for the item from the payor bank. The California comment is even more direct. CAL. COMM. CODE § 4201, Comment 1 (West 1964): "The agency status terminates when settlement is final. At this point the bank becomes the customer's debtor." See also UNIFORM COMMERCIAL CODE § 4-213, Comment 9, for further discussion of the collecting bank's debtor status.
66. 9 Cal. 3d at 379, 507 P.2d at 615, 107 Cal. Rptr. at 7. Perhaps primary emphasis is placed on Jennings rather than on § 4-201(1) because the presumption in § 4-201(1) is not explicitly incorporated into the definitional scheme of Article 3. See text accompanying note 50 supra.
from liability in conversion in the ordinary check collection transaction, because these banks do not deal with the transferor as representatives, a basic prerequisite for exemption under the section.\footnote{67} The court has again turned to common law theory to explain "representative" as it did to define "proceeds." For this explanation of representative, however, there is ample corroboration in the Code to support the court's position.

**Legislative Intent**

The court's strongest, though briefest, argument is its analysis of the comments to section 3-419(3). A comparison of \textit{Cooper} with \textit{Ervin v. Dauphin Deposit Trust Co.},\footnote{68} which reaches the same result with a similar fact situation, shows that the California court relied more heavily on an analysis of "proceeds" and "representative" for its holding, with several buttressing arguments based on legislative intent, while \textit{Ervin} relied primarily on the legislative intent, and secondarily on a proceeds analysis. The reason for the different approach lies in the quality of legislative materials available to each court to aid it in construing the statute.

**California Comment**

The California legislature used peculiarly imprecise and inad-

\footnote{67} This argument is epitomized in the following language: "Unlike the ordinary bank collection transaction, in which the collecting bank and its customer have tacitly agreed a debtor-creditor relationship will emerge upon collection, the ordinary agency transaction gives rise to no such debt when the agent receives funds intended for the principal. Such funds, instead of being mingled, must be kept separate from the agent's own funds and identified as the property of the principal. Thus, when the true agent remits the amount of an instrument to his customer, the agent actually does part with the proceeds. It is to this kind of situation, rather than to the typical bank collection transaction, that section 3419, subdivision (3) appears to be addressed." 9 Cal. 3d at 382-83, 507 P.2d at 618, 107 Cal. Rptr. at 10.

\footnote{68} Ervin v. Dauphin Deposit Trust Co., 38 Pa. D. & C.2d 473 (C.P. Dauphin Co. 1965) reached essentially the same result in its view of "proceeds" as did \textit{Cooper}, but without the gloss of Supreme Court dictum to help define "representative." It is perhaps for this reason that Ervin has been so severely criticized, for example, in \textit{White & Summers, supra} note 30, at 505. In colorful language, the hornbook authors castigate the manner in which \textit{Ervin} interpreted § 3-419(3): "Perhaps those bankers whose hands were doubtless at work in the drafting of 3-419(3) got what they deserved. If the section be not dead it certainly is mortally wounded; one can only mourn that \textit{Dauphin Trust Co. [Ervin]} inflicted fatal wounds with such little grace. . . . Although we deplore that mentality which leads a court to think it is completely free to disregard legislative language, we appreciate the strength of the policy arguments against the restrictions that the bankers presumably wrote into 3-419(3) . . . . (emphasis added)." Professors White and Summers would presumably argue that \textit{Cooper} has delivered the coup de grace to § 3-419(3). They would presumably also deplore similar mentality in the California court.
equate wording in its comment to section 3-419(3), and refers to no case law. The comment in its entirely reads:

Subdivision (3) is new statutory law. Its basic premise that a person dealing in good faith with the property of another is not liable for conversion is consistent with prior California law on the tort of conversion.69 This would imply that "good faith" is the touchstone for general exemption from liability in conversion, which is an erroneous characterization of both California and general authority on conversion. The general rule in California is that the innocent agent is liable for conversion when he deals with goods for another, even though he acted in good faith.70 Although there are no cases on point in California, an exception to this rule is recognized elsewhere in the case of certain negotiable instruments when the agent who acts in good faith reliance upon the legitimacy of his principal's claim to the paper sells the instrument and remits the proceeds to his principal.71 Since the California comment is such an inaccurate and incomplete statement of prior common law,72 it is not a very good basis for divining the legislature's intent. The court seized on a very slim reed to support its position that section 3-419(3) be construed in accordance with prior common law on collecting bank liability in the phrase "consistent with prior California law on the tort of conversion."73 The California comment is much too vague to indicate legislative intent, however, and the court was compelled to turn to the drafters' intent as set forth in the official comments. It is evident that the analysis in Ervin pointed the direction.

69. CAL. COMM. CODE § 3419, Comment 5 (West 1964). Prior versions of this comment were even shorter. CAL. COMM'N ON UNIFORM STATE LAWS, CAL. ANNO. ON THE PROPOSED UNIFORM COMM. CODE 51 (1960), Comment to § 3419 (3), reads: "Subdivision (3) is new." Id. at 50 (1952 ed.) reads: "Subsection (3) is new law." An inspection of Sixth Progress Report to the Legislature by the Senate Fact Finding Committee on Judiciary (1959-1961), Part I, the Uniform Commercial Code, Report of Professors Harold Marsh Jr. and William D. Warren 436, 468 in 1 APPENDIX TO THE JOURNAL OF THE SENATE (1961) and California State Bar Committee on the Commercial Code, The Uniform Commercial Code, 37 CAL. ST. B.J. 119, 131-32 (1962) reveals no comment as to the effect on California law of § 3419(3). The four sources cited here comprise the total comment available in California legislative studies of the proposed § 3419(3).


71. See note 25 supra.

72. It is interesting to note that the 1952 recommended comments (see note 69 supra), which were co-authored by Professor Prosser, did not contain the second, inaccurate statement which appears in the present comment.

73. For a discussion of this argument, see text accompanying note 81 infra.
Official Comment

In *Ervin* the court had the aid of specific legislative comment.\(^7^4\) The section was to be interpreted in accord with a Pennsylvania case, *First National Bank v. Goldberg*,\(^7^5\) where no liability was imposed on an innocent broker who, in good faith, assisted in the sale of stolen negotiable bonds and later remitted all the proceeds to his principal. The *Ervin* court reasoned that section 3-419(3) should be applied only to a depositary or collecting bank which had acted in the capacity of an agent or broker, in accord with the legislative comment.

Although neither the California comments nor the official comments to section 3-419(3) cite specific broker-agent exemption cases, the state comments to the codes of Pennsylvania, Massachusetts,\(^7^6\) and New York\(^7^7\) include references to such cases\(^7^8\) within their respective jurisdictions. *Cooper* cites these cases as the "decisions" referred to in the official comment,\(^7^9\) thereby incorporating their holdings into the common law of California. Like the *Ervin* court, *Cooper* then interprets section 3-419(3) as extending protection to the collecting bank only when it acts as broker or true agent in accordance with the broker-agent cases.\(^8^0\)

In turning to the broker-agent cases the court was finally able to draw on solid case law to interpret 3-419(3). The most compelling legislative intent argument, however, which the court presents in support of its holding is its simple observation: "Had such substantial

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75. 340 Pa. 337, 17 A.2d 377 (1941). This is the common law exemption referred to in text accompanying notes 22-24 supra.
79. Uniform Commercial Code § 3-419, Comment 5 (emphasis added). "Subsection (3), which is new, 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. . . ."
and controversial deviation from prior law been intended, moreover, it could be expected that the official commentary to section 3-419 would have so stated and would have included extensive explanation of the reasons for the change. A brief look at the comment to subsection (1)(c) suggests the rationale for this statement. This comment states explicitly that section 3-419(1)(c) will reverse California law in providing the payee with an action directly against the payor bank in conversion. Surely, if 3-419(3) were intended to deprive the payee for all practical purposes of his direct action against the collecting bank, consistency would compel the legislature to so indicate. It is entirely possible that even if 3-419(3) had been designed by the drafters to relieve the collecting banks of liability, the legislature may not have realized the full significance of the language and did not intend the result the drafters had envisioned. When one considers the sheer bulk and complexity of the Uniform Commercial Code, which was enacted in toto, a lapse of this kind on the part of the legislature is entirely possible. The court has presented a convincing reading of the legislative comment as indicating that no drastic change in the law was intended.

Scope of the Exemption in California after Cooper

While Cooper may dispose of the question in California regarding collecting bank liability, it leaves unanswered an important question: if the exemption does not apply to collecting banks in the normal collection process, but does apply to “true agents remitting proceeds,” in what situation does a collecting or depositary bank act as a true agent? Moreover, in using the general term “instrument” instead of the more limited “bearer instrument” in its discussion of the exemption, has the court approved a wider reading of the broker exemption to include protection to agents who remit funds on forged indorsements?

The following hypothetical situation will illustrate the possible ramifications of such a position. An Attorney acts as renting agent for his client, Landlord. Attorney receives five rent checks, indorses them “Attorney, as agent for Landlord,” deposits the checks in a separate account (not his personal account) in Depositary Bank, and remits the rent proceeds to Landlord by one check drawn on the separate account. One of the five rent checks was a paycheck drawn on Drawee Bank, payable to the order of Mary Doe. The renter who remitted this check to the Attorney had stolen it from Mary Doe, forged her indorsement, and added the words “pay to the order of Attorney, as

81. 9 Cal. 3d at 382, 507 P.2d at 617, 107 Cal. Rptr. at 9-10.
83. The answer would be dictum, of course, since the question was not presented by the facts.
84. See note 67 supra.
agent for Landlord." Under dicta in Cooper, section 3-419(3) would exempt agent Attorney from liability in conversion to Mary Doe, since he has fulfilled the necessary conditions set forth in the section. (Under the Restatement illustration, Attorney would be liable to Mary Doe, since he cannot transfer title to Landlord.) Depositary Bank's liability would be in accordance with pre-Code law: when Mary Doe, payee-true owner, brings an action in conversion against Depositary Bank, Depositary is deemed to have collected the proceeds by the ratification doctrine, and to have remitted its own funds to Attorney agent. Depositary may debit Attorney's account for the amount of the bad check, or sue him on the warranty theory, and may or may not recover the amount, but Depositary is still liable to Mary Doe for the proceeds of her check, which Cooper says Depositary constructively retains. Depositary would be liable under the warranty theory to Drawee bank, absent ratification of the collection of the proceeds from Drawee which would occur when Mary Doe sues Depositary.

Conclusion

The decision in Cooper is not the product of a mentality that felt it was completely free to disregard the legislative language, as Professors Summers and White presumably would argue. It is, rather, a type of judicial law making entirely appropriate under the circumstances. The distinction made by J. Cohen between desirable and undesirable judicial "law-making" in his study of statutory interpretation illustrates this conclusion. Cooper presents the type of situation described in this summary by Julius Stone of Professor Cohen's distinction:

[A third type of situation exists] where there is neither clarity of language and purpose, nor a conscious delegation, but simple vagueness or ambiguity, or internal inconsistency of language, affecting the statutory words. In this, as distinct from the first two kinds, the judicial search is for legislative meaning, and thus for legislative policy. The judicial task in cases of this third kind is to mend the legislative expression so as to yield a solution that can reasonably be attributed to the legislature, whether by surface search of the syntax, by reading in the context of the whole statute, or by probing for a principle which the statute expresses, or for hints of the legislator's purpose, consciously or unconsciously held by him.

85. See text accompanying note 27 supra.
86. She may also sue the drawee-payor.
87. See note 48 supra.
88. See note 68 supra.
The internal inconsistencies in section 3-419(3), compounded by inaccurate and contradictory legislative comment, threw upon the court the burden of finding a reasonable solution. In the absence of any legislative indication that the section was designed to significantly rearrange the liabilities of the parties to a forged indorsement except the explicit change allowing the true owner an action directly against the payor, the court was compelled to construe the section in light of the common law, and to reaffirm the traditional liability of a collecting bank. The court achieved a reasonable solution in terms of fundamentally sound policy.

The result of this decision to the innocent true owner is to guarantee to him the pre-Code action against the collecting bank. Considered together with the new action against the payor granted by section 3-419(1)(c), the result is a broader remedy for the true owner than he had before the enactment of the Code. The true owner may sue either the depositary, an intermediary, or the payor, whichever is most convenient for him under the circumstances: he chooses the remedy which is the simplest for him. In the case of a single payor and multiple depositaries, it will be more convenient to sue the payor. In cases like Cooper where there are many payors and relatively few depositaries, the only plausible defendant for the true owner to sue is the depositary bank; this action is preserved. The leeway given the true owner is in accord with the common law principle of protecting the innocent true owner in such a situation at the expense of the depositary bank, which can insure against loss and spread the risk over all its customers.

The result to the depositary and collecting bank is to continue the settled commercial law in California. While there may be some policy justification in absolving an innocent nondepositary collecting bank from liability, to extend a blanket exemption to

91. The true owner must elect his remedy, of course, since it is clear that the proceeds follow the suit, under the ratification doctrine, and the proceeds cannot be in two or three places at once.

92. See Kessler, supra note 10, at 895.

93. While the situation may arise where the collecting bank will be simultaneously sued by the true owner in conversion and the payor bank for breach of warranty, double liability can be avoided by pleading one of the suits in bar to the other.

94. An interesting issue should be noted here. Does the holding in Cooper apply to intermediary-collecting banks as well as depositary-collecting banks, in view of the fact that no intermediary banks were involved in the litigation in Cooper? The court, of course, uses the generic term "collecting bank" in stating its holding. This term, as defined in the Code, includes both depositaries and intermediaries. And, of course, section 3-419(3) combines the two types of banks in its wording. It is submitted, however, that the answer to this question goes to the heart of the rationale of the case: liability for conversion is predicated on the fact of collecting and holding the proceeds—constructively or otherwise—and not on the fact of accepting a forged indorsement in the role of depositary. Since an intermediary can also collect and hold
all collecting banks, including depositaries, would drastically reduce the protection hitherto afforded the innocent payee, whose simplest remedy (and in many cases, only remedy) is against the depositary. The court has not been unduly harsh to the collecting or payor banks, however. The rigid common law rule of absolute liability has been gradually mitigated by recognizing the negligence of the true owner as an estoppel defense to the collecting and payor bank, and the success of this defense in Cooper, partially limiting the plaintiff's recovery, shows the court is willing to take a close look at the actions of the true owner.

The result to the "true" agent is not clear; dictum suggests that section 3-419 extends the broker exemption to all agents dealing with negotiable instruments, including depositary and collecting banks when they act as "true" agents. Whether this is sound policy is questioned. Since the original purpose of the broker exemption was to enhance marketability of negotiable securities, the extension of this exemption to situations where marketability is not needed seems unwise and threatens the special protection the common law has traditionally given to the true owner of an order instrument.

California's treatment of section 3-419 will undoubtedly be closely studied by courts in other jurisdictions. If reliance is placed by them on an examination of the term "proceeds" for a satisfactory result, however, these courts will be involving themselves in a fruitless struggle. The better approach is to examine the legislative intent; unless a clear intent appears to limit drastically the true owner's right of action against the collecting bank, the court should preserve this right in its interpretation of section 3-419(3).

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proceeds, under the common law ratification doctrine, it too must be liable under the holding in Cooper.

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