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# Commercial Paper - Conversion - A Collecting Bank May Limit Its Liability for Conversion When It Pays a Payable through Draft Containing a Missing Indorsement Pursuant to Subsection 4-207(4) of the Uniform Commercial Code

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# COMMERCIAL PAPER — CONVERSION — A COLLECTING BANK MAY LIMIT ITS LIABILITY FOR CONVERSION WHEN IT PAYS A PAYABLE THROUGH DRAFT CONTAINING A MISSING INDORSEMENT PURSUANT TO SUBSECTION 4-207(4) OF THE UNIFORM COMMERCIAL CODE

On May 20, 1982, Great American Insurance Companies (Great American) issued a "payable through draft"[1] to Welch Rathole Service (Welch) and Ford Motor Credit Company (Ford Credit) in settlement of an insurance claim.[2] Great American delivered the draft to Welch.[3] Welch indorsed and deposited the draft in its account at American State Bank without the indorsement of Ford Credit.[4] On May 27, 1982, American State Bank indorsed the draft and credited Welch's account for the amount of the draft.[5] American State Bank then forwarded the draft through banking channels to Great American.[6] On June 3, 1982, an employee of Great American reviewed and initialed the draft in accordance with its procedures for paying payable through drafts.[7] In December 1982, Great American was informed that Ford Credit had not been paid.[8] On March 30, 1983, Great

1. *See* U.C.C. § 3-120 (1978) [N.D. CENT. CODE § 41-03-20 (1983)]. The Uniform Commercial Code defines a payable through draft as follows: "An instrument which states that it is 'payable through' a bank or the like designates that bank as a collecting bank to make presentment but does not of itself authorize the bank to pay the instrument." *Id.*

2. Great Am. Ins. Co. v. American State Bank, 385 N.W.2d 460, 461 (N.D. 1986). Great American insured a truck owned by Welch and financed by Ford Credit. *Id.* The truck was involved in an accident and the insurance policy listed Welch and Ford Credit as loss payees for claims on the truck. *Id.*

3. *Id.* Great American issued a "payable through" draft to the order of Welch and Ford Credit in the amount of $13,000. *Id.* Ford Credit's interest in the draft was $9,712.08 and Welch's interest was $3,287.92. *Id.*

4. *Id.*

5. *Id.*

6. *Id.* American State Bank forwarded the draft to Great American's bank, Provident. *Id.* Provident then presented the draft to Great American for payment. *Id.*

7. *Id.* Both American State Bank and Great American failed to recognize that Ford Credit's indorsement was missing. *Id.*

8. *Id.* Great American took possession of the truck and sold it for salvage to George Franchuk. *Id.* Mr. Franchuk subsequently informed Great American that Ford Credit would not release its lien on the truck because it had not been paid. *Id.*

American paid Ford Credit $9,712.08 for a release and assignment of all of Ford Credit's interest and rights in the May 20th draft.[9]

Great American then commenced an action against American State Bank alleging that the bank had converted the May 20th draft.[10] The district court granted judgment against American State Bank.[11] On appeal to the North Dakota Supreme Court, American State Bank contended that its liability for conversion should be limited by subsection 4-207(4) of the Uniform Commerical Code.[12] Subsection 4-207(4) provides that, unless the claim is made within a reasonable time, liability will be discharged on the presentment warranties to the extent of any loss caused by a person's delay in asserting a claim for breach of presentment warranties.[13] The North Dakota Supreme Court *held* that, although Great American, as Ford Credit's assignee, brought an action for conversion and not one for breach of presentment warranties, assignment did not preclude American State from asserting that its

9. *Id.*

10. *Id.* In addition to its conversion claim Great American brought a claim for breach of presentment warranties pursuant to § 4-207 of the Uniform Commercial Code. *Id.* at 461-62; *see* U.C.C. § 4-207(1) (1978) [N.D. CENT. CODE § 41-04-17(1) (1983)]. Section 4-207(1) provides:

> Each Customer or collecting bank who obtains payment or acceptance of an item and each prior customer and collecting bank warrants to the payor bank or other payor who in good faith pays or accepts the item that
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> (a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title; and
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> (b) he has no knowledge that the signature of the maker or drawer is unauthorized, except that this warranty is not given by any customer or collecting bank that is a holder in due course and acts in good faith
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> (i) to a maker with respect to the maker's own signature; or
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> (ii) to a drawer with respect to the drawer's own signature, whether or not the drawer is also the drawee; or
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> (iii) to an acceptor of an item if the holder in due course took the item after the acceptance without knowledge that the drawer's signature was unauthorized; and
>
> (c) the item has not been materially altered, except that this warranty is not given by any customer or collecting bank that is a holder in due course and acts in good faith
>
> (i) to the maker of a note; or
>
> (ii) to the drawer of a draft whether or not the drawer is also the drawee; or
>
> (iii) to the acceptor of an item with respect to an alteration made prior to the acceptance if the holder in due course took the item after the acceptance, even though the acceptance provided "payable as originally drawn" or equivalent terms; or
>
> (iv) to the acceptor of an item with respect to an alteration made after the acceptance.

*Id.* Great American subsequently moved to dismiss its breach of warranty action before trial. *Great American*, 385 N.W. 2d at 462.

11. *Great American*, 385 N.W.2d at 462.

12. *Id.; see* U.C.C. § 4-207(4) (1978) [N.D. Cent. Code § 41-04-17(4) (1983)]. Subsection 4-207(4) provides: "Unless a claim for breach of warranty under this section is made within a reasonable time after the person claiming learns of the breach, the person liable is discharged to the extent of any loss caused by the delay in making claim." *Id.*

13. U.C.C. § 4-207(4) (1978) [N.D. CENT. CODE § 41-04- 17(4) (1983)].

liability was limited pursuant to subsection 4-207(4) of the Uniform Commercial Code.[14] Furthermore, the court *held* that for the purposes of a payable through draft with missing indorsements, the party claiming a breach of presentment warranties "learns of the breach" within the meaning of subsection 4-207(4) when it approves the draft for payment.[15] *Great American Ins. v. American State Bank*, 385 N.W.2d 460 (N.D. 1986).

Subsection 3-419(1) of the Uniform Commercial Code provides three instances in which a negotiable instrument can be converted.[16] Specifically, subsection 3-419(1)(c) provides that "an instrument is converted when . . . it is paid on a forged indorsement."[17] However, courts have not interpreted subsection 3-419(1) to be an exclusive statement of what actions constitute conversion.[18]

In *Humberto Decorators, Inc. v. Plaza National Bank*[19] a payee of a cashier's check sued a collecting bank for conversion when the collecting bank paid the check without the indorsement of the payee.[20] The court in *Humberto* stated that, although subsection 3-419(1) does not specifically provide that payment over a missing indorsement constitutes conversion, courts are free to supplement the Code with general principles of common law.[21] Therefore,

14. *Great American*, 385 N.W.2d at 462, 466.

15. *Id.* at 462; *see* U.C.C. § 4-207(4) (1978). For the text of § 4-207(4), see *supra* note 12.

16. *See* U.C.C. § 3-419(1) (1979) [N.D. CENT. CODE § 41-03-56(1) (1983)]. Subsection 3-419 (1) provides: "An instrument is converted when (a) a drawee to whom it is delivered for acceptance refuses to return it on demand; or (b) any person to whom it is delivered for payment refuses on demand either to pay or return it; or (c) it is paid on a forged indorsement." *Id.*

17. *See id.* § 3-419(1)(c).

18. *See* Commercial Credit Corp. v. University Nat'l Bank, 590 F.2d 849, 851-52 (10th Cir. 1979). In *Commercial Credit Corp.* the drawer of a draft brought a conversion action against a collecting bank. *Id.* at 850. The drawer claimed that the bank had converted the draft when it negotiated the draft to a third party after the drawer had stopped payment on the draft. *Id.* at 851. In its determination that the three types of conversion listed in § 3-419 were not exclusive, the court stated that a person converts a negotiable instrument when he or she unlawfully takes, detains, or refuses to surrender a negotiable instrument belonging to another. *Id.* at 852; *see* U.C.C. § 3-419(1) (1978) [N.D. CENT. CODE § 41-03-56(1) (1983)] (conversion of instrument). For the text of § 3-419(1), see *supra* note 16. The court's definition of conversion is analogous to the traditional definition of common-law conversion, which is the wrongful exercise of control over another's personal property. *See Commercial Credit Corp.*, 590 F.2d at 852; *see also In re* Quantum Dev. Corp., 397 F. Supp. 329, 337 (D.V.I. 1975) (Code's list of acts that constitute conversion is not exclusive and the general principles of law relating to the conversion of property remain in force), *aff'd*, 534 F.2d 532 (3d Cir. 1976), *cert. denied*, 429 U.S. 827 (1976); Aetna Cas. & Sur. Co. v. Hepler State Bank, 6 Kan. App. 2d 543, ____, 630 P.2d 721, 725 (1981) (the three listed types of conversion in § 3-419 are not intended to be exclusive); Continental Cas. Co. v. Huron Valley Nat'l Bank, 271 N.W.2d 218, 220 (Mich. 1978) (in forged indorsement cases, conversion has been defined as the wrongful act of dominion over another's property).

19. 180 N.J. Super. 170, 434 A.2d 618 (1981).

20. Humberto Decorators, Inc. v. Plaza Nat'l Bank, 180 N.J. Super. 170, ____, 434 A.2d 618, 618-19 (1981). Despite the fact that the payee only alleged negligence on the part of the collecting bank, the court determined that the collecting bank was liable for conversion. *Id.* at ____, 434 A.2d at 618-19.

21. *Id.* at ____, 434 A.2d at 619; *see* U.C.C. § 1-103 (1978) [N.D. CENT. CODE § 41-01-03 (1983)]. Section 1-103 provides: "Unless displaced by the particular provisions of this Act, the

because the court perceived no legal difference between payment of an instrument on a forged indorsement and payment on no indorsement, the bank was liable for conversion of the cashier's check.[22] The *Humberto* decision is just one example of broad judicial interpretation of subsection 3-419(1) of the Uniform Commercial Code.[23]

Subsection 3-419(3) of the Uniform Commercial Code, however, provides a collecting bank with a defense to an alleged conversion action involving negotiable instruments.[24] Subsection 3-419(3) provides that as long as a bank acts in good faith and in accordance with reasonable commercial standards, it will be liable for conversion to the owner of the instrument only to the extent that any of the proceeds are still in its possession.[25] Because of the variety of circumstances that may arise, courts have defined "reasonable commercial standards" in several different ways.[26]

In *Knesz v. Central Jersey Bank & Trust* [27] a payee of two drafts sued a depositary bank for conversion after the bank paid the drafts containing forged indorsements of the payee.[28] An attorney of the payee sold some of the payee's property and received the drafts, drawn to the order of the payee, in exchange for the property.[29]

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principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions." *Id.*

22. *Humberto,* 180 N.J. Super. at ____, 434 A.2d at 619.

23. *See id.* at ____, 434 A.2d at 619; *see also* Aetna Cas. & Sur. Co. v. Hepler State Bank, 6 Kan. App. 2d 543, ____, 630 P.2d 721, 725 (1981) (although the Uniform Commercial Code fails to expressly include unauthorized indorsements other than forgeries in § 3-419, courts may define conversion from the Code and by general principles of common law).

24. *See* U.C.C.§ 3-419(3) (1978) [N.D. CENT. CODE § 41-03-56(3) (1983)]. Subsection 3-419(3) provides:

> 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.

*Id.*

25. *Id.* For the text of § 3-419(3), see *supra* note 24.

26. *See, e.g.,* Tubin v. Rabin, 389 F. Supp. 787, 790 (N.D. Tex. 1974) (payment of cashier's check containing missing indorsement of copayee was not in accordance with reasonable commercial standards), *aff'd,* 533 F.2d 255 (5th Cir. 1976); Federal Deposit Ins. Corp. v. Marine Nat'l Bank, 431 F.2d 341 F.2d 341, 344 (5th Cir. 1970) (banks do not, as a matter of reasonable commercial practice, deal with instruments lacking the necessary indorsements); Barnett Bank v. Lipp, 364 So. 2d 28, 30 (1978) (blind reliance on the indorsement does not constitute action in accordance with the reasonable commercial standards of the industry).

27. 97 N.J. 1, 477 A.2d 806 (1984).

28. Knesz v. Central Jersey Bank & Trust, 97 N.J. 1, ____, 477 A.2d 806, 807-08 (1984).

29. *Id.* at ____, 477 A.2d at 807. Knesz, the payee of two drafts, hired an attorney to maintain and collect the rent from an apartment he owned. *Id.* at ____, 477 A.2d at 807. The attorney, Moringeillo, sold the apartment and received a number of drafts in exchange for payment. *Id.* at ____, 477 A.2d at 807.

The attorney subsequently forged the payee's indorsement on the drafts and negotiated them to a customer of the depositary bank.[30] The customer then indorsed the drafts and deposited them into his account at the depositary bank.[31] The depositary bank accepted and paid the drafts.[32]

The court in *Knesz* determined that the depositary bank acted in a commercially reasonable manner in paying the drafts because it did not deal with the forger, but with the bank's customer.[33] In addition, the restrictive indorsement was properly utilized and indorsed, and none of the indorsements were in any way irregular on their face.[34] Therefore, the court concluded that the depositary bank was entitled to a defense pursuant to subsection 3-419(3) and was not liable for conversion.[35]

In addition to a bank's "reasonable commercial standards" defense, the drawer of a check may be precluded from shifting the loss to collecting banks when the drawer is negligent pursuant to subsection 4-406(1) of the Uniform Commercial Code.[36] Subsection 4-406(1) requires a bank customer to inspect his or her bank statement and checks and to promptly notify the drawee bank of any unauthorized signatures or alterations.[37] Section 4-406 does not on its face impose a duty on the drawer to exercise reasonable

30. *Id.* at ____, 477 A.2d at 807.

31. *Id.* at ____, 477 A.2d at 807.

32. *Id.* at ____, 477 A.2d at 807.

33. *Id.* at ____, 477 A.2d at 809. The court stated that the depositary bank acted in a commercially reasonable manner when it accepted the drafts from the attorney, who was one of the bank's regular customers, even though the drafts contained forged indorsements. *Id.* at ____, 477 A.2d at 809. The drafts appeared as if they were properly indorsed by both the attorney and the law firm in which he worked. *Id.* at ____, 477 A.2d at 809. The court stated there were no irregularities in the drafts that were sufficient to raise any suspicion on the part of the bank. *Id.* at ____, 477 A.2d at 810.

34. *Id.* at ____, 477 A.2d at 809. The court determined that the indorsements indicated a proper chain of title because the forged drafts contained all the necessary indorsements. *Id.* at ____, 477 A.2d at 809.

35. *Id.* at ____, 477 A.2d at 810; *see* U.C.C. § 3-419(3)(1978) [N.D. CENT. CODE § 41-03-56(3) (1965)]. For the text of § 3-419(3), see *supra* note 24. Generally, courts have noted that, whether the collecting bank acted in a commercially reasonable manner in order to shift liability for the loss, is a question of fact to be decided by the jury. *See* Casarez v. Garcia, 99 N.M. 508, ____, 660 P.2d 598, 603 (Ct. App. 1983) (whether the bank acted in accordance with reasonable commercial standards in failing to check the validity of the indorsements presented a factual issue to be decided by the jury).

36. *See* U.C.C. § 4-406(1) (1978) [N.D. CENT. CODE § 41-04-33(1) (1983)]. Subsection 4-406(1) provides:

> When a bank sends to its customer a statement of account accompanied by items paid in good faith in support of the debit entries or holds the statement and items pursuant to a request for instructions of its customer or otherwise in a reasonable manner makes the statement and items available to the customer, the customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on an item and must notify the bank promptly after discovery thereof.

*Id.*

37. *Id.*

care in reporting a forged indorsement.[38] However, subsection 4-406(4) implies a duty of care by imposing a three year statute of limitations after which the drawer will be precluded from shifting the liability for a forged indorsement onto the drawee.[39]

If the drawer or drawee cannot be determined to be negligent in accordance with section 4-406 of the Uniform Commercial Code, the collecting bank may be able to preclude the drawee or depositary bank from shifting the loss onto the collecting bank pursuant to section 4-207 of the Code.[40] Section 4-207 defines the

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. 38. *See id. See generally* B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS, AND CREDIT CARDS, 6-78 (Rev. ed. 1981) (drawer not in a good position to recognize items with forged indorsements that, unlike the drawer's forged signature or material alteration, will reconcile with his records at the end of the month). *But cf.* U.C.C. § 4-406 official comment 6 (1978) (nothing in this section is intended to affect any decision holding that a customer who has notice of something wrong with an indorsement must exercise reasonable care to investigate and notify the bank).

39. U.C.C. § 4-406(4) (1978) [N.D. Cent. Code § 41-04-33(4) (1983)]. Subsection 4-406(4) provides:

> Without regard to care or lack of care of either the customer or the bank a customer who does not within one year from the time the statement and items are made available to the customer (subsection 1) discover and report his unauthorized signature or any alteration on the face or the back of the item or does not within three years from that time discover and report any unauthorized indorsement is precluded from asserting against the bank such unauthorized signature or indorsement or such alteration.

*Id.* Moreover, § 4-406(5) precludes the payor bank from asserting a claim against the collecting bank under certain circumstances. *See id.* § 4-406(5) [N.D. CENT. CODE § 41-04-33(5) (1983)]. Subsection 4-406(5) provides in relevant part:

> If under this section a payor bank has a valid defense against a claim of a customer upon or resulting from payment of an item and waives or fails upon request to assert the defense the bank may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim.

*Id.; see also* Abraham v. Moore & Schley, 18 U.C.C. Rep. 1023 (N.Y. Sup. Ct. 1976) (by alleging tardiness on the part of the drawer in discovering the forgery, the depositary bank set up a possible defense pursuant to § 4-406(5) of the Uniform Commercial Code and avoided summary judgment against itself). However, courts have interpreted § 4-406(5) to apply only to the defenses created in § 4-406 and not to defenses found in other provisions of the Code. *See, e.g.,* Girard Bank v. Mount Holly State Bank, 474 F. Supp. 1225, 1240 (D.N.J. 1979) (§ 4-406(5) refers to the defenses created by § 4-406 and not to the defense based on a customer's negligent drawing of a check created by § 3-406); *accord* Menthor v. Swiss Bank Corp., 549 F. Supp. 1125, 1130 (S.D.N.Y. 1982).

40. *See* U.C.C. § 4-207 (1978) [N.D. CENT. CODE § 41-04-17 (1983)]. Section 4-207 outlines the warranties that a customer or collecting bank makes during the transfer or presentment of items. *Id.* In addition, § 4-207 states the time period in which a warranty action must be commenced. *Id.* For the text of § 4-207(1), (4), see *supra* notes 10, 12. Subsections 4-207(2), (3) provide:

> (2) Each customer and collecting bank who transfers an item and receives a settlement or other consideration for it warrants to his transferee and to any subsequent collecting bank who takes the item in good faith that
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> (a) he has a good title to the item or is authorized to obtain payment or acceptance on behalf of one who has a good title and the transfer is otherwise rightful; and
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> (b) all signatures are genuine or authorized; and
>
> (c) the item has not been materially altered; and
>
> (d) no defense of any party is good against him; and

warranties that customers and banks make in the transfer or presentment of items.[41] Pursuant to subsection 4-207(1) a collecting bank warrants to the payor bank that the collecting bank has good title; that it has no knowledge of an unauthorized signature; and that the item has not been materially altered.[42] Furthermore, courts have stated that the warranty of good title in subsection 4-207(1) extends only to the genuineness of all the necessary indorsements.[43]

When an initial collecting bank receives a check with a forged indorsement and obtains payment from a subsequent collecting bank in the collection chain or the drawee bank, the initial collecting bank breaches its warranty of good title to the subsequent collecting bank and the drawee bank.[44] Consequently, any bank that appears later in the collection chain will recover the payment from the initial collecting bank and the initial collecting bank may then seek to recover from the forger.[45] If recovery from the forger is not possible, then the initial collecting bank must bear the loss.[46]

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(e) he has no knowledge of any insolvency proceeding instituted with respect to the maker or acceptor or the drawer of an unaccepted item.

In addition each customer and collecting bank so transferring an item and receiving a settlement or other consideration engages that upon dishonor and any necessary notice of dishonor and protest he will take up the item.

(3) The warranties and the engagement to honor set forth in the two preceding subsections arise notwithstanding the absence of indorsement or words of guaranty or warranty in the transfer or presentment and a collecting bank remains liable for their breach despite remittance to its transferor. Damages for breach of such warranties or engagement to honor shall not exceed the consideration received by the customer or collecting bank responsible plus finance charges and expenses related to the item, if any.

*Id.*

41. *Id.* § 4-207(2), (3).

42. *See id.* § 4-207(1) [N.D. CENT. CODE § 41-04-17(1) (1983)] (warranties of customer or collecting bank in transfer or presentment of items). For the text of § 4-207(1), see *supra* note 10.

43. *See, e.g.*, Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978). In *Sun 'n Sand* an employee of Sun 'n Sand deposited company checks into her personal account after altering the checks and forging the indorsement of the employer. *Id.* at 679, 582 P.2d at 926, 148 Cal. Rptr. at 335. The employer sued the depositary bank on the theory that the bank had breached its warranty of good title. *Id.* at 685, 582 P.2d at 929, 148 Cal. Rptr. at 338. After determining that the term "good title" referred only to the validity of all the necessary indorsements, the court stated that this limitation of the scope of the warranty of good title was derived from the official comments to be Uniform Commercial Code, the Uniform Negotiable Instruments Law, and the structure of the Code provisions distributing losses caused by forgeries. *Id.* at 685-86, 582 P.2d at 930, 148 Cal. Rptr. at 339; *see also* Federal Ins. Co. v. Groveland State Bank, 37 N.Y.2d 252, 261, 372 N.Y.S.2d 18, 23-24, 333 N.E.2d 334, 338 (1975) (warranty of good title intended to permit drawee to recover from the party presenting an instrument that has a forged indorsement); Aetna Life & Cas. Co. v. Hampton State Bank, 497 S.W.2d 80, 84-85 (Tex. Civ. App. 1973) (warranty of title is nothing more than an assurance that no one has better title to the check than the warrantor).

44. *See* U.C.C. § 4-207(1) (1978) [N.D. CENT. CODE § 41-04-17(1) (1983)] (warranties of customer or collecting bank in the transfer or presentment of items); *see also* 7 R. ANDERSON, UNIFORM COMMERCIAL CODE, § 4-207:15, at 40 (3d ed. 1985) (collecting bank that obtains payment from drawee bank on check containing forged indorsement is liable to drawee bank for breach of warranty of good title).

45. 7 R. ANDERSON, *supra* note 44, at 40. Anderson notes that the Uniform Commercial Code contemplates that the drawee bank will recover the payment from the collecting bank on the theory that the collecting bank breached its warranty of good title. *Id.*

46. *See* Stapelton v. First Sec. Bank, 675 P.2d 83 (Mont. 1983). In *Stapelton* a husband forged the indorsement of his wife on two checks that were payable to them as copayees and deposited the

In *Federal Deposit Insurance Corp. v. Marine National Bank*[47] a bankruptcy trustee for one of two joint payees sued a depositary bank and two collecting banks for conversion when the banks paid a joint payee draft over the missing indorsement of one of the joint payees.[48] One of the collecting banks, which took the draft from the depositary bank and was second in the collection chain, moved for dismissal based on the warranty provisions of section 4-207.[49] The court granted the motion after determining that the first bank that takes the item for collection or deposit is primarily responsible for checking the indorsements to make sure that they are proper.[50] Moreover, the court noted that the policy behind the Uniform Commercial Code warranty provisions is to speed up the collection process and to remove the burden from every bank in the collection chain to meticulously check the indorsements of each item transferred.[51] Consequently, the court stated that, in order to satisfy its presentment warranty obligations, the first bank taking an item for collection is primarily responsible for obtaining the necessary indorsements.[52]

A collecting bank's liability for breach of presentment warranties pursuant to subsection 4-207(1) of the Uniform Commercial Code may also be limited by the express provisions of

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checks into his personal account. *Id.* at 85. The wife sued the depositary-collecting bank for breach of the Code warranty provisions. *Id.* at 86; *see* U.C.C. § 4-207 (1978) [N.D. CENT. CODE § 41-04-17 (1983)]. After summarizing a collecting bank's warranty liability under Montana state law, the court stated that the objective of the Uniform Commercial Code is to place the loss on the wrongdoer or, because the wrongdoer is usually unavailable or unable to pay, upon the party who last dealt with the wrongdoer. *Stapelton,* 675 P.2d at 86. The court reasoned that this party is best able to prevent the conversion by carefully checking indorsements when the forger presents the check. *Id.; see also* Bank of the West v. Wes-Con Dev. Co., 15 Wash. App. 238, 241-42, 548 P.2d 563, 566 (1976) (if recovery from the forger is precluded by the forger's unavailability or insolvency, the party dealing with the forger must bear the loss).

47. 303 F. Supp. 401 (M.D. Fla. 1969), *aff'd,* 431 F.2d 341 (5th Cir. 1970).

48. Federal Deposit Ins. Corp. v. Marine Nat'l Bank, 303 F. Supp. 401, 402 (M.D. Fla. 1969), *aff'd,* 431 F.2d 341, 343 (5th Cir. 1970). In *Federal Deposit* a debtor's surety issued a joint payee draft to two creditors, Southern Steel and Central National Bank, in payment of the debtor's obligation to them. 303 F. Supp. at 402. Central deposited the draft into its account at Marine National Bank without the indorsement of Southern Steel. *Id.* Marine National Bank, without noticing the missing indorsement, accepted and forwarded the draft to the drawee bank, Atlantic, who also accepted the draft containing a missing indorsement. *Id.*

49. *Federal Deposit,* 303 F. Supp. at 402. Atlantic Bank filed a motion to dismiss the trustee's claim against it based on the warranty of good title provisions of 4-207(2). *Id.; see* U.C.C. § 4-207(2) (1978) [N.D. CENT. CODE § 41-04-17(2) (1983)]. For the text of 4-207(2), see *supra* note 40.

50. *Federal Deposit,* 303 F. Supp. at 403. The court stated it placed the burden to check for the necessary indorsements on the first bank that accepted the draft, because the first bank is in a better position to insure that the transferor has good title than are subsequent banks in the collection chain. *Id.*

51. *Id.*

52. *Id.* The court in *Federal Deposit* stated that if the rationale of the warranty provisions is to facilitate the speedy transfer and collection of items, banks who subsequently take an item from a depositary bank are not negligent if they do not thoroughly inspect each item for missing indorsements. *Id.*

subsection 4-207(4).[53] Subsection 4-207(4) provides that a person must make a claim for a breach of warranty within a reasonable time after learning of the breach or the party liable will be discharged to the extent of any loss resulting from that person's delay.[54] However, courts have varied in their determination of what constitutes a reasonable period of time for a person to "learn of the breach" of presentment warranties.[55]

The North Dakota Supreme Court addressed the issue of what constitutes a reasonable time for a party claiming breach of presentment warranties to learn of a missing indorsement on a payable through draft in *Great American Insurance Co. v. American State Bank*.[56] Before reaching this issue, however, the court first considered whether subsection 3-419(1) of the Uniform Commercial Code displaced common-law conversion in North Dakota.[57] Great American contended that American State Bank had converted a payable through draft when the bank paid the draft without a copayee's indorsement.[58] American State Bank argued that its failure to obtain a copayee's indorsement did not constitute conversion because section 3-419 referred only to a forged indorsement in defining conversion.[59] However, Great American contended that a collecting bank which pays a draft without the indorsement of a joint payee is liable for conversion under the common law and under the Code.[60] American State Bank then argued that section 3-419 displaced the common law for conversion of negotiable instruments in North Dakota.[61] Great American

53. *See* U.C.C. § 4-207(1) (1978) [N.D. CENT. CODE § 41-04-17(1) (1983)] (warranties customers and collecting banks make in the transfer and presentment of items); *id.* § 4-207(4) (1978) [N.D. CENT. CODE § 41-04-17(4) (1983)] (person must bring warranty cause of action within reasonable amount of time). For the text of § 4-207(1),(4), see *supra* notes 10, 12.

54. *See id.* § 4-207(4).

55. *See, e.g.*, Home Indem. Co. v. First Nat'l Bank, 659 F.2d 796, 799 (7th Cir. 1981) (after finding a number of instances of the payor's dilatory behavior, the court determined that a delay of 18 days by the payor was unreasonable when the depositary bank could have avoided the loss had it been informed of the forgery); Phoenix Assurance Co. v. Davis, 126 N.J. Super. 379, ____, 314 A.2d 615, 622 (1974) (a 10 week delay after a party learned of the breach was unreasonable even though certain records had been lost due to mergers and relocation of offices); First Fed. Sav. & Loan Ass'n v. Branch Banking & Trust Co., 282 N.C. 44, ____, 191 S.E.2d 683, 692 (1972) (a reasonable time for notification depends upon the circumstances of each case).

56. 385 N.W.2d 460, 464 (N.D. 1986).

57. Great Am. Ins. v. American State Bank, 385 N.W. 2d 460, 462 (N.D. 1986); *see* U.C.C. § 3- 419(1) (1978) [N.D. CENT. CODE § 41-03-56(1) (1983)] (conversion of instrument). For the text of § 3-419(1), see *supra* note 16.

58. *Great American*, 385 N.W.2d at 462.

59. *Id.* American State Bank argued that because § 3-419(1) refers only to a forged indorsement and not to a missing indorsement, the latter does not constitute conversion under the Code. *Id.; see* U.C.C. § 3-419(1) (1978) [N.D. CENT. CODE § 41-03-56(1) (1983)] (conversion of instrument). For the text of § 3-419(1), see *supra* note 16.

60. *Great American*, 385 N.W.2d at 462.

61. *Id.; see* U.C.C. § 3-419(1) (1978) [N.D. CENT. CODE § 41-03-56(1)(1983)] (conversion of instrument). American State Bank contended that pursuant to § 1-01-06 of the North Dakota Century Code there is no common law in North Dakota when the law is declared by statute. *Great*

countered that section 3-419 did not displace common-law conversion, but instead supplemented it.[62] The court agreed with Great American and determined that the Uniform Commercial Code permitted the principles of equity and the common law to supplement the Code.[63] Therefore, a collecting bank could be liable for conversion pursuant to the common law and the Code.[64]

The second issue the court addressed was whether payment of a check over a missing indorsement constitutes conversion pursuant to the Code.[65] The court perceived no legal difference between payment on a forged indorsement and payment on no indorsement.[66] Moreover, the court stated that the payment of an instrument on a forged indorsement and payment on a missing indorsement both constitute common-law conversion.[67] Consequently, the court determined that a collecting bank may be liable for conversion of a payable through draft when it pays the draft over the missing indorsement of a copayee.[68]

The court recognized that a collecting bank may limit its liability pursuant to subsection 3-419(3) of the Uniform Commercial Code.[69] Subsection 3-419(3) limits a collecting bank's liability if the bank deals with the instrument according to reasonable commercial standards.[70] The court agreed, however, with the trial court's finding that American State Bank had not acted in accordance with reasonable commercial standards in

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*American*, 385 N.W.2d at 462; *see* N.D. CENT. CODE § 1-01-06 (1975). Section 1-01-06 provides: "In this state there is no common law in any case where the law is declared by the code." *Id.*

62. *Great American*, 385 N.W.2d at 462. Great American argued that the Uniform Commercial Code, rather than displacing the common law, was supplemented by it pursuant to § 1-103 of the Code. *Id.; see* U.C.C. § 1-103 (1978) [N.D. CENT. CODE § 41-01-03 (1983)] (general principles of law and equity supplement the Code); *id.* § 3-419 [N.D.CENT. CODE § 41-03-56 (1983)] (conversion of instrument). For the text of § 1-103, see *supra* note 21.

63. *Great American*, 385 N.W.2d at 462. The court determined that the particular language of § 1-103 of the Uniform Commercial Code controls the broad language of § 1-01-06 of the North Dakota Century Code. *Id. Compare* U.C.C. § 1-103 (1978) [N.D. CENT. CODE § 41-01-03 (1983)] (general principles of law and equity supplement the Code) *with* N.D. CENT. CODE § 1-01-06 (1975) (where the North Dakota Century Code declares the law it supplants the common law).

64. *Great American*, 385 N.W.2d at 462; *cf.* Willow City v. Vogel, Vogel, Bratner & Kelly, 268 N.D.2d 762, 766-67 (N.D. 1978) (Uniform Commercial Code is not a comprehensive codification and therefore the common law of assignment and debtor/creditor is still in effect in North Dakota).

65. *Great American*, 385 N.W.2d at 462.

66. *Id.* (quoting Humberto Decarators Inc. v. Plaza Nat'l Bank 180 N.J. Super. 170, ___ 434 A.2d 618, 619 (1981)). For a discussion of *Humberto* and the issue of whether a missing indorsement is analagous to a forged indorsement, see *supra* notes 19-22 and accompanying text.

67. *Great American*, 385 N.W.2d at 462. The court reasoned that payment on either a forged indorsement or on no indorsement constituted a wrongful exercise of dominion over another's property. *Id.*

68. *Id.*

69. *Id.* at 462-63; *see* U.C.C. § 3-419(3) (1978) [N.D. CENT. CODE § 41-03-56(3) (1983)] (reasonable commercial standards defense). For a discussion of § 3-419(3), see *supra* notes 23-35 and accompanying text.

70. *See* U.C.C. § 3-419(3) (1978) [N.D. CENT. CODE § 41-03-56(3) (1983)]. For the text of § 3-419(3), see *supra* note 24.

paying the draft over a missing indorsement.[71] Therefore, the court concluded that subsection 3-419(3) of the Uniform Commercial Code did not exonerate American State Bank.[72]

American State Bank also contended that its liability for conversion should be limited pursuant to subsection 4-207(4) of the Uniform Commercial Code.[73] Subsection 4-207(4) discharges a collecting bank's liability for breach of presentment warranties to the extent of any loss caused by a delay in making the claim.[74] The court recognized that if Ford Credit had proceeded directly against Great American for conversion, Great American could have sued American State Bank for breach of good title.[75] American State Bank could then have counterclaimed that its liability was discharged pursuant to subsection 4-207(4) of the Uniform Commercial Code to the extent of any loss caused by Great American's delay in bringing the claim.[76] Moreover, if Ford Credit had directly sued American State Bank for conversion and recovered the proceeds of the draft, the court believed that American State Bank would still have a valid claim pursuant to subsection 4-207(4) against Great American for its delay in learning of the forgery.[77] Therefore, although Great American, as Ford Credit's assignee, brought an action against American State Bank for conversion pursuant to subsection 3-419(1) and not an action for breach of good title pursuant to subsection 4-207(1), the court determined that the assignment did not preclude American State Bank from asserting that its liability could be limited by subsection 4-207(4) of the Uniform Commercial Code.[78]

71. *Great American,* 385 N.W.2d at 463. American State Bank accepted the joint payee payable through draft from Welch without the indorsement of Ford Credit. *Id.* at 461. An employee for American State Bank testified at trial that its acceptance of the draft without Ford Credit's indorsement was not in accordance with reasonable commercial standards in the industry. *Id.* at 463.

72. *Id.; see* U.C.C. § 3-419(3) (1978) [N.D. CENT. CODE § 41-03-56(3) (1983)] (reasonable commercial standards defense). American State Bank characterized its conduct in paying the draft over a missing indorsement as a "mistake," implying that this was a reasonable commercial standard. *Great American,* 385 N.W.2d at 463. However, the court, without any explanation, failed to see any validity in the bank's argument. *Id.*

73. *Great American,* 385 N.W.2d at 464; *see* U.C.C. § 4-207(4) (1978) [N.D. CENT. CODE § 41-04-17(4) (1983)] (person must bring warranty cause of action within reasonable amount of time). For a discussion of § 4-207(4), see *supra* notes 12, 53-55 and accompanying text.

74. *See* U.C.C. § 4-207(4) (1978) [N.D. CENT. CODE § 41-04-17(4) (1983)].

75. *Great American,* 385 N.W.2d at 464.

76. *Id.; see* U.C.C. § 4-207(4) (1978) [N.D. CENT CODE § 41-04-17(4) (1983)].

77. *Great American,* 385 N.W.2d at 464; *see* U.C.C. § 4-207(4) (1978) [N.D. CENT. CODE § 41-04-17(4) (1983)].

78. *Great American,* 385 N.W.2d at 464-65. The court cited *Sun n' Sand, Inc. v. United California Bank* as authority for its conclusion that a collecting bank may limit its liability for conversion pursuant to § 3-419(1) by the application of 4-207(4) of the Code. *Id.; see* Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 684, 582 P. 2d 920, 929, 148 Cal. Rptr. 329, 338 (1978) (a collecting bank and payee may assert the same defenses as are available to drawee banks in an action brought by a drawer against a drawee bank); U.C.C. § 3-419(1) (1978) [N.D. CENT. CODE § 41-03-56(1) (1983)] (conversion of instrument); *id.* § 4-207(4) [N.D. CENT. CODE § 41-04-17(4) (1983)] (person

Since American State Bank could use the "subsection 4-207(4) defense" to limit its liability for conversion, the court had to determine when Great American "learned of the breach" in order to determine whether any loss was caused by Great American's delay. [79] The court noted that this was a special case of a payable through draft in which Great American was both a drawer and drawee of the draft and a nonbank entity.[80] Moreover, the court noted that in the usual check collection case a drawee bank that pays an item over a missing indorsement is generally not obligated to discover that forgery.[81] Therefore, in the usual collection case between a drawer and drawee, the drawee bank does not "learn of the breach" when it pays a check over a missing indorsement.[82]

The drawer-customer, however, has certain responsibilities pursuant to subsection 4-406(1) of the Uniform Commercial Code to make reasonable inspections of its bank statements and canceled checks for unauthorized signatures, indorsements, and alterations.[83] Furthermore, the court in *Great American* noted that a drawer-drawee insurance company rather than the collecting bank is better able to detect a forged payee's signature on a payable through draft by comparing the signature on the draft with the insured's signature on the insurance application.[84]

Consequently, the North Dakota Supreme Court concluded that, since a drawer-customer usually has a duty to check his or her statement, and since Great American was both the drawer and drawee and in the best position to check for the missing indorsement, "logic and equity" commanded Great American to have learned of the breach when it paid the draft on June 3, 1982.[85]

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must bring warranty cause of action within a reasonable amount of time). For the text of § 3-419(1), see *supra* note 16. For the text of § 4-207(4), see *supra* note 12.

79. *Great American,* 385 N.W.2d at 465; *see* U.C.C. § 4-207(4) (1978) [N.D. CENT. CODE § 41-04-17(4) (1983)]. For the text of § 4-207(4), see *supra* note 12. American State Bank contended that the date when Great American's employee initialed the check, June 3, 1982, should be used as the date when Great American learned of the breach, because Welch's account at American State Bank had sufficient funds to cover the draft on this date. *Great American,* 385 N.W.2d at 465.

80. *Great American,* 385 N.W.2d at 465.

81. *Id.* For a discussion of the policy reasons why a drawee bank normally does not have the burden to check for missing or forged indorsements, see *supra* notes 42-52 and accompanying text.

82. *Id.*

83. *Id.; see* U.C.C. § 4-406(1) (1978) [N.D. CENT. CODE § 41-04-33(1) (1983)] (customer's duty to discover and report unauthorized signatures or alterations). For a discussion of § 4-406(1), see *supra* notes 36-38.

84. *Great American,* 385 N.W.2d at 465; *see also* Murray, *Drafts 'Payable Through' Banks,* 77 COM. L.J. 389, 390 (1972). Murray states that the historical reason why the collecting bank has the final responsibility for a forged indorsement is because it is in the best position to discover a forged payee's signature by requesting identification of the payee. *Id.* He adds, however, that if anyone is in a position to detect forgeries in the payees signature, it is the drawer-drawee insurance company, which is able to compare the payee-insured's signature on the draft with the insured's signature on insurance application forms, claim forms, and letters, before it approves the draft. *Id.*

85. *Great American,* 385 N.W.2d at 465-66.

Therefore, because the trial court had not determined what was a reasonable time for Great American to present the claim after it learned of the breach, the North Dakota Supreme Court remanded the case.[86]

In its decision in *Great American*, the North Dakota Supreme Court created an equitable remedy for collecting banks to raise in a conversion action.[87] The court allowed the estoppel defense of subsection 4-207(4) to be asserted in an action for conversion pursuant to subsection 3-419(1)(c) of the Uniform Commerical Code.[88]

Before *Great American*, a collecting bank was absolutely liable if it mistakenly paid a draft over a forged indorsement and in so doing was not in accordance with reasonable commercial standards.[89] A payor bank could sit on its laurels after it learned of the forgery and bring an action for conversion against the collecting bank at any time within the confines of the statute of limitations imposed by subsection 4-406(4) of the Code.[90] Furthermore, while the payor bank delayed in presenting its claim, the forger could withdraw the proceeds of the forged draft that were still in the possession of the collecting bank.[91] These funds would no longer be available to the collecting bank for it to offset against the loss when it subsequently learned of the forgery.[92] Accordingly, *Great American* seems to fill a void in the Code that had inflicted unjust hardships on collecting banks.

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86. *Id.* at 466.

87. *See id.* at 464-65.

88. *Id.; see* U.C.C. 4-207(4) (1978) [N.D. CENT. CODE § 41-04-17(4) (1983)] (person must bring warranty cause of action within reasonable amount of time); *id.* § 3-419(1)(c) [N.D. CENT. CODE § 41-03-56(1)(c) (1983)] (conversion of instrument). For the text of § 4-207(4), see *supra* note 12. For the text of § 3-419(1)(c), see *supra* note 16.

89. *See* National Sur. Corp. v. Citizens State Bank, 41 Colo. App. 580, 582, 593 P.2d 362, 364 (1978), *aff'd*, 199 Colo. 497, 612 P.2d 70 (1980). In *Citizens State Bank* a corporation alleged that a depositary bank converted several checks containing forged indorsements. *Id.* at 581, 593 P.2d at 363. An employee who had stolen the checks from the corporation presented them to the bank and the bank cashed them. *Id.* at 581, 593 P.2d at 363. The Colorado Court of Appeals stated that a claim for conversion is established when a depositary bank has paid a check on a forged indorsement. *Id.* at 582, 593 P.2d at 364. Furthermore, the court stated that it is incumbent on the depositary bank to plead and prove "good faith" and "commercial reasonableness" pursuant to § 3-419(3) of the Uniform Commercial Code as an affirmative defense to a conversion allegation under the Code. *Id.* at 582, 593 P.2d at 364; *see* U.C.C. § 3-419(3) (1978) [N.D. CENT. CODE § 41-03-56(3) (1983)] (reasonable commercial standards defense). For the text of § 3-419(3), see *supra* note 24.

90. *See* U.C.C. § 4-406(4) (1978) [N.D. CENT. CODE § 41-04-33(4) (1983)] (statute of limitations to discover and report unauthorized signatures and alterations). For the text of § 4-406(4), see *supra* note 39.

91. *See* U.C.C. § 4-207(4) (1978) [N.D. CENT. CODE § 41- 04-17(4) (1983)] (person must bring warranty cause of action within reasonable amount of time). For a discussion of § 4- 207(4), see *supra* notes 12, 53-55 and accompanying text.

92. *See id.*