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CERTIFIED CHECKS AND FUNDS REDIRECTION

RICHARD A. LORD†

I. Introduction

THE PRACTICE OF CERTIFYING CHECKS began over 150 years ago in England as a collection aid.¹ When an instrument was certified, or “marked,” it was given preference for payment over other checks of the drawer if presented the following day.² Although the certified check never became established in England,³ in the United States its function as a collection aid was expanded, and by 1860 it was held to be an unconditional promise by the certifying bank to pay on demand.⁴ The certified check represented a promise by the bank as well as by the drawer to pay the instrument and therefore was viewed as highly reliable commercial paper.⁵

The desirable stability created by this dual liability on the certified check has been duplicated today by other instruments, includ-

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2. Section 3-504(1) of the Uniform Commercial Code, U.C.C. § 3-504(1), defines presentment as “a demand for acceptance or payment made upon the maker, acceptor, drawee or other payor by or on behalf of the holder.” Id.
3. Steffen & Starr, supra note 1, at 463.
4. See id. at 463-64.
6. See generally Steffen & Starr, supra note 1, at 466-72. Section 3-411 of the Uniform Commercial Code, U.C.C. § 3-411, which continues the rule of the UNIFORM NEGOTIABLE INSTRUMENTS LAW §§ 187-188, provides that when the holder procures certification of the instrument “the drawer and all prior indorsers of the instrument are discharged.” U.C.C. § 3-411(1). Where certification is procured by a drawer, however, the drawer and the drawee remain liable. See id. § 3-411, Comment 1: H. BAILEY, THE LAW OF BANK CHECKS § 7.6, at 136 (4th ed. 1969).

The drawer remains liable when either a third party or the drawer himself seeks certification at the insistence of the holder or payee. Id. The benefit to subsequent takers is clear under this rule since the drawer, the indorsers, and the certifying bank are all available in the event of dishonor. Id. In the usual case where the drawer has the check certified and then delivers it to the payee, the paper carries the dual obligation of the drawer and the certifying bank. See id. See generally State Bank v. Mid-City Trust & Sav. Bank, 295 Ill. 599, 603-04, 129 N.E.2d 498, 499-500 (1950) (acceptance or certification by drawee bank of check presented by a forger was ineffective to change obligations of drawer and drawee bank); Randolph Nat'l Bank v. Hornblower, 160 Mass. 401, 401-02, 35 N.E. 850, 850-51 (1894) (failure of drawee bank, whose certification of a check was obtained by drawer, will not relieve drawer of its obligation to payee); Anglo-South Am. Bank v. National City Bank, 161 A.D. 268, 275-77, 146 N.Y.S. 457, 462-63 (1914), aff'd mem., 217 N.Y. 726, 112 N.E. 1053 (1916) (where certification was procured by an unlawful holder and check was paid over a forged indorsement, certifying bank was liable to drawer, but not to payee, who could still hold drawer liable on underlying contract).
ing the cashier's check,\textsuperscript{7} the bank draft,\textsuperscript{8} and the money order.\textsuperscript{9} The availability of these equally marketable instruments\textsuperscript{10} in combination

\begin{itemize}
  \item A cashier's check is an instrument "drawn by a bank upon itself, accepted in advance by the act of issuance." Ross v. Peck Iron & Metal Co., 264 F.2d 262, 269 (4th Cir. 1959). The instrument represents a promise by the bank to pay a primary obligation of the bank. Id. Under this interpretation, the bank occupies the position of both drawer and drawee. Id. Several courts have disagreed with the Fourth Circuit's analysis that a cashier's check is accepted by the bank upon issuance. See Banco Ganadero y Agricola, S.A. v. Society Nat'l Bank, 418 F. Supp. 520, 524 (N.D. Ohio 1976); Dziurak v. Chase Manhattan Bank, N.A., 85 Misc. 2d 641, 646-47, 386 N.Y.S.2d 496, 501-02 (Sup. Ct. 1976); H. \textsuperscript{11} Bailey, supra note 6, \textsection 1.6 at 10. Although the liability of the bank which draws the draft is fixed by its issuance, the liability of the bank on which the draft is drawn is determined by the bank's acceptance or payment. Kohler v. First Nat'l Bank, 157 Wash. 417, 422-23, 289 P. 47, 49 (1930). While ordinarily the liability of a bank draft will be singular rather than dual, since the correspondent drawee is like any other drawee, the fact that both the drawer and the drawee are banks lends great stability to the paper. For a discussion of bank drafts and cashier's checks, see Capital Nat'l Bank v. People's Bank & Trust Co., 166 Miss. 376, 382, 148 So. 386, 388 (1933); In re Bank of United States, 243 A.D. 287, 291, 277 N.Y.S. 96, 100 (1933); Anderton v. Shippee, 111 R.I. 2, 4 n.1, 298 A.2d 533, 534 n.1 (1973); H. \textsuperscript{11} Bailey, supra note 6, \textsection 1.6 at 10. See note 10 infra.
  \item A money order is a form of a tripartite credit instrument calling for the payment of money to the named payee. Bailey, \textit{Bank Personal Money Orders as Bank Obligations}, 81 \textit{Banking L.J.} 669, 670 (1964). The three parties are the payee, the drawee, and the remitter. \textit{Id.} A money order can be negotiable or nonnegotiable and may be issued by a governmental agency, a bank, a private person, or any other entity authorized to issue it. People v. Norwood, 26 Cal. App. 3d 148, 155-56, 103 Cal. Rptr. 7, 12 (1972); Hong Kong Importers, Inc. v. American Express Co., 301 So. 2d 707, 709 (La. Ct. App. 1974). Money orders issued by a bank may take one of two forms, either the so-called "bank money order" or the "personal money order." H. Bailey, supra note 6, \textsection 1.7, at 10-11. The primary distinction between these is that the personal money order, which closely resembles an ordinary check, is not signed by the issuer-bank, whereas the bank money order usually is signed. \textit{Id.} at 11. Some courts do not view the personal money order as the bank's obligation at the point of issuance, since it is not signed by the bank. See Garden Check Cashing Serv. Inc. v. First Nat'l Bank, 23 A.D. 2d 137, 140-41, 267 N.Y.S.2d 698, 701-02, \textit{aff'd mem.}, 18 N.Y.2d 941, 223 N.E.2d 566, 277 N.Y.S.2d 141 (1966). There is authority, however, to the contrary. See generally H. Bailey, supra note 6, \textsection 7.1, at 12: Bailey, supra, at 672-78. The bank money order, as the equivalent of the cashier's check, is clearly the issuing bank's obligation. See United States v. Milton, 382 F.2d 976, 978 (6th Cir. 1967), \textit{cert. denied}, 390 U.S. 952 (1968); First Nat'l Bank v. Farmers & Merchants State Bank, 417 S.W.2d 317, 323 (Tex. Ct. App. 1967): H. Bailey, supra note 6, \textsection 1.7, at 12. Therefore, the bank money order cannot theoretically be countermanded by the purchaser. See Bank of Niles v. American State Bank, 14 Ill. App. 3d 729, 733, 303 N.E.2d 186, 188 (1973). \textit{But see} Trouard v. First Nat'l Bank, 247 So. 2d 607, 610-11 (La. Ct. App. 1971). Both types of money orders give the holder security as "paid for" obligations, because they are purchased by the remitter and are not subject to problems of insufficient funds like ordinary checks. See Bailey, supra, at 671. Unlike the ordinary check and the certified check, the money order does not require that the purchaser have an account at the bank. See id. at 670-71. Money orders have thus been labeled "the poor man's checking account." \textit{Id.} at 671.
  \item See notes 7-9 supra. Although the instruments are equally marketable, they are not necessarily equally secure. A certified check allows the payee to rely upon the credit of both the bank and the drawer, whereas the bank money order gives recourse only against the issuer. See U.C.C. \textsection 3-411; H. Bailey, supra note 6, \textsection 1.7, at 12; \textit{id.}, \textsection 1.7, at 7 (Supp. 1975). The payee
with the problems encountered when certified checks are processed through an automated system has called into question the usefulness of certified checks. Nevertheless, statutes enacted when certified checks were more prominent instruments provide them with continued utility. Such statutes typically allowed or required the certified check to be substituted for cash in specified situations. Until of a bank draft has recourse only against the drawer bank until the draft is accepted by the drawee bank. See First Nat'l Bank v. Farmers State Bank, 120 Kan. 706, 709, 244 P. 1039, 1040 (1926); H. Bailey, supra note 6, § 1.6, at 7 (Supp. 1975). The cashier's check provides recourse only against one entity, the issuing bank. See State ex rel. Babcock v. Perkins, 165 Ohio St. 185, 187-88, 134 N.E.2d 839, 842 (1956); H. Bailey, supra note 6, § 1.6, at 7 (Supp. 1975). A cashier's check may generally be regarded as theoretically equivalent to a certified check in that neither can be countermanded, both circulate in the commercial world as primary obligations of the issuing bank, and both act as substitutes for the money represented. See id. at 6-8. The bank, however, in its dual role as drawee and drawer of the cashier's check, is the sole obligor for the amount of the check, as opposed to the certified check where both the drawee and the drawer are liable on the instrument. Id. at 7. Of course, this distinction is meaningless to the extent that the drawer-drawee bank is solvent. Unlike the certified check or cashier's check, where the instrument is accepted by the bank upon certification or issuance, the drawee bank of a bank draft is in the same position as with a check drawn by an individual. See Chetopa State Bank v. Farmers & Merchants State Bank, 114 Kan. 463, 467, 218 P. 1000, 1002 (1923). Until the instrument is accepted and paid by the drawee bank, the drawee owes no obligation or payment to the payee. See U.C.C. § 3-409; First Nat'l Bank v. Farmers State Bank, 120 Kan. at 709, 244 P. at 1040. The stability of the bank draft exists, therefore, not in the nature of the obligation on the instrument, but in the status of the drawer as a bank and not an individual. See generally H. Bailey, supra note 6, § 1.6, at 10. Particularly in this day of few bank insolvencies and Federal Deposit Insurance Corporation insurance, the bank generally is viewed as a better credit risk than an individual.

The security of the bank money order derives mainly from the same source as the bank draft—the secure nature of the issuer. See Bailey, supra note 9, at 671. The personal money order, however, if viewed as substantially the equivalent of the ordinary check and not as the bank's obligation, is secure only because it has been purchased and, unless countermanded, the funds are available to pay the instrument. See note 9 supra.

11. See H. Bailey, supra note 6, § 7.1, at 149-50. See also Bowie County v. Farmers' Guar. State Bank, 289 S.W. 451, 455 (Tex. Ct. App. 1926) (Hodges, J., dissenting). Where checks are handled electronically, certification causes complications. See Windsor, The Certified Check, A Special Handling Item in Automation, 81 Banking L.J. 480 (1964); Freed, Some Legal Implications of the Use of Computers in the Banking Business, 19 Bus. Law. 355, 362 (1964). A customer's account is generally charged when the check is certified, but the magnetic encoding (micro) on the check itself is not changed to show that the amount has been deducted from the account balance. Windsor, supra at 481. Since the electronic processor does not pick up this certification, the customer's account is recharged when the check is later presented for payment. Id. For proposed changes and possible alternatives, see id. at 483-88; Freed supra, at 362.


new legislation changes these provisions, the certified check remains both useful and necessary. Moreover, the litigation which occasionally arises demonstrates that the certified check is not yet an extinct type of commercial paper. This article explores some of the troublesome issues which surround certified checks and in particular addresses the question of the drawer’s ability to redirect the sum evidenced by the instrument to someone other than the named payee.

II. The Initial Problem

Consider what must be a daily occurrence throughout the United States: D, the drawer of a check made payable to payee (P), decides instead to use the funds represented thereby to pay alternative payee (AP). If the check has already been issued to P, D can order the drawee bank to stop payment as long as the check has not yet been presented to and acted upon by the drawee bank. While D remains liable to P on the underlying obligation for which the check was issued, the bank must obey the stop order, and D may use
the funds in his checking account to pay AP. D could also invoke a less formal means of countermand by merely requesting that P not present the check. That approach, however, has the potential drawback that P may refuse to accede to the request.

Less difficult, at least theoretically, is the situation where D has not delivered the check to P. In that case, it would appear that D remains the owner and controller of the instrument, at least absent

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20. This should be true notwithstanding loose language in cases like Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962), which dealt with the altogether different issue of whether a drawer may sue a collecting bank in conversion. Id. at 5, 184 N.E.2d at 361. Unfortunately, language appropriate in one context is likely to be misappropriated to another. The court suggested:

Here the plaintiff drawer of the checks, which were never delivered to the payee... had no valuable right to them. Since... it did not have the right of a payee or subsequent holder to present them to the drawee for payment, the value of its rights was limited to the physical paper on which they were written, and was not measured by their payable amounts.

Id. at 8, 184 N.E.2d at 362 (citations omitted) (emphasis added).

That statement is sound when the question is whether the drawer can sue a depositary bank in conversion for "cashing" a forged check. The drawer and the collecting bank have never dealt with each other and the drawer has rights against the drawee bank if it fails to detect the forger, subject to drawee defenses which might not operate in favor of the depositary. Moreover, the drawer's intent has been more frustrated by the forger than by the depositary bank. Since an "innocent" drawer ultimately will recover the improper payment from his bank, which may in turn recover from the depositary bank, it does not seem harsh to limit the drawer's rights against the depositary to the value of the paper representing his fund. This does not mean, however, that no valuable rights exist or that all attributes of ownership are curtailed. It may in fact be urged that although the drawer has no right to payment, other "valuable rights" are present. For example, the drawer retains both the right to stop payment on the checks by informing the drawee of the loss or theft and the right to sue the thief or even an innocent finder. Without quarreling with the result in Stone & Webster Eng'r Corp., one nevertheless may wince at its language, particularly since the Fifth Circuit relied on it to rebut an "ownership rights" argument of a drawer:

Although it is clear this case presents no prospect of a true payee raising a superior claim to payment of these checks, [appellant] Perini attempts somehow to raise such a claim in its own name, asserting conclusory that the checks belong to it.

Perini, however, has no claim to payment on the checks. The drawer of a valid order instrument cannot demand payment from the drawee... [citing Stone & Webster Eng'r Corp.] Similarly, one whose pre-printed checks are stolen owns the piece of paper, but the order of payment created by the thief who forges the drawer's signature does not run to the victim.

Perini Corp. v. First Nat'l Bank, 553 F.2d 398, 413 n.22 (5th Cir. 1977) (emphasis added). The point, of course, is that the drawer of an authorized check or the person whose name has been forged as drawer does indeed have ownership rights. As this article will develop, those rights may even include the right to receive payment from the drawee instead of the named payee under certain circumstances. The proposition advanced in both Stone & Webster Eng'r Corp. and Perini, highly appropriate for the achievement of the desired results in those cases, becomes at best too broad and at worst incorrect when uttered as a general rule.

The drawer in Perini sought to hold a depositary bank liable on improper indorsements. Id. at 408-16. The drawer argued that, although no payee existed to challenge an alleged improper payment, the drawer should nevertheless be able to challenge the improper indorsements on a theory of ownership rights. Id. at 413-14, 414 n.22. The court failed to give sufficient consideration to this challenge, but it correctly determined that in the particular case the ownership rights did not matter. Id. at 414.

The Stone & Webster Eng'r Corp. principle was also transformed by the court in Johnson v. State, 304 N.E.2d 555 (Ind. Ct. App. 1973), an appeal from a criminal theft conviction, id. at 556, into the following: "The landmark case interpreting this uniform code section [U.C.C.
If that is true, D can simply destroy or otherwise void the check as originally drawn and write a new check to AP. Since the act of drawing a check has no effect on the funds represented thereby, D has managed to "change" the payee, so that AP receives the funds represented by the check. Of course, D still remains liable to P for any unsatisfied obligation for which the original check was issued. The act of voiding the paper will cost D only the amount of money he pays for the check, not the dollar amount of the instrument.

Two other ways to manage the problem of redirection would be for D to add his own name or AP's name as an alternative payee, or to add words sufficient to make the instrument bearer paper. Either method would permit D to negotiate the check and redirect the funds to AP. These two alternatives have the advantage of saving the costs associated with the destruction of the check or the stoppage of payment and can also qualify AP for holder in due course status.

Still another legitimate, yet highly curious, method of redirection is for D to obliterate P's name from the check and insert AP's. If D is neat, AP and all subsequent takers could ostensibly take as holders in due course. Even if D makes an obvious change, so that AP and others cannot claim holder in due course status, D, as the person

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21. See note 20 supra. See also note 33 infra.
22. U.C.C. § 3-409(1). A check does not represent an assignment of any funds which the drawee has for its payment. Id.
23. See note 18 and accompanying text supra.
24. U.C.C. § 3-110 provides in part that an instrument may be payable to the order of "two or more payees together or in the alternative." Id. § 3-110(1)(d). Additionally, an instrument which is payable to two or more persons "in the alternative is payable to any one of them and may be negotiated, discharged or enforced by any of them who has possession of it." Id. § 3-116(a).
25. Inserting "or bearer" or similar words after P's name ought to be sufficient. See U.C.C. § 3-111. The Uniform Commercial Code (Code) defines the word bearer as "the person in possession of any instrument, document of title, or security payable to bearer or indorsed in blank." Id. § 1-201(5). The Code, however, places a limitation on bearer paper by providing that "[a]n instrument made payable both to order and to bearer is payable to order unless the bearer words are handwritten or typewritten." Id. § 3-110(3). See also id. § 3-110, Comment 6.
26. "Negotiation is the transfer of an instrument in such form that the transferee becomes a holder." Id. § 3-202(1).
27. If D names himself as alternative payee, negotiation would occur by his indorsing the check and delivering it to AP. See id. In the case of D adding bearer words, negotiation would occur solely by delivery to AP. See id.
28. See id. For the Uniform Commercial Code's definition of a holder in due course, see id. § 3-302. See note 29 infra.
29. A holder in due course must, among other things, take without notice of defenses against or claims to the instrument. U.C.C. § 3-302(1)(c). Such notice exists if "the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay . . . ." Id. § 3-304(1)(a). It should be noted that the key is not whether the instrument
making the change, should be precluded from asserting this as a defense against a drawee bank which subsequently honors the check. Since it is the drawer who redirects the funds, the check is properly payable although it does not appear so, and the drawee may recover the amount of the check from the drawer. The net effect is as if $D$ had destroyed the check and written a new one. No cases are to be found which deal with this method of redirection, indicating either that people do not ordinarily utilize it or that banks dishonor such checks upon presentment and private settlement occurs.

The final successful, but least acceptable, method of funds redirection shall be termed implied funds redirection. It assumes that $D$ could have redirected the funds by inserting his own name as alternative payee or by adding bearer words on the check, but did not. Rather, he merely indorsed the check in his own name, even though it was payable to the order of $P$. By doing so, $D$ has implied that he no longer wants the money represented thereby to go to $P$. It is unclear, however, to whom he intends the money to pass. If implied

has been altered, see id. § 3-407, or is irregular, but whether it looks as if it has been altered or is irregular. See notes 211-31 and accompanying text infra.

It may legitimately be asked whether notice of a defect should preclude holder in due course status if the alteration is in reality not a defect. For a discussion of this problem relative to overdue status, as opposed to notice of defenses, see Chafee, Rights in Overdue Paper, 31 HARV. L. REV. 1104, 1122 (1918).

30. This result would arise under common principles of estoppel. One might also argue that even if no taker could be a holder in due course, the instrument could nevertheless be enforced according to its original tenor under U.C.C. § 3-407(2)(b). See notes 198-200 and accompanying text infra.

31. What ought to be done in an ideal world will not always correspond with what is actually done. A drawee bank which takes an obviously altered check does so either in error or upon the presenter’s word. To create the fiction in either case that the check was properly payable because the drawer, and not someone else, altered it is to indulge in the worst kind of tautology. It is not too difficult to theorize as to the “right” result after the fact with the benefit of hindsight. It is another thing altogether to suggest to a bank that it should honor checks that do not look properly payable on the chance that they are because the alterations effectuate the drawer’s intent. In terms of planning, therefore, a bank probably should dishonor a check where the payee’s name has been obliterated. If that is not feasible without harming the bank-customer relationship, the bank should be prepared to bear any loss caused by honoring an improperly payable item. However, the mere fact that an error has been made or that the bank chose to believe the customer should not deprive the mistaken bank of all remedy. See text accompanying notes 267-69 infra.

32. If it is correct that the drawee bank which honors a check with $P$’s name obliterated and $AP$’s name inserted may recover from the drawer, quaere whether the drawer could bring an action against a bank which refuses to honor the check. See U.C.C. § 4-402; notes 245-66 and accompanying text infra.

Oral funds redirection may also be possible. For example, suppose Corporation A is headed by X who is also a director of Corporation B. Corporation B draws a check payable to Bank in payment of a debt to Bank. X then calls Bank and orally instruct it to change the payee to Corporation A. Bank applies the funds to Corporation A which later goes bankrupt. Corporation B then challenges payment on the ground that the funds reached the wrong payee. One must ask whether the oral redirection should be sufficient to change the payee. Corporation B may be estopped from challenging the redirection. Section 4-403(2) of the Uniform Commercial Code, id. § 4-403(2), gives a customer the right to countermand payment orally. Id. Whether the customer should also be able to redirect orally is debatable.
funds redirection is to be successful, one of two views must be accepted. Either the paper must be treated as bearer paper after the redirection-indorsement, which is probably the preferable view, or the redirection must be given effect only if D in fact delivers it to AP. The difficulty is that here, unlike in the prior illustrations, the intent of the drawer cannot be divined with any certainty from the instrument. The best advice to a bank is not to take such paper. If a bank does accept the check, it should be properly chargeable against D’s account because it represents D’s redirection.

The question of whether a drawee bank can charge its customer’s account is important not only in adjusting the rights of the drawer-drawee, but also those of the drawee vis-à-vis the collecting banks. If the drawer’s intent has been effectuated, the drawee should be able to charge the drawer’s account and all prior transferors will be discharged from any possible liability. This may not solve the problem of what to do when a collecting bank accepts a check which attempts funds redirection, and the drawee bank then refuses payment because the check “looks” bad. It could be argued that each collecting bank has recourse against its transferor and that this chain would eventually lead to the drawer, who could undo any harm. If the drawer alone is not capable of undoing the harm, however, the collecting banks will want to force the drawee to honor the check as drawn. The power of collecting banks to do this is discussed later in this article.

A second and more important problem for the purposes of this article is the effect of certification of the check on the ability of the drawer to redirect the funds. The type of redirection attempted

33. The anticipated problem is the loss or theft of the check after D’s indorsement and before delivery to AP. It could be argued that this possibility militates against allowing this method of funds redirection at all, but once the drawer has indorsed the check, the result is not much different from the all too common lost or stolen bearer paper dilemma. The risk of forgery remains on the drawee bank, while the risk of loss after indorsement remains on the loser of the check. For cases in which the payee lost an indorsed check, see American Book Co. v. White Sys. 223 Miss. 510, 78 So. 2d 582 (1955); Watkins v. Sheriff of Clark County, 85 Nev. 246, 453 P.2d 611 (1969); Unaka Nat’l Bank v. Butler, 113 Tenn. 574, 83 S.W. 655 (1904).

34. See U.C.C. § 4-401.

35. See id. §§ 3-601 to 3-606; H. Bailey, supra note 6, § 10.9, at 274-76.

36. Technically, this would not be a dishonor, unless funds redirection had been accomplished by the addition of drawer’s name or bearer words as payee. U.C.C. §§ 3-507, 4-401.

37. See id. § 4-207.

38. One reason for this inability would be the certification of the redirected check. It would not be feasible for a drawee bank which certified a redirected check at the request of the drawer to ask the drawer to reissue the check when the drawee bank later wants to revoke certification. This is particularly true where the revocation of certification will leave the collecting banks without hope of recovering their money.

39. See generally notes 159-81 and accompanying text infra.

40. See generally H. Bailey, supra note 6, § 7.6, at 154-57.
may determine whether redirection can occur. If the redirection is effected under circumstances which enable subsequent takers to be holders in due course, the drawee bank that certified the check would seem powerless to object to redirection, other than complaining to its customer, the drawer. If the redirection does not leave subsequent takers as potential holders in due course, the answer, largely based on policy grounds, is probably the same.

Before these problems can be developed and discussed, the rights and obligations of the drawee bank, the collecting banks, and the drawer with respect to certified checks must be discussed. An excellent vehicle for doing so is the recent New York case of Tonelli v. Chase Manhattan Bank.

III. THE TONELLI DECISION

In Tonelli, the plaintiff, a union pension fund, drew two $100,000 checks on its account with the Chase Manhattan Bank (Chase) payable to the order of Totowa Savings and Loan (Totowa) to be used for the purchase of two certificates of deposit. The checks were marked "CD" and entrusted to one Naiman, who was to deliver them to Totowa in exchange for the certificates. After having Chase certify the checks, Naiman met with Totowa's president and requested that two certificates be issued, one in the name of the pension fund and one in the name of Playmate Enterprise Products, Inc. (Playmate), which Naiman asserted was a subsidiary of the fund. Totowa's president denied the request, but suggested that the Playmate account could be opened if Naiman obtained a bank check or a cashier's check for $100,000 payable to Totowa. Naiman returned to Chase, purporting to be a representative of Totowa, and requested that the certified check be replaced with a cashier's check for

41. See U.C.C. §§ 3-302, 3-305; see notes 201-10 and accompanying text infra.
42. See notes 201-10 and accompanying text infra.
44. 86 Misc. 2d at 681, 386 N.Y.S.2d at 724.
45. 41 N.Y.2d at 668, 363 N.E.2d at 565, 394 N.Y.S.2d at 859.
46. 86 Misc. 2d at 682, 386 N.Y.S.2d at 724.
47. Id.
48. Id.
49. 41 N.Y.2d at 669, 363 N.E.2d at 566, 394 N.Y.S.2d at 859.
50. 86 Misc. 2d at 682, 386 N.Y.S.2d at 724. Totowa's president consulted with a subordinate who advised Naiman that the fund's certified check could not be used to open a Playmate account. Id.
51. Id. If Naiman had held himself out as a representative of the fund it would have been bound by his consent, given his apparent authority under principles of agency, to payment of the check without indorsement. See H. Bailey, supra note 6, § 5.15, at 102-04; id., § 15.15, at 501-07. See also First Nat'l Bank v. Nicholas & Barrera, 500 S.W.2d 906 (Tex. Ct. App. 1973).
the same amount naming Totowa as payee.\textsuperscript{52} Chase apparently thought that Naiman was acting on behalf of the payee, which had the right to request an exchange of the certified check for the cashier's check,\textsuperscript{53} or that the type of check issued was insignificant as long as the payee remained the same.\textsuperscript{54} The bank issued the cashier's check, noting on the certified check "not used for purpose intended."\textsuperscript{55} The certified check was exchanged by Chase even though it had not been indorsed by the payee, Totowa.\textsuperscript{56}

Naiman then returned to Totowa, delivered the cashier's check in exchange for a $100,000 certificate of deposit made payable to Playmate, borrowed $90,000 from Totowa using the Playmate account as collateral,\textsuperscript{57} and eventually defaulted on the loans.\textsuperscript{58} The fund later discovered that it had purchased only one certificate of deposit\textsuperscript{59} and brought suit against Chase, alleging that Chase had been negligent in exchanging the unindorsed certified check for the cashier's check.\textsuperscript{60} The fund's motion for summary judgment was granted by the trial court,\textsuperscript{61} affirmed by a split court at the intermediate level,\textsuperscript{62} and affirmed unanimously by the Court of Appeals of New York.\textsuperscript{63}

The central issue raised by this case is whether a drawee is negligent if it exchanges an unindorsed certified check for a cashier's check in the same amount made payable to the same payee.\textsuperscript{64} The three courts that heard the case had difficulty not only in articulating an answer, but also in formulating an underlying theory for it.

The \textit{Tonelli} trial court began its analysis by suggesting that Totowa would have been liable in conversion if it had allowed Naiman to use the fund's certified check to open the Playmate account and that Chase's exchange of checks without indorsement by the fund ac-

\begin{itemize}
  \item \textsuperscript{52} 86 Misc. 2d at 681, 386 N.Y.S.2d at 724.
  \item \textsuperscript{53} Since a cashier's check and a certified check are virtual equivalents, the requested exchange, more likely than not, would have been made. See note 7 supra.
  \item \textsuperscript{54} In terms of value, this would be true. See notes 7 & 10 supra. However, a certified check bearing the drawer fund's name would indicate that the fund was the issuer, thereby suggesting to a taker that a certificate of deposit purchased with the check should also be issued in the name of the fund. The cashier's check, on the other hand, would bear Chase's name as drawer, and could as easily have been remitted by Naiman individually as by the fund. The lack of identification of the drawer would theoretically make it easier for Naiman to defraud the fund. See note 66 infra.
  \item \textsuperscript{55} 86 Misc. 2d at 682, 386 N.Y.S.2d at 724.
  \item \textsuperscript{56} Id.
  \item \textsuperscript{57} Id. The president of Totowa made two loans of $80,000 and $10,000 to Playmate. Id.
  \item \textsuperscript{58} 41 N.Y.2d at 669, 363 N.E.2d at 566, 394 N.Y.S.2d at 859.
  \item \textsuperscript{59} 86 Misc. 2d at 682, 386 N.Y.S.2d at 724. The fund had actually paid $200,000 for one $100,000 certificate. Id.
  \item \textsuperscript{60} Id. at 683, 386 N.Y.S.2d at 724.
  \item \textsuperscript{61} Id. at 685, 386 N.Y.S.2d at 726.
  \item \textsuperscript{62} 53 A.D.2d at 184, 386 N.Y.S.2d at 425.
  \item \textsuperscript{63} 41 N.Y.2d at 673, 363 N.E.2d at 568, 394 N.Y.S.2d at 862.
  \item \textsuperscript{64} See 86 Misc. 2d at 683, 386 N.Y.S.2d at 725.
\end{itemize}
accomplished the same result.\textsuperscript{65} It is not altogether clear that a conversion would have occurred, and, even if it did occur, an innocent converter\textsuperscript{66} would be able to raise defenses against the drawer, including that of the drawer’s negligence in selecting a dishonest

\textsuperscript{65} Id. at 683, 386 N.Y.S.2d at 724-25.

\textsuperscript{66} Although it appears highly doubtful from the facts that Totowa was innocent, since both Naiman and Totowa’s president were indicted for conspiracy, it will be assumed that Totowa had no prior knowledge of Naiman’s scheme. Id. at 682, 386 N.Y.S.2d at 724. The question then becomes whether the transferee of a check loses its innocent status by taking a check which is then applied for the benefit of one other than the drawer. The general rule is that there is no presumption of lack of innocence based upon the application of a check. See Wysowatcky v. Denver-Willys, Inc., 131 Colo. 266, 269, 291 P.2d 165, 166 (1955); McConnico v. Third Nat’l Bank, 499 S.W.2d 874, 881-83 (Tenn. 1973); Schneider Fuel & Supply Co. v. West Allis State Bank, 70 Wis. 2d 1041, 1049-50, 236 N.W.2d 266, 270-71 (1975).

If there is no presumption against innocence, the next question is whether the application constitutes sufficient notice to preclude holder in due course status. It is one thing to say that no inference of \textit{mala fides} arises; it is quite another to say that a transferee can still be a holder in due course. U.C.C. § 3-304(2) is instructive: “The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.” Id. Section 3-304(4)(e) of the Code, U.C.C. § 3-304(4)(e), qualifies this somewhat by providing that knowledge that a person negotiating the instrument is or was a fiduciary does not of itself give the purchaser notice of a defense or claim. Id. It becomes apparent from these sections that the transferee must actually know that the transferor is a fiduciary and that he is negotiating the instrument in breach of his fiduciary duty. See id. § 3-304(4)(e). This should require more than a mere showing that a check was drawn by X but used for Y, although cases can be found which erroneously dilute the knowledge requirement. See \textit{e.g.}, Mott Grain Co. v. First Nat’l Bank & Trust Co., 259 N.W.2d 667, 671 (N.D. 1977); Jackson v. First Nat’l Bank, 55 Tenn. App. 545, 551-56, 403 S.W.2d 109, 112-15 (1966).


This inquiry requirement may be viewed in four ways. First, the duty to inquire may graft an additional step onto § 3-304(4)(e). Under this analysis, the purchaser, who has knowledge that the negotiating person is a fiduciary but fails to inquire into the use of the funds, is deemed to have knowledge under § 3-304(2). A second analysis which is perhaps more consistent with §§ 3-304(2) and 3-304(4)(e) interprets that payee’s failure to inquire as an absolute presumption of knowledge of fiduciary breach. Although this may comport well with 3-304, it is not consistent with § 1-201(25) of the Code, U.C.C. § 1-201(25), which defines knowledge as “actual knowledge.” Id. Under a third view, the receipt of the instrument without inquiry as to its use is considered an absolute bar to holder in due course status purely on policy grounds. Finally, the rule may be explained as an aberration unique to New York and Nebraska which does not affect holder in due course status, but merely blocks innocent converter status. For a “non-innocent” converter, holder in due course status may be unachievable according to dictum in Federal Ins. Co. v. Groveland State Bank, 44 A.D.2d 182, 354 N.Y.S.2d 220 (1974), that bona fide purchaser status is ineffective as a defense to failure to inquire. Id. at 188-89, 354 N.Y.S.2d at 227.

This deduction may not be totally accurate, however, for no New York case can be found which specifically addresses the problem. It is suggested that the better analysis is to suggest a two-tiered approach. One must first ask whether the taker is an innocent or a culpable converter. If culpable, the inquiry ends. If innocent, the question becomes whether he might nevertheless qualify as a holder in due course. The answer to that may consider the manner of
Moreover, a converter who qualifies as a holder in due course may take the check free of the drawer's defense of delivery for a special purpose. Had the trial court continued its conversion analysis, it might have found that, absent actual knowledge of the fraud, the drawer fund and not Totowa, the payee-converter, should bear the loss. The court would then have faced the issue of receipt so that one who takes under sufficiently unusual circumstances will be barred from holder in due course status. However, the inquiry allows the taker who has given value and taken in good faith to be accorded the respect traditionally reserved for good faith purchasers. See Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057 (1954).

This analysis shows that if Totowa had no knowledge of Naiman's intent, it was in the position of a New York innocent converter which must establish holder in due course status. Totowa should therefore neither lose its innocence nor risk its holder in due course status by taking the fund's check to open an account in the name of Playmate. Even if Totowa knew that Naiman was a fiduciary, it did not know that the delivery of the certified check was in violation of a fiduciary duty. It should be noted that § 3-304 may not even apply here since no negotiation has occurred. See Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 296 Minn. 130, 137, 207 N.W.2d 282, 287 (1973). Without a finding that Totowa was privy to Naiman's scheme, its taking of the fund's check and applying it to the Playmate account would not affect its holder in due course status.

A different result occurs in the second transaction, where Totowa lent money to Naiman using the Playmate account as collateral. See 86 Misc. 2d at 682, 386 N.Y.S.2d at 754. Since Naiman's debt was personal, Totowa had the requisite knowledge that he was violating his fiduciary duty, thus precluding holder in due course status as to the certificate. 67. The Court of Appeals in Tonelli pointed out that this defense was not available to Chase since the instrument could not be negotiated without the payee's indorsement, although it would be available to an innocent converter. 41 N.Y.2d at 671-72, 363 N.E.2d at 567-68, 394 N.Y.S.2d at 861-62.

68. See U.C.C. § 3-302(1)-(2). Totowa could not qualify as a holder in due course if it had actual knowledge of Naiman's fraud or attempted fraud. See id. § 3-302(1). The converter who does qualify as a holder in due course must demonstrate that it has not dealt with the drawer if it is to take the instrument free of the drawer's defenses. Id. § 3-305. Totowa would have little difficulty in showing that it had not dealt with the fund, given the intercession of Naiman. See Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 296 Minn. 130, 137, 207 N.W.2d 282 (1973). For a discussion of this case, see note 70 infra. See also E. Farnsworth & J. Honnold, Cases and Materials on Commercial Law 231 (2d ed. 1976), construing U.C.C. § 3-302, Comment 2 and id. § 3-305.

69. See U.C.C. § 3-305.

70. An Official Comment to U.C.C. § 3-302 gives the following illustration of when a payee is a holder in due course:

D draws a check payable to P and gives it to his agent to be delivered to P in payment of D's debt. The agent delivers it to P, who takes it in good faith and without notice in payment of the agent's debt to P. But as to this case see Section 3-304(2), which may apply.

Id., Comment 2. This example would be similar to Tonelli, if Totowa had acted innocently. Eldon's Super Fresh Stores, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 296 Minn. 130, 207 N.W.2d 282 (1973), discusses the application of U.C.C. § 3-304(2). 296 Minn. at 137-40, 207 N.W.2d at 287-89. The plaintiff drew a check for the purchase of stocks payable to the defendant brokerage firm and gave it to its own lawyer for delivery. Id. at 131-32, 207 N.W.2d at 284. The lawyer used the check to purchase securities for himself. Id. at 132, 207 N.W.2d at 285. After plaintiff had inquired of the brokerage firm about the stock certificate, it sued the defendant payee, seeking to be declared the owner of the stocks purchased with the check. Id. at 133, 207 N.W.2d at 285. The plaintiff claimed that defendant had notice of plaintiff's ownership, since the check was drawn by the plaintiff. Id. at 134, 207 N.W.2d at 285. The court first noted that § 3-304(2) or U.C.C. § 3-304(4)(e) might not apply because the check was
whether the drawee's conceded negligence shifted the loss to it, and it might well have concluded that the fund should bear the loss and that Chase, the drawee, was immune.

Instead, the trial court in Tonelli considered the result if Chase had refused to exchange the unindorsed certified check for its cashier's check and had insisted on Totowa's indorsement. The trial judge determined that an indorsement would have offered the fund protection. The Uniform Commercial Code (Code), however, would not yield the conclusion reached by the trial court judge.

not negotiated, and then suggested that the question was whether defendant had either actual knowledge of the drawer's claim or knowledge of facts from which the drawer's claim could be inferred. 296 Minn. at 134-35, 138, 207 N.W.2d at 286, 288. The court concluded that:

Merrill Lynch did not have "notice of any claim of the drawer, Eldon's, simply by virtue of its receipt of the check and confirmation notice from Drexler. The fact that Merrill Lynch was the named payee on the check drawn by Eldon's did not in and of itself constitute "notice" that Drexler was using the check improperly. Id. at 138-39, 207 N.W.2d at 288.

The court then held that:

Under the circumstances of this case, namely, where (1) a bank check was delivered to the payee by the drawer's agent with the drawer's consent and knowledge, (2) the check itself contained no restrictions or designations as to its use, and (3) the payee, a stock brokerage firm, had no trading account with, or indebtedness to, the drawer, we hold that the payee took the check without notice of the drawer's claims. Thus, the payee became a holder in due course of the instrument.

Id. at 140, 207 N.W.2d at 289. See also Breslin v. New Jersey Investors, Inc., 70 N.J. 466, 470-71, 361 A.2d 1, 3 (1976).


71. There would seem to be no basis for shifting the loss except on the policy ground that the drawee, as a bank, is better able to bear the loss. In fact, all relevant considerations would point to the conclusion that the loss should remain on the drawer. The court is justified in leaving equally innocent, or equally negligent, parties where it finds them. See Holly v. Missionary Soc'y, 180 U.S. 284, 295 (1901); Mattawan Mfg. Co. v. Chemical Bank & Trust Co., 244 A.D. 404, 410, 279 N.Y.S. 495, 502 (1935), modified on other grounds, 272 N.Y. 411, 3 N.E.2d 845 (1936); Roberts v. Sterr, 312 P.2d 449, 451 (Okla. 1957). Moreover, U.C.C. § 4-407 would seem to subrogate the payor bank, Chase, to the rights of the holder in due course if such a holder exists:

If a payor bank has paid an item . . . under circumstances giving a basis for objection by the drawer . . ., to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank shall be subrogated to the rights

(a) of any holder in due course on the item against the drawer . . .; and

(b) of the payee or any other holder of the item against the drawer . . .

Id. One must first ask whether the drawer would have a basis for objection, even though the check is improperly payable. See id. § 4-407, Comment 5. Assuming the drawer may object, the question is whether unjust enrichment or a loss will occur absent subrogation. Here, the bank will incur a loss if there is no subrogation. Unjust enrichment of the drawer will occur to the extent that one accepts the premise that it is equitable for the drawer to bear the loss as against the innocent payee-converter, for then it is unjust to allow the drawer to avoid the loss.

72. 86 Misc. 2d at 683, 386 N.Y.S.2d at 725.

73. Id. at 683-84, 386 N.Y.S.2d at 725.

74. See notes 75-97 and accompanying text infra.
If Chase had refused to accept the unindorsed certified check from Naiman, one of three things would likely have occurred. First, Naiman might have returned to Totowa and purchased a certificate of deposit in the name of the fund which he should have done initially. Second, he might have informed Totowa’s president that its indorsement was required. If Totowa refused to indorse the check, Naiman would have been in the same position as if he had never gone back to Totowa. If Totowa indorsed the check, it would have proven that Totowa had received the check, which might have aided the fund in a conversion action. Indorsement would also have enabled Chase to become a holder in due course of the check. The indorsed check would have been properly payable in any event, and Chase would therefore have had the right, under the Code, to charge the fund’s account. The fund’s only recourse would have been an action for conversion against Totowa and not against Chase.

The third and perhaps most likely course of action available to Naiman if Chase had refused to accept the unindorsed certified check would have been to forge Totowa’s indorsement. If Chase then honored the check, it would have been liable for paying over a forged indorsement. Chase also could have attempted to avail itself of traditional defenses against the drawer and the payee.

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75. See U.C.C. § 3-302(1). A holder in due course is one who takes the instrument for value, in good faith and “without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person.” Id. Totowa’s indorsement would have made negotiation of the check possible since an instrument which “is payable to order . . . is negotiated by delivery with any necessary indorsement.” Id. § 3-202. Value was given by Chase since it issued the cashier’s check. See 86 Misc. 2d at 682, 386 N.Y.S.2d at 724. See U.C.C. § 3-303(c). Moreover, Chase took the check in good faith. See id. § 1-201(19). Chase also took without notice. See id. § 3-304. An argument that Chase had notice because it refused the exchange after seeing the unindorsed check would be untenable since return for lack of indorsement is not dishonor for purposes of § 3-302(1). See id. § 3-507(3).

76. See U.C.C. § 4-401. This discussion assumes that the money represented by the certified check was still in the fund’s account. Ordinarily, the drawer’s account is debited upon certification, and a “certified check account” is credited. See 5B MICHIE ON BANKS & BANKING, § 256(b), at 21-22 (1973) [hereinafter cited as MICHIE]. An interesting question is whether that account constitutes a customer’s account, so that the check must in fact be “properly payable” under the provisions of U.C.C. § 4-401 before the certified check account can be charged. The court in Tonelli stated the facts so as to lead one to believe either that Chase had not charged the fund’s account at the time of certification or that if the account had been debited, it was recredited when the certified check was presented for exchange and then redebited on the issuance of the cashier’s check. See 86 Misc. 2d at 682, 386 N.Y.S.2d at 724. If the latter were the case, it would clearly have been improper for Chase to issue the cashier’s check, for it would then have been analogous to honoring the order of one not authorized to withdraw money from the fund’s checking account. Counsel for Chase indicate in their brief that a certified check account was used. Brief for Appellant at 4. Appreciation is due Andrew J. Connick, Esquire, of the firm of Milbank, Tweed, Hadley & McCloy for making a copy of their brief available.

77. See U.C.C. §§ 3-404, 4-401.

78. Chase would have been able to urge the substantial negligence of both the Fund and Totowa in giving Naiman the check. See id. § 3-406. Moreover, it could be argued that the
the drawee wins or loses in this context is of little import since the law of forged indorsements at least is firmly established. 79

Rather than stand on this firm ground, however, the Tonelli trial court focused on what would have happened if Chase had insisted on receiving Totowa's indorsement. 80 At that point, the court stated, proper presentment would have occurred and negotiation would have been possible. 81 The court then made the startling remark that "[u]nder those circumstances, a number of warranties would have arisen by operation of law in favor of Chase and, derivatively, in favor of the fund, Chase's depositor." 82 First, the court said, Totowa would have warranted that it had title. 83 Second, and more significantly, the court agreed that Totowa's indorsement would have resulted in a warranty under section 3-417(2)(d) of the Code 84 that no defense of any party is good against the warrantor. 85 The court indicated that these warranties would somehow have enabled the fund to claim more than negligence or conversion against Totowa. 86 Since Chase did not insist upon the indorsement, the court reasoned that it proximately caused the fund's loss. 87 Finally, and most remarkably, the court concluded:

Chase’s failure to avail itself of the safeguards and warranties which are specifically provided in the Uniform Commercial Code is the proximate cause of Totowa’s present ability to argue that it never received the proceeds of the Fund’s check. Had Chase obtained a proper indorsement, Totowa would have no such defense . . . and there would be clear evidence on the instrument itself that Totowa had, in fact, received the proceeds and benefits of the Fund’s check. In the present case, there was no such evidence and the lack of an indorsement, in and of itself, provides prima facie evidence that the proceeds of the check did not reach the intended payee. Chase had failed to present any evidence whatsoever to the contrary and, accordingly, was not entitled to pay the check out of the Fund’s account. 88

drawer and the payee should be precluded from complaining since the payee did receive the proceeds of the check. See text accompanying note 113 infra. This argument was raised in Tonelli and failed. 41 N.Y.2d at 671, 363 N.E.2d at 567, 394 N.Y.S.2d at 861. See also Hillsley v. State Bank, 24 A.D.2d 28, 263 N.Y.S.2d 578 (1965).

79. See U.C.C. § 3-404(1). See generally H. Bailey, supra note 6, § 15.7, at 470-74.
80. 86 Misc. 2d at 683-84, 386 N.Y.S.2d at 725-26.
81. Id. at 683, 386 N.Y.S.2d at 725. See U.C.C. § 3-302.
82. 86 Misc. 2d at 683, 386 N.Y.S.2d at 725.
83. Id. at 683-84, 386 N.Y.S.2d at 725.
84. U.C.C. § 3-417(2)(d). See note 91 infra.
85. 86 Misc. 2d at 684, 386 N.Y.S.2d at 725, construing U.C.C. § 3-417.
86. 86 Misc. 2d at 684, 386 N.Y.S.2d at 725.
87. Id.
88. Id. at 684-85, 386 N.Y.S.2d at 725-26 (citation omitted), citing U.C.C. § 3-417(2).
The court’s analysis of the scenario is disturbing. Although it is certain that Totowa, had it indorsed the certified check, would indeed have made certain warranties to Chase, it is far less certain that those warranties would have inured to the benefit of the drawer, the fund. Indeed, the warranties of sections 3-417 and 4-207, which are essentially the same in this instance, are specifically said to run to payors, acceptors, and subsequent transferees. These warranties run downstream only and do not run back upstream to the drawer. In addition, these warranties are for the protection of transferees and not of the payor bank. Indeed, one commentator has stated that “[a] payor bank cannot rely on the warranties embodied in 4-207(2) (or in 3-417(2)) because those warranties do not run to payors. Although one might argue that the word ‘transferee’... includes a payor bank... the Code draftsmen quite clearly did not intend the word ‘transferee’ to include a payor.”

Although the Tonelli trial court spoke of the warranty of good title in the hypothetical event of a genuine indorsement by Totowa, that warranty was not at issue in the case. Since both the good title and the 3-417(2) warranties were unavailable, it becomes clear that no warranties given would have been breached even if Totowa had indorsed the check. Even if the warranties in favor of Chase

89. U.C.C. § 3-417.
90. Id. § 4-207.
91. Id. §§ 3-417, 4-207. Section 3-417 details the warranties provided on presentment and transfer to a payor, acceptor, or transferee. Id. § 3-417. Section 4-207 specifies the warranties provided by a customer or collecting bank on the transfer or presentment of items. Id. § 4-207.
92. See id. §§ 3-417, 4-207. J. White & R. Summers, Uniform Commercial Code § 15-5, at 509-14 (1972). See also Nida v. Michael, 34 Mich. App. 290, 296, 191 N.W.2d 151, 155 (1971); Life Ins. Co. v. Snyder, 141 N.J. Super. 539, 542, 358 A.2d 859, 860-61 (1976). It is possible to adopt a third party beneficiary, assignment, or subrogation theory which would offer the fund the benefit of any warranty action the drawee might have. That possibility, however, might: 1) be unfair, for it would leave Totowa with the burden of proving the fund’s negligence; 2) be unnecessary, since the fund may already have an action against Totowa in tort; and 3) be unrealistic, since Totowa would have breached no warranty it made to Chase. See notes 82-91 and accompanying text supra; notes 93-97 and accompanying text infra.
94. 86 Misc. 2d at 684, 386 N.Y.S.2d at 725.
96. U.C.C. § 3-417(3).
97. If one accepts that § 3-417(2) warranties are unavailable, the possible warranty liabilities available to Chase are limited to good title, i.e., no forged indorsement, no knowledge of unauthorized drawer’s signature, and no material alterations. See id. § 4-207(1). The facts indicate that none of those warranties was breached.
somehow inured to the fund’s benefit, they would provide no assistance to the fund. Since the lack of warranties formed the basis for the trial court’s decision, that should have been sufficient to cause the appellate court to reverse.  

The opinion of the Appellate Division of the New York Supreme Court focused not on the warranty issue, however, but rather on the misapplication of the proceeds. The dissenting opinion, however, shifted the emphasis by suggesting that the real question was whether the purpose of the drawer had been effected, and, if not, whether the drawer or Chase was more at fault. Under that reasoning, the case assumed the character of a funds redirection problem and the question became whether the redirector had the power to redirect, even though he had no right to do so. Since the drawer’s expressed purpose was effectuated through the transaction, i.e., the intended payee received the funds, the drawer was not harmed by the exchange of certified check for cashier’s check. Any harm suffered did not result from Chase’s act or omission, but was attributable to Totowa’s negligence in accepting the cashier’s check knowing that it represented the exchanged certified check. According to the dissent, therefore, Chase ought to prevail and Hillsley v. State Bank, a case involving forged payee’s indorsement, was not appropriate. The majority disagreed, apparently adopting the lower court’s warranty theory, and proceeded to explain how Hillsley was analogous. Hillsley involved a check payable to Hillsley and Glennon as joint payees. Glennon forged Hillsley’s indorsement, exchanged the check for a cashier’s check payable to Hillsley, and delivered the check to Hillsley in partial satisfaction of a debt. When

98. The trial court noted that Chase’s failure to insist on indorsement and its accompanying warranties were “the proximate cause of Totowa’s present ability to argue that it never received the proceeds of the fund’s check.” 86 Misc. 2d at 684, 386 N.Y.S.2d at 725. This dictum was rendered irrelevant by the Court of Appeals, which assumed that Totowa did receive the proceeds and rested its decision on the “purpose of the drawer,” irrespective of whether Totowa received the actual cash. 41 N.Y.2d at 671, 363 N.E.2d at 567, 394 N.Y.S.2d at 861. See text accompanying note 88 supra.

100. Id. at 185-87, 386 N.Y.S.2d at 426-27 (Markewich, J., dissenting).
101. Id. at 186, 386 N.Y.S.2d at 427 (Markewich, J., dissenting).
102. Id. at 187, 386 N.Y.S.2d at 427 (Markewich, J., dissenting).
103. Id. at 186-87, 386 N.Y.S.2d at 427 (Markewich, J., dissenting).
105. Id. at 29-30, 263 N.Y.S.2d at 578-80.
106. 53 A.D.2d at 187, 386 N.Y.S.2d at 427 (Markewich, J., dissenting).
107. Id. at 184, 386 N.Y.S.2d at 425-26.
108. 24 A.D.2d at 29, 263 N.Y.S.2d at 579-80. The check represented a progress payment due Hillsley on a home he was building for Glennon. Id.
109. Id.
Hillsley discovered the forged indorsement,\textsuperscript{110} he sued Glennon and the collecting bank.\textsuperscript{111} The collecting bank defended on grounds that it should not be liable in damages since Hillsley, the intended payee, in fact received the proceeds, albeit for a purpose not intended by the drawer.\textsuperscript{112} The court disagreed, noting that the bank had failed to establish that the plaintiff had not been damaged.\textsuperscript{113}

The majority in the intermediate \textit{Tonelli} opinion apparently believed that \textit{Hillsley} was sufficiently analogous to \textit{Tonelli} to preclude the distinctions raised by the dissent as to the pure law question.\textsuperscript{114} There are, however, a number of factual and legal distinctions which tend to make \textit{Hillsley} far less supportive of the \textit{Tonelli} result than the appellate division believed.\textsuperscript{115}

First, whereas \textit{Hillsley} involved a forged indorsement,\textsuperscript{116} in \textit{Tonelli} there was no indorsement at all.\textsuperscript{117} The drawee which pays over a forged indorsement ordinarily cannot charge its customer,\textsuperscript{118} and the payment constitutes a conversion giving rise to a cause of action in the payee or other true owner.\textsuperscript{119} The appellate division majority failed to realize that its partial analogy to the forged indorsement cases deprived the defendant not only of the defense that the payee actually received the funds, but also of all other forged indorsement defenses.\textsuperscript{120} A second and perhaps more important distinction between the two cases is the factual setting of \textit{Hillsley}. Whereas the \textit{Hillsley} plaintiff was the payee of the original check,\textsuperscript{121}

\begin{enumerate}
\item Id. at 30, 263 N.Y.S.2d at 580. Hillsley demanded the balance due on the home contract from its owner who then showed Hillsley the check with the forged indorsement. \textit{Id.}
\item Id.
\item Id. at 30, 263 N.Y.S.2d at 581. The bank admittedly took the check over a forged indorsement and therefore had converted the check. \textit{Id.} This case arose prior to the effective date of the Code in New York. See \textit{U.C.C.} \S 3-419(3) (if converter acts in good faith and in accordance with reasonable commercial standards, his liability in conversion is limited to amount of proceeds still in his hands).
\item 24 A.D.2d at 31-32, 263 N.Y.S.2d at 581-82.
\item See 53 A.D.2d at 184-85, 386 N.Y.S.2d at 425-26.
\item See notes 116-25 and accompanying text infra.
\item 24 A.D.2d at 31-32, 263 N.Y.S.2d at 581-82.
\item 116. \textit{Tonelli}. \S 3-419(3) (if converter acts in good faith and in accordance with reasonable commercial standards, his liability in conversion is limited to amount of proceeds still in his hands).
\item 53 A.D.2d at 184-85, 386 N.Y.S.2d at 425-26.
\item See notes 116-25 and accompanying text infra.
\item 24 A.D.2d at 29-30, 263 N.Y.S.2d at 579-80.
\item 86 Misc. 2d at 682, 386 N.Y.S.2d at 724.
\item See \textit{U.C.C.} \S\S 3-404(1), 4-401(1). \textit{See also E. FARNSWORTH \& J. HONNOLD, supra} note 68, at 316-17. The doctrine that payment over a forged indorsement is improper is based on the fact that such payment is not in accord with the drawer's direction to pay only according to the order of a named payee. \textit{Id.}
\item \textit{U.C.C.} \S 3-419(1)(c). As a defense to such an action, the drawee can prove that the drawer or true owner was negligent and that the negligence substantially contributed to the making of the unauthorized signature or forged indorsement. See \textit{id.} The drawee must also show that it took in good faith and in accordance with reasonable commercial standards. \textit{Id.} \S 3-406. Moreover, the authority of the signer to act as a representative of the person whose name is signed can be raised by the drawee. \textit{Id.} \S 3-404.
\item See note 119 supra.
\item 24 A.D.2d at 29-30, 263 N.Y.S.2d at 579-80.
\end{enumerate}
the Tonelli plaintiff was the drawer.\textsuperscript{122} While the law is clear that a payee has a cause of action in conversion for payment over a forged indorsement,\textsuperscript{123} it is far less clear that a drawer had the same right.\textsuperscript{124} The case was clearly distinguishable from Tonelli,\textsuperscript{125} and, for reasons of equity alone, the appellate division court should have reversed the trial court. It did not, however, and the case was appealed to New York’s highest court.

The Court of Appeals of New York, after reciting the facts,\textsuperscript{126} began its opinion by holding that the certified check was not chargeable against the fund’s account since it lacked a necessary indorsement and was therefore not properly payable.\textsuperscript{127} Although it is true that no check is properly payable without the necessary indorsement of the payee, there is a long standing rule of estoppel that prevents the drawer from asserting improper payment when the intended payee in fact receives the funds represented by the improperly paid item.\textsuperscript{128} Moreover, the court’s decision that the check was not properly payable assumes that there was payment. The transaction might be better characterized as an exchange, particularly since Chase took the precaution of issuing its cashier’s check in the name of the same payee.\textsuperscript{129} The court of appeals deftly avoided this characterization

\textsuperscript{122} 86 Misc. 2d at 681-82, 386 N.Y.S.2d at 724.
\textsuperscript{123} U.C.C. § 3-419. See also J. WHITE & R. SUMMERS, supra note 92 § 15-4, at 499-501.
\textsuperscript{124} For a discussion of cases which support both an affirmative and negative answer, see J. WHITE & R. SUMMERS, supra note 92, § 15-4, at 499-501.
\textsuperscript{125} Several other distinctions can be drawn between these cases. For example, in Hillsley, neither the payee, who never saw the check, nor the drawer, who made the check payable jointly to the payee and the forger, was negligent. See 24 A.D.2d at 29-30, 263 N.Y.S.2d at 579-80. The drawer in Tonelli, however, was negligent in its choice of Naiman as an agent. See 86 Misc. 2d at 682, 386 N.Y.S.2d at 724. Totowa, as payee, was also arguably negligent or worse when it accepted the proceeds of a check with knowledge that the funds it represented did not belong to the presenter, Naiman. See id. at 683, 386 N.Y.S.2d at 724-25. Additionally, in Hillsley, a notation on the check indicated not only the general purpose for which the check was issued, but also the specific person to whose credit the funds would go. 24 A.D.2d at 29, 263 N.Y.S.2d at 580. The “CD” on the Tonelli check only explained its purpose. See 41 N.Y.S.2d at 668, 363 N.E.2d at 565, 394 N.Y.S.2d at 859. Although the payee in Tonelli knew the source and purpose of the original check, 86 Misc. 2d at 682, 386 N.Y.S.2d at 724, the payee in Hillsley did not know the source of the funds. See 24 A.D.2d at 29, 263 N.Y.S.2d at 580.

Moreover, the Hillsley court rested its decision on the drawer’s failure to show that the payee had not been damaged by its action in exchanging the check. 24 A.D.2d at 30-31, 263 N.Y.S.2d at 581. Since the drawer’s loss in Tonelli was probably not caused by Chase’s failure to use due care in exchanging the unindorsed certified check, see notes 60-63 supra, Hillsley was in no way apposite.
\textsuperscript{126} 41 N.Y.S.2d at 668-69, 363 N.E.2d at 565-66, 394 N.Y.S.2d at 859-60.
\textsuperscript{127} Id. at 669, 363 N.E.2d at 566, 394 N.Y.S.2d at 860.
\textsuperscript{128} See text accompanying note 174 infra.
\textsuperscript{129} See 86 Misc. 2d at 682, 386 N.Y.S.2d at 724. The transaction can be viewed in at least three ways. The first is to suggest that it is the exchange of one obligation for another. This would release the drawer from liability. Secondly, the transaction can be classified as a cancella-
problem by asserting that the setting was analogous to a forged indorsement case,\footnote{41 N.Y.2d at 670, 363 N.E.2d at 567, 394 N.Y.S.2d at 860.} which it indeed may be.\footnote{See text accompanying notes 48-51 supra.} The court dismissed the estoppel theory by stating that "Totowa, the true payee, never actually received the proceeds of the original certified check for the purpose intended by the drawer."\footnote{41 N.Y.2d at 670-71, 363 N.E.2d at 567, 394 N.Y.S.2d at 861.} The court, however, completely ignored the fact that Totowa had knowledge of the source of the funds.\footnote{Id. at 671, 363 N.E.2d at 567, 394 N.Y.S.2d at 861.} Finally, the Tonelli court ruled that the negligence of the fund in entrusting the certified check to a dishonest agent was not at issue since the check could only have been made properly payable with an authorized indorsement.\footnote{Id. at 671-72, 363 N.E.2d at 567-68, 394 N.Y.S.2d at 861-62.}

The court of appeals was careful to emphasize that it reserved the question of Chase’s remedy against Totowa based on Totowa’s knowledge of the source of the cashier’s check.\footnote{Id. at 672-73, 363 N.E.2d at 568, 394 N.Y.S.2d at 862.} One must then ask whether a bank which honors a check without a necessary indorsement is liable to its customer. When the question is framed that way the answer must be affirmative. In addition, it seems reasonable as a matter of policy to place the loss on the bank since it arguably has the last clear chance to avoid the loss and since it is in a financial position to absorb or spread the loss.

In spite of those persuasive arguments, there are many objections to a holding that places loss on the negligent bank as opposed to the negligent drawer. First, the law is not as clear as it may first appear to be.\footnote{See text accompanying notes 203-09 infra.} Second, a court should not ignore a factual setting in order to make a policy determination. Finally, cases like Tonelli tend to assume a large place in the area of commercial paper. The Tonelli decision could be cited as support for a broad rule of law that it is per se negligent to make any payment or exchange of checks without indorsement. When a bank does so, there can be no hope of

\footnote{130. See text accompanying notes 203-09 infra. It is sufficient to note that prior to Tonelli, a lower New York court ruled that a certified check did not require an indorsement to create a right of payment in the taker. Sweedler v. Oboler, 65 Misc. 2d 789, 790, 319 N.Y.S.2d 89, 91 (Sup. Ct.), aff’d mem., 57 A.D.2d 1049, 325 N.Y.S.2d 966 (1971). Although Sweedler was cited in the brief of the appellant, it was ignored by the court of appeals. Brief for Appellant at 9.}
recovery since no defense will be available. Presumably, even au-
thorized agents could not bind their principals in similar cases, absent
ratification thereafter, because of the bank's negligence. *Tonelli* could
also be subjected to a narrow interpretation by limiting its holding to
the facts of the case.\textsuperscript{137}

The *Tonelli* decision is unfortunate because there is little, if any-
thing, that the bank could have done to avoid losing the money rep-
resented by the certified check, while the drawer could have pre-
vented the loss. Nevertheless, not only does the initial burden fall on
the bank, but it also falls without the benefit of any defenses. Addition-
ally, the decision creates problems from the perspective of funds
redirection. Although *Tonelli* can be distinguished, it is certain to be
asserted as the leading decision rendering the taker of an unindorsed
certified check without right or remedy, even though the funds are
properly applied thereafter. If that assertion is accepted, it follows
that funds redirection can never occur without an indorsement or
other writing. Though the *Tonelli* case is not specifically a funds re-
direction case since any redirection was improper, its rule, if broadly
applied, would affect funds redirection, particularly in the realm of
certified checks. It is submitted that this rule should not be broadly
applied.

\textbf{IV. Certification and Funds Redirection}

\textbf{A. Introduction}

Suppose that $D$ draws a check payable to the order of $P$, and
\textit{then procures the check's certification}, only to determine thereafter
that he wants an alternative payee, $AP$, to receive the money. As has
been indicated, there are several methods by which funds redirection
can be accomplished successfully in the absence of certification.\textsuperscript{138}
The question then becomes whether certification adds or subtracts
any necessary steps from the process.

Initially, it is clear that the certifying bank has some interest in
the item, since both that bank and the drawer are liable on the in-
strument.\textsuperscript{139} The bank's interest however, should not extend beyond
determining that the check has been paid according to the drawer's
intent and up to the limits of the certified amount. Secondly, it
should be noted that the bank is under no obligation to certify a

\textsuperscript{137} To keep this analysis in perspective and to rebut such an effect, see U.C.C. § 3-202.

\textsuperscript{138} See notes 15-33 and accompanying text supra.

\textsuperscript{139} See U.C.C. § 3-411(1).
Where it does certify a check, the bank is afforded protection both by its internal procedures and by the law.

These two factors suggest that the rules governing the drawer's ability to redirect funds represented by a certified check should differ slightly, if at all, from those governing uncertified checks. As far as can be determined, that suggestion has in fact been followed. Certification modifies an informal means of redirection and subtracts a unilateral formal method. The drawer can request that the certifying bank withdraw its certification, and if it does so, he can then destroy the check, write another, and have it certified. The only real difference between this and the act of the drawer in voiding or destroying an uncertified check is that the bank has an interest in ensuring that the check is voided before it will recredit the drawer's account. Likewise, the drawer alone cannot stop payment since the obligation on the certified check is not solely his. Thus while the act of certification modifies the cancellation and reissue method of redirection, it eliminates the most frequently used mode of unilateral funds redirection, the stop payment order.

There may, however, be times when the drawer of a check which has been certified at his request is unwilling to have that certification cancelled. The certification may be valuable and difficult to obtain. If the certification, once withdrawn, might not be reissued, the drawer might desire to redirect the funds without formal means. To the extent that he can do so without changing the check in a way that is conspicuous, such as by adding alternative payees or bearer words, the certifying bank will undoubtedly have to pay. The bank in turn will be able to prevail in any suit brought by the drawer whose intent has been effectuated. To the extent that the redirection is done less skillfully, the results should nevertheless be the same. The remainder of this article will deal with these less sophisticated methods of redirection. The primary focus will be on implied funds redirection, where the drawer attempts to redirect a certified check merely by indorsing it without changing the payee. The concept of certification will be explored first, followed by an analysis of the redirection problem.

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140. Id. § 3-411(2).
141. See text accompanying notes 144 & 156-58 infra.
142. See U.C.C. §§ 4-303(1)(a), 4-403(1).
143. The drawer may be insolvent, rapidly approaching insolvency, or may have so many creditors that he fears they will garnish his bank account when it is recredited. Perhaps his nemesis is the certifying bank itself as it might be concerned that the customer is in default on other obligations and would like to cancel the certification, recredit the customer's account, and then exercise a right of set-off.
B. Certification

When a check is certified, the bank customarily debits the drawer's account immediately to ensure that upon presentment by a payee or holder it will have the funds to pay what is now its obligation. It is often said that the drawer no longer has control over the funds represented by the certified check. This statement is true only to the extent that it means that third parties, such as creditors of the drawer, cannot reach the sum represented by the check or that the drawer cannot unilaterally countermand payment after delivery of the check. A broad assertion that a drawer loses all control over the certified check is misleading, as is the statement that a certifying bank is absolutely liable on its certification, since the drawer and the certifying bank may in fact agree to cancel the certification. In addition, a bank may unilaterally effect cancellation before the check comes into the hands of a bona fide purchaser for value.

If the drawer had no control over the sums represented by the certified check, lost certified checks would forever be beyond the

145. See H. Bailey, supra note 6, § 7.6, at 154. One commentator has stated: Certification operates as a setting aside from the account of the drawer of funds sufficient to pay the check. When a check is certified, the drawer immediately loses control of so much of his funds as are necessary to pay the check. A creditor of the drawer who is unable to obtain custody of the check may not reach the funds so set aside or prevent the bank paying the check. Id. at 154-55 (footnote omitted). The reason for this rule is that the obligation to pay the check is now the certifying bank's as well as the drawer's, and in order to protect the certifying bank from liability, other persons are said no longer to have an interest. See id. at 155.
reach of their true owner, payees would have a cause of action against the certifying bank immediately upon certification, and the certification would immediately and forever bind the bank to pay checks even though certification was procured through fraud and the fraudulent party still had possession. The proper rule must be that since the obligation to pay the certified check is now shared by the certifying bank, the drawer cannot take any unilateral action that will operate to the detriment of the bank, such as stop payment on the check or otherwise countermand it. Moreover, to the extent that the drawer has parted with the check, he can no longer affect the payment of the instrument.

To illustrate the unreasonableness of the statement that the drawer loses control over the funds, one need only ask to whom the funds represented by a certified check belong prior to delivery. There are three possibilities: the drawer, the bank which accepted the check by certifying it, and the payee. Cases indicate that the ownership of the funds represented by a certified check depends upon who is claiming the funds. If a third party creditor claims the funds, courts hold that the drawer does not own them. The rule is the same under section 4-303(1)(a) of the Code. Were it otherwise, the bank would run the risk of double liability, to the drawer upon certification and to the creditor. It is equally clear, however, that the

149. If that were the case, the drawer could not maintain an action under U.C.C. § 3-804 to recover on the instrument because such remedy is available only to the owner. Id. If the drawer is deemed to have no ownership interest in the instrument after certification, the remedy would not be available to him and the instrument and its proceeds would be lost to him forever.


151. See note 146 supra.

152. See notes 153-58 and accompanying text infra.

153. See McIntire v. Raskin, 173 Ga. 746, 749-50, 161 S.E. 363, 365 (1931); Standard Factors Corp. v. Manufacturers Trust Co., 182 Misc. 701, 707, 50 N.Y.S.2d 10, 15 (Sup. Ct. 1944), aff'd mem., 269 A.D. 658, 53 N.Y.S.2d 461 (1945). For example, the Standard Factors court held that the creditor could attach the certified check only by serving a warrant upon the holder of the instrument. 182 Misc. at 707, 50 N.Y.S.2d at 14. The court stated that "upon the certification of the check, eo instante, the sum appropriated from the credit of the drawer thereupon stood as a sum to the credit of the certified check," and no longer to the drawer's credit. Id.

154. U.C.C. § 4-303(1)(a). This section states:

Any knowledge, notice or stop-order received by, legal process served upon or setoff exercised by a payor bank, whether or not effective under other rules of law to terminate, suspend or modify the bank's right or duty to pay an item or to charge its customer's account for the item, comes too late to so terminate, suspend or modify such right or duty if the knowledge, notice, stop-order or legal process is received or served and a reasonable time for the bank to act thereon expires or the setoff is exercised after the bank has done any of the following:

(a) accepted or certified the item . . . .

Id.
payee of a certified check does not own the funds, at least prior to delivery of the check: \textsuperscript{155} "Where the drawer has a check certified, the payee acquires no rights against the certifying bank unless and until the check has been delivered." \textsuperscript{156}

It should also be clear that the certifying bank's only interest in the fund is in ensuring that its liability does not extend beyond the sum debited to the drawer's account. \textsuperscript{157} If the certifying bank's liability is not thus limited, the payee would have a vested claim against the drawee from the moment of certification and the payee would effectively become an irrevocable assignee of the drawer. Although courts hold that the funds are beyond the reach of the drawer in order to protect the certifying bank, it is clear that the drawer has ownership rights superior to those of the payee or the certifying bank, as long as he does not exercise them to the prejudice of the certifying bank. \textsuperscript{158}

C. Certification, Delivery, and Funds Redirection

The problem in the area of funds redirection caused by certification may be illustrated by the following hypothetical: Assume that $D$ draws and has certified a check payable to $P$, but now wants to redirect the funds to $AP$. Assume further that he does so through implied funds redirection by indorsing the check in his ($D$'s) own name. $AP$ brings the check to his bank (Bank-2), which takes it in good faith for value without checking it too carefully. When the check is presented by Bank-2, payment is refused because the check is missing a proper indorsement or looks as if it may have been altered. Bank-2 can go back to $AP$, who can go back to $D$, who can rectify the matter in several ways. If something intervenes which makes such tracing impossible, such as $D$'s insolvency or the certifying bank's unwillingness to honor its acceptance, $AP$ and/or Bank-2 should be able to enforce the check as certified against the certifying bank. If Bank-2 can establish that $D$ had control over the instrument and ownership rights in it

\textsuperscript{155} Umbsen v. Crocker First Nat'l Bank, 33 Cal. 2d 599, 601-02, 203 P.2d 752, 754 (1949); In re Williamson, 264 A.D. 615, 616, 35 N.Y.S.2d 1016, 1018 (1942).

\textsuperscript{156} H. Bailey, supra note 6, § 7.6, at 156 (footnote omitted).


\textsuperscript{158} See Grubb v. General Contract Purchase Corp., 94 F.2d 70, 73 (2d Cir. 1938); Umbsen v. Crocker First Nat'l Bank, 33 Cal. 2d 599, 601, 203 P.2d 752, 754 (1949); Maurice Abrams & Co. v. Union Nat'l Bank, 31 La. Ann. 61, 62 (1879); In re Williamson, 264 A.D. 615, 616, 35 N.Y.S.2d 1016, 1018 (1942). See also 5B Michie, supra note 76, § 256(b), at 21-22.
at the time of the implied funds redirection to AP, then Bank-2 should prevail over the certifying bank. The extent of control over the instrument maintained by the drawer depends upon whether the check was ever delivered and whether, absent delivery to the named payee, the drawer has acted so as not to prejudice the certifying bank.\footnote{159}

When the drawer of a check has possession of it, a presumption arises that it has not been delivered to the payee.\footnote{160} That proposition, of ancient origin, has been reiterated by the Illinois Supreme Court as recently as 1974 in \textit{Gillespie v. Riley Management Corp.}\footnote{161} In that case, the court likened a cashier's check to a certified check and stated that "the purchaser of a cashier's check [like the drawer of a certified check] remains the 'owner' thereof until such time as he delivers or negotiates it to the payee."\footnote{162} This proposition was previously recognized in the context of a certified check in \textit{Umbsen v. Crocker First National Bank.}\footnote{163} The California Supreme Court in \textit{Umbsen} was confronted with a check that had been certified in 1905 and had never been presented.\footnote{164} The state claimed the proceeds as abandoned property, but the plaintiff, a successor to the last known owner, claimed that his right to the proceeds was superior to that of the bank or the state.\footnote{165} The court considered whether the check had ever been delivered and determined that

\[ \text{the transfer [of the drawer's funds] occurs at the time of certification, if the check is certified at the instance of the payee to whom the check has been delivered. If certification is procured at the instance of the drawer, however, the transfer does not occur until the check is delivered to the payee . . . .} \footnote{166} \]

The \textit{Umbsen} court also addressed the drawer's right to have the proceeds of the check recredited to his account before delivery.\footnote{167} In ruling that the plaintiff successor could recover, the court noted that

\begin{enumerate}
\item \footnote{159} See text accompanying notes 145-58 supra.
\item \footnote{160} Buehler v. Galt, 35 Ill. App. 225, 230 (1899); 5B Michie, supra note 76, § 256, at 32; H. Bailey, supra note 6, § 7.15, at 165.
\item \footnote{162} 59 Ill. 2d at 217, 319 N.E.2d at 757.
\item \footnote{163} 33 Cal. 2d 599, 203 P.2d 752 (1949).
\item \footnote{164} Id. at 600, 203 P.2d at 753.
\item \footnote{165} Id. at 601, 203 P.2d at 753.
\item \footnote{166} Id. at 601-02, 203 P.2d at 754 (citations omitted). The result should be the same under the Code. See U.C.C. § 3-411.
\item \footnote{167} 33 Cal. 2d at 602, 203 P.2d at 754.
\end{enumerate}
just as there exists a presumption of delivery when one is in possession of an instrument, there is also a presumption against delivery when an instrument has not been presented.\textsuperscript{168}

It should therefore be clear that as between the drawer, the payee, and the certifying bank, the operative question is whether the drawer has delivered the check to the payee. If he has, the payee then has immediate rights in the instrument; if he has not, then the payee has no claim to the instrument. The extent to which this proposition has been applied is demonstrated by the early Missouri case of \textit{Bathgate v. Exchange Bank},\textsuperscript{169} where the court held that a certifying bank was not obligated to pay a check certified at the drawer’s request when the check was delivered to the payee without the consent of the drawer.\textsuperscript{170} Until there is delivery to the payee with the drawer’s consent, the payee has no right to the check, and the drawer may control it and engage in funds redirection notwithstanding its certification.

If there has been no delivery to the named payee, the question of who owned and controlled the check is narrowed to either the drawer or the certifying bank. Since the funds represented by the certified check have been debited to the drawer’s account, the sole interest of the certifying drawee bank is in ensuring that it will only have to pay the funds once. The certifying bank is not concerned with to whom it pays the funds, so long as the payment will not prejudice its future rights or liabilities with respect to the instrument itself.\textsuperscript{171} The question thus becomes whether the drawer, by his actions, has prejudiced the certifying bank. If he has not, and if the certifying bank’s liability will be extinguished by making payment to a subsequent nonpayee taker, including a negligent collecting bank, then the certifying bank should be compelled to pay the drawer’s alternative payee and/or Bank-2.

A certified check involves two contractual obligations on the part of the certifying bank. The first, which is the same contract that the bank makes with all of its checking account depositors, is that it will pay the check properly, according to the order of the drawer.\textsuperscript{172} The

\textsuperscript{168} \textit{Id.} See text accompanying note 160 \textit{supra}.
\textsuperscript{169} 199 Mo. App. 583, 205 S.W. 875 (1918).
\textsuperscript{170} \textit{Id.} at 587-88, 205 S.W. at 877. Provided that the payee is not a holder in due course protected by U.C.C. § 3-305, the result under the Code should be the same. \textit{Id.} § 3-306.
\textsuperscript{171} This assumes that the certifying bank does not intend to exercise any available right of set-off. To the extent that any prejudice arises from the act of the certifying bank in the first instance, it does not seem too unfair to leave the bank on a par with all other creditors.
\textsuperscript{172} See U.C.C. § 4-401.
second is unique to certified checks, since the contractual obligation of payment, by the act of certification, runs to holders or assignees of the check. Since the payee has no interest in the certified check before delivery and a collecting bank or other subsequent holder is the holder or assignee of the check, the certifying bank can refuse payment only if it is improper as against the drawer. Where the drawer intends that AP and/or Bank-2, and not the named payee, be paid, one must ask if the certifying bank can pay according to that intent and avoid further liability. A bank which pays according to the intent of its customer may in fact do so without fear of liability to the customer, for, as one commentator has stated, "[i]f the depositor has lost nothing he should recover nothing; a bank being liable to its depositor only for the damages sustained by him by reason of its paying a check upon a forged indorsement." This principle is even more appropriate in the implied funds redirection case since the indorsement is not forged, but is that of the drawer himself. The drawer cannot later claim that he has been damaged since it is his signature, and he would therefore have no cause of action against the certifying bank for improperly paying the instrument. In that situation, the certifying bank should not be able to refuse payment.

As indicated in Tonelli, the general rule is that a bank may charge its customer's account only for items properly payable. Ordinarily, only the named payee's genuine indorsement will make the instrument properly payable, since usually that is the drawer's intent, and an unauthorized signature cannot operate to defeat that intent. If it is the intent of the drawer that the payee's indorsement is not required, however, then a bank which pays without the indorsement or on a forged indorsement will not be liable to the drawer for the payment:

Where the circumstances are such as to amount to a direction from the drawer to the bank to pay without reference to the genuineness of indorsements, or are equivalent to a subsequent admission that the indorsement is genuine, in reliance upon which the bank is induced to alter its position, the bank will not be chargeable with the loss.

173. Under U.C.C. § 3-411(1), certification is acceptance. Id. The certifying bank becomes the acceptor and, as such, engages to pay the instrument under U.C.C. § 3-413, which sets forth the contract of an acceptor. Id.
174. 5B MICHIE, supra note 76, § 277(a), at 89.
175. 41 N.Y.2d at 669, 363 N.E.2d at 566, 394 N.Y.S.2d at 860, construing U.C.C. § 4-401.
176. U.C.C. § 3-404.
177. 5B MICHIE, supra note 76, § 281, at 137-38.
To summarize, where the drawer has indicated his intent to pay without the payee's indorsement, a bank which pays will not be liable to the drawer. Since the certifying bank's sole interest is whether it can safely pay the check, the fact that the drawer could not assert improper payment is dispositive. Also, where the drawer has indicated his intent to pay without the payee's indorsement, he will be estopped from asserting improper payment. Such an estoppel operates to protect all parties, including the drawee bank which ordinarily bears the risk of improper payment. If the drawer's intent is effectuated by the authorization of payment, he is not harmed and thus the drawee bank cannot be liable for improper payment.

D. The Power to Redirect Funds

The only possible claimants to the funds are the payee, the certifying bank, the alternative payee, and the drawer. If, as has been demonstrated, the payee has no interest, and the drawer-owner's intent is effectuated so that he cannot hold the certifying bank liable for improper payment, the only remaining question is whether the drawer-owner has the power to implement his intent by indorsing a certified check and thereafter renegotiating it. No cases have directly decided whether the drawer has the power of implied funds redirection. Had the drawer inserted his name as alternative payee, and then indorsed it, Bank-2 would have, however, received payment from the certifying bank:

[I]t has been held that where the drawer of a check payable to a certain person or order has the same certified by the bank on which it is drawn, he may, at any time before any third person acquires a right in such check, alter it, making it payable to bearer; and, when so changed, the bank, by paying it to bearer, will be

178. 5A id., § 181, at 487-88. "But the drawer of a check authorizing payment without the payee's indorsement is estopped from contending that the drawee was liable for payment without such indorsement." Id.

179. The Court of Appeals of New York in Tonelli dismissed the estoppel argument by citing Hillsley as authority for the proposition that the payee who unwittingly receives funds of the drawer in payment for a different debt has not received the proceeds of the check. See 41 N.Y.2d at 671, 363 N.E.2d at 567, 394 N.Y.S.2d at 861. For a discussion of Tonelli and Hillsley, see notes 104-25 and accompanying text supra.

180. See U.C.C. § 4-402.

181. See Gordon v. State St. Bank & Trust Co., 361 Mass. 258, 280 N.E.2d 152 (1972). The Gordon court stated that "[t]he drawer is not harmed if the drawee bank's action with respect to a check carries out . . . the drawer's purpose with respect to that check." Id. at 260, 280 N.E.2d at 154.

182. See text accompanying notes 155-58, 169 & 170 supra.

183. See text accompanying notes 174-77 supra.
protected against any claim of the payee first named, or the claim of any person through any private agreement with the drawer, of which the bank had no notice.\textsuperscript{184}

The foregoing rule that the drawer may alter the name of the payee is based upon the case of \textit{Maurice Abrams & Co. v. Union National Bank}.\textsuperscript{185} In that case, the court held that the bank was not liable for paying the check to the "altered" payee, stating:

There is no intimation that . . . [the payee] ever knew or assented to the certification of the check in his favor, or ever held it for a moment. . . . On the contrary, the allegation is that . . . [the drawers], who held the check when certified, themselves altered it before parting with it. \textit{What right had the Bank to object to the change, when made by the drawer before any third person had acquired any rights in or under the check? . . . If I draw my check on the Bank to the order of another, and myself procure its certification, until I part with the check, or, certainly, until the payee has consented to accept the stipulation in his favor, I may withdraw it, and the Bank could not refuse to cancel or redeem the check in my hands.}\textsuperscript{186}

It should thus be clear that if the drawer had inserted the words "or bearer" or had inserted his name and then indorsed the check, Bank-2 could recover on the instrument.

The question therefore becomes whether, despite this omission of alternative words, the drawer's intent as manifested by his indorsement ought to be followed or whether the certifying bank should be allowed to thwart that clearly manifested intent. If the drawer's intent as the owner of an instrument until delivery is not given primary effect, it must be because the certifying bank has an interest in seeing that only the named payee is paid. It has long been held that the intent of the drawer or owner of a cashier's check should be given effect over the intent of the issuer,\textsuperscript{187} since the purchaser should control to whom payment is made. One court has explained that "the rationale of the rule . . . [is] that an issuing bank . . . has no personal interest in the person or entity named as payee."\textsuperscript{188} The same reasoning should apply to the drawer of a certified check.

\textsuperscript{184} 5B \textsc{Miche}, supra note 61, \S 256(b), at 22 (footnotes omitted).
\textsuperscript{185} 31 La. Ann. 61 (1879).
\textsuperscript{186} \textit{Id.} at 62 (citation omitted) (emphasis added).
\textsuperscript{188} \textit{United States Nat'l Bank v. Bank of America}, 264 Cal. App. 2d 871, 873, 71 Cal. Rptr. 6, 7 (1968) (emphasis added).
This right of the purchaser of a cashier’s check and of the drawer of a certified check to control to whom the funds are paid is a right incident to ownership. While the two species of checks differ, the rights respecting them should not. As the California Court of Appeals stated in *Burke v. Mission Bay Yacht Sales*:

> Even though the plaintiff was not actually the drawer of the instant cashier’s check, her rights in the premises simulated those of the drawer of an ordinary check. . . . For the purpose at hand, there is no legally significant distinction between such a situation and that which would have existed if she had deposited $10,000 with the bank and requested its certification of her check payable to that defendant. In the latter instance the payee’s right to have the $10,000 would not have come into being until the check had been delivered, and in the meantime the plaintiff would have had the right to cause it to be cancelled and her account recredited with the amount thereof. . . . The check was the property of the plaintiff until delivery.

It is thus apparent that the drawer has the right to alter the name of the payee before delivery.

It is clear that the drawer’s intent, as manifested by his indorsement, is to redirect the sums represented by the check as if he had altered the instrument to name either himself or bearer as alternative payee. Had he actually altered the check, he could have negotiated the instrument by indorsing it, since an instrument payable to the order of two or more persons in the alternative may be negotiated by any of them who has possession. The fact that the drawer failed to insert his name as alternative payee should not change this result. Where the intent to change the payee is clear from the instrument and the facts, it should be given effect.

The question becomes whether the certifying bank in the hypothetical has been so prejudiced by the attempted funds redirection by altering the payee’s name that it should be discharged from its undertaking. Under section 3-407(2)(a) of the Code, an alteration, such as the addition of a party payee, may operate to discharge a nonconsenting party to the instrument only if the alteration is: 1) made by the holder; 2) material; and 3) fraudulent. Without a

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189. See notes 6, 7 & 10 supra.
191. Id. at 732, 29 Cal. Rptr. at 690 (citations omitted) (emphasis added).
192. U.C.C. § 3-116(a).
193. Id. § 3-407(2)(a).
194. Id.
showing that the drawer acted fraudulently, there can be no discharge of the party who certified the check.\footnote{195} Also, it is the drawer and not a holder of the check who has altered the instrument. Section 3-407 further provides that in order to discharge the party defending on the grounds of alteration, that alteration must change his contract.\footnote{196} Although the addition of a payee would ordinarily change contract liability, here, where the certifying bank's only liability is to pay the instrument to the holder or assignee, the contract liability remains unchanged. According to section 3-407(a)(b) of the Code,\footnote{197} "no other alteration discharges any party and the instrument may be enforced according to its original tenor, or as to incomplete instruments according to the authority given."\footnote{198} Since the instrument has been altered neither fraudulently nor by a holder, it can be enforced according to its original tenor. Although it could be argued that tenor encompasses more than merely the amount, it should not be so interpreted when to do so would prejudice the good faith purchaser.\footnote{199} Moreover, it might be argued that the drawer has treated the instrument as if it were incomplete since the payee's name has been changed. The instrument should therefore be enforced as completed with the payee's name changed, according to the authority of the drawer, as manifested by his indorsement.\footnote{200}

Given that the drawer could have altered the check without discharging the certifying bank, and Bank-2 could thereafter have enforced the check, the question becomes whether the certifying bank should be allowed to refuse payment when the redirection is accomplished by implied means.

\footnote{195}{See id.}
\footnote{196}{Id.}
\footnote{197}{Id. \S 3-407(2)(b).}
\footnote{198}{Id.}
\footnote{199}{The question whether tenor encompasses more than mere payment is answered both affirmatively and negatively. Standing alone, the word tenor probably means nothing more than exact copy. By that interpretation, the altered instrument could be enforced according to an exact copy of the original. Such a reading of the word is probably too broad. A more exacting definition, focusing on time, place, and manner of payment, can be found in C. NORTON, BILLS AND NOTES \S 43, at 121 (4th ed. 1914) which states: "THE TENOR OF THE BILL—Is the request in the bill to pay the money at the time and place and in the manner mentioned in it." Id. This definition places the emphasis on the instrument as a payment device, and although it requires exactitude with respect to time, place, and manner, the primary focus seems to be on amount. Although little pre-Code and no post-Code case law interpretations exist, it is probable that tenor as used in the Code refers to amount, time, place, and manner. Tenor ought to include the original payee in the ordinary certified check case, although this would depend on a finding that manner includes the payee, which may be questionable. In any event, the admission of parol evidence would be required and thus summary judgment, which was granted in Tonelli, would be precluded. See 86 Misc. 2d at 685, 386 N.Y.S.2d at 726.}
\footnote{200}{See U.C.C. \S 3-115.}
Ordinarily, as the basis of the *Tonelli* rule postulates, the certifying bank is obligated to pay on its certification only when the check is properly indorsed at presentment.\(^{201}\) As has been shown, however, if the drawer indicates that proper indorsement is not necessary, the bank will not be liable for paying an improperly indorsed check.\(^{202}\) One must thus inquire whether the certifying bank can refuse to pay the check, insisting upon the formality of Bank-2 returning the check to AP, who will return it to the drawer for the purpose of inserting his name as payee, and presenting it again before enforcing Bank-2's rights against the certifying bank. This insistence may cause great hardship to AP and/or Bank-2. The certifying bank may assert that certification had been withdrawn before AP or Bank-2 became entitled to the proceeds of the check. AP or Bank-2, who both gave the drawer value and took the instrument in good faith, would not be able to recoup the sums expended in reliance upon the drawer's representations and the certifying bank's certification.

For reasons of policy and practicality, it would be more appropriate to adopt the reasoning of the New York Supreme Court in *Sweedler v. Oboler.*\(^{203}\) In *Sweedler,* the defendant bank had issued a cashier's check to and had certified personal checks of a third party.\(^{204}\) The third party purchased goods from the plaintiff, paying for them with these checks.\(^{205}\) The plaintiff later discovered that the checks had not been indorsed by the payee, who subsequently refused to indorse them.\(^{206}\) Since the checks were not indorsed, the certifying bank refused to pay, asserting that there was no presumption of ownership.\(^{207}\) The court disagreed and held that the plaintiff was entitled to be paid,\(^{208}\) stating:

> The law regards that as done which ought to have been done. There can be no doubt that it was intended that the purchaser indorse the checks given in payment for the merchandise which he took into his possession . . . . The failure to so indorse was either the result of a mutual mistake or mistake on plaintiff’s part and fraud on the purchaser’s part. Whichever it is, the purchaser has obtained merchandise without paying for it . . . .
The issuance of a certified or cashier’s check by a bank simply means the setting aside of funds to meet payment thereof. The bank, of course, has no interest therein, so long as its depositor cannot hold it liable for releasing such funds in payment of a certified or cashier’s check.

A determination by the court that plaintiff is entitled under these circumstances to payment of the certified checks and cashier’s check will relieve defendant bank of any responsibility in making such payment and avoid any possibility of liability to its depositor.209

The only material distinction between the Sweedler case and the hypothetical is that the drawer in Sweedler was originally the payee,210 whereas in the hypothetical the drawer was not the payee. It is submitted that this difference is irrelevant. Where, as in the hypothetical, AP and Bank-2 part with value in reliance on the representation of the drawer, the certifying bank’s only interest in the check is its own liability. The drawer intended to vest ownership in AP and thereafter in Bank-2, as evidenced by the apparently improper indorsement. That intent, implied by the attempted funds redirection, should be implemented without regard to the formality of the instrument itself.

V. POST FUNDS REDIRECTION STATUS

A. Introduction

Assuming that implied funds redirection has taken place, and that a court analyzes the problem in the terms suggested above, it will also be important to determine the status of the subsequent takers, AP and Bank-2. They may be either holders, holders in due course, or mere transferees.

B. Holder/Holder in Due Course

The threshold question is whether AP or Bank-2 can be holders and subsequently holders in due course. To be a holder in due course, one must come within the Code’s definition of a holder as “a person who is in possession of . . . an instrument . . . drawn, issued or indorsed to him or to his order or to bearer or in blank.”211 If D had the right to alter the named payee, intended to do so, and effec-

210. Id. at 789, 319 N.Y.S.2d at 91.
211. U.C.C. § 1-201(20).
ulated that intent by his indorsement, the AP and Bank-2 would be holders. If AP and Bank-2 satisfy the requirements of section 3-302 of the Code\(^{212}\) by taking for value, in good faith, and without notice that the instrument has been dishonored or is overdue, or of any defense of claim, they would be holders in due course.\(^{213}\) It is assumed that AP and Bank-2 gave value\(^{214}\) and took the instrument in good faith.\(^{215}\)

Accepting the proposition that AP and/or Bank-2 became holders by the drawer's indorsement, the only remaining question is whether they had notice that the check was overdue or had been dishonored or of any defense or claim to it on the part of any person.\(^{216}\) As to notice of claims, neither the original payee, the certifying bank, or any third person had any right in the instrument at all.\(^{217}\) Assuming that the impropriety of the indorsement cannot be raised by the drawer, the only conceivable defense that could be asserted in the hypothetical would be withdrawal of certification. In any event, such a withdrawal would occur too late if the instrument had already come into the hands of a third person, such as AP or Bank-2, regardless of whether or not the third person is a holder. Although it might be urged that the mere fact that the instrument appears to be altered should give notice of possible defenses, this argument should be dismissed since the drawer is in possession of the instrument and the taker is receiving it directly from D. While it may be argued that ordinarily a taker with notice of one possible defense takes subject to all defenses, the question here is whether it is more appropriate to place a loss on one who has purchased in good faith, although with possible notice, or on a bank which voluntarily certified an instrument that led to a good faith purchase. It appears that the bank

\(^{212}\) Id. \(\S\) 3-302.
\(^{213}\) Id. Section 3-302(1) provides: "A holder in due course is a holder who takes the instrument (a) for value; and (b) in good faith, and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." Id.
\(^{214}\) Section 3-303 of the Code, id. \(\S\) 3-303, defines taking for value:
A holder takes the instrument for value (a) to the extent that the agreed consideration has been performed or that he acquires a security interest in or a lien on the instrument otherwise than by legal process; or (b) when he takes the instrument in payment of or as security for an antecedent claim against any person whether or not the claim is due; or (c) when he gives a negotiable instrument for it or makes an irrevocable commitment to a third person.

Id.

\(^{215}\) Good faith is defined in the Code as "honesty in fact in the conduct or transaction concerned." Id. \(\S\) 1-201(19).
\(^{216}\) Id. \(\S\) 3-302(1).
\(^{217}\) See text accompanying notes 188-91 supra.
should bear the loss, either because both are equally blameworthy or equally blameless and the bank can best bear the loss. While AP could have avoided the loss by using more caution, by hypothesis he is not sophisticated. Even Bank-2, as a more sophisticated taker, should not take subject to the certifying bank's rights since it takes largely in reliance on the certification.\footnote{To compare the rules regarding banks in the position of Bank-2 with respect to restrictive indorsements and notice, see U.C.C. § 3-206.} In addition, subsequent takers do not have notice of dishonor since the instrument has not been and may never be dishonored, despite the fact that the certifying bank refuses to pay it when it is first presented.\footnote{See text accompanying notes 251 & 252 infra.}

The final requirement for holder in due course status is that the holder must take the instrument without notice that it is overdue.\footnote{U.C.C. § 3-302(1)(c).} The Code provides that the ordinary check drawn and payable in the United States is presumed to be overdue after thirty days.\footnote{Id. § 3-304(3)(c).} The certified check, however, "stands on a different footing from any ordinary check."\footnote{National Mechanics' Bank v. Schmelz Nat'l Bank, 136 Va. 33, 40, 116 S.E. 380, 382 (1923).} The only case which found a certified check overdue involved a check which was presented almost twelve years after issue.\footnote{See Weaver v. Harrell, 115 W. Va. 409, 414, 176 S.E. 608, 610 (1934).} It therefore seems clear that both AP and Bank-2 would be without notice that the instrument was overdue. Consequently, they would qualify as holders in due course.

The certifying bank undoubtedly would argue that AP and Bank-2 cannot be holders by virtue of section 3-202 of the Code,\footnote{U.C.C. § 3-202.} which provides that negotiation can only occur through the indorsement of the instrument by or on behalf of the instrument's holder.\footnote{Id.} Since the drawer was not a holder of the instrument, the certifying bank would contend that the indorsement by him could not qualify his transferee as a holder. This argument has traditionally been used by courts to deny holder status to takers from thieves.\footnote{See Stone & Webster Eng'r Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 6, 184 N.E.2d 358, 362 (1962).} In the hypothetical, however, the drawer was not a thief but rather the owner of the instrument. If the owner and holder are not identical, the owner should prevail and his intent should be determinative. "No party can ever be a holder of an order instrument stolen prior to indorsement by the owner of the instrument."\footnote{J. White & R. Summers, supra note 92, § 14-3, at 459 (footnote omitted) (emphasis added).} Since here the
owner has indorsed the instrument, those takers who satisfy the requirements of the Code \(228\) should be classified as holders or as holders in due course.

This situation may be analogized to the fictitious payee or padded payroll cases addressed by section 3-405 of the Code, \(229\) which provides that an indorsement by any person in the name of the payee is effective to constitute subsequent takers as holders and holders in due course. \(230\) The intent of the drawer as to whether the named payee or some other person should have an interest is crucial. Similarly, the intent of the drawer in the hypothetical should control and operate to vest in his transferee the rights of a holder in due course. \(231\)

Assuming that there are no deficiencies other than the added payee or the drawer’s indorsement on the instrument which would yield notice, both AP and Bank-2 should be deemed holders in due course, at least to the extent that they meet the requirements of good faith and value.

C. Transferee

If AP and Bank-2 are not assumed to be holders, the result should not change significantly. AP and Bank-2, under section 3-201 of the Code, \(232\) would still have such rights as the transferor has in the instrument. \(233\) Since the drawer has been shown to be the owner of the instrument, \(234\) AP and Bank-2 would thus acquire those ownership rights. Even if AP and Bank-2 are deemed to take subject to any claims or defenses, there are no claims or defenses available to any party other than the possible right of the certifying bank to cancel its certification. \(235\) At this stage of analysis, it is enough to say that neither AP’s nor Bank-2’s position is dependent upon a finding that they are holders in due course.

\(228\) See notes 211-23 and accompanying text supra.
\(229\) U.C.C. § 3-405.
\(230\) Id.
\(231\) See Gordon v. State St. Bank & Trust Co., 361 Mass. 258, 261, 260 N.E.2d 152, 154 (1972). Discussing § 3-405, the court noted that the drawer in Gordon was not damaged because only those persons who were intended by the drawer to take an interest received money from the forgery. Id. at 261, 280 N.E.2d at 154.
\(232\) U.C.C. § 3-201.
\(233\) Section 3-201(1) provides:

(1) Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.

\(234\) U.C.C. § 3-201(1).
\(235\) See text accompanying notes 184-91 supra.
VI. WITHDRAWAL OF CERTIFICATION

Irrespective of whether or not AP and Bank-2 qualify as holders in due course, the law is clear that a certifying bank may not cancel its certification after the instrument has come into the hands of a bona fide purchaser for value.236

A certifying bank may generally cancel or withdraw its certification under the following circumstances: 1) where it has certified the instrument by mistake; 2) where it has been induced by the depositor's fraud, as where the depositor induces the bank to certify a check in excess of his balance; 3) where it conditionally certifies an unindorsed check which is not later indorsed; 4) where the drawer still has possession of the check; or 5) where there is proof that the instrument has been lost.237 Except where the instrument has been lost, the bank's certification may be withdrawn only if the rights of third parties have not intervened.238 As soon as the certified check is transferred to a third person, the certifying bank's right to withdraw or cancel the certification terminates regardless of whether it knew of the transfer,239 thus making the time of the transfer crucial. Withdrawal in the hypothesized setting will most likely occur after the certifying bank learns that the original payee has not received the proceeds of the check. At that point, when the check is presented without the original payee's indorsement, the certifying bank may attempt to cancel the certification. By that time, however, it will be cognizant of AP's and/or Bank-2's interest and will not be able to withdraw certification.240

The certifying bank ought to at least be estopped from asserting its right to cancel the certification after acquiring knowledge of AP's

236. See National Bank of Commerce v. Baltimore Commercial Bank, 141 Md. 554, 556, 118 A. 855, 855-56 (1922); Balducci v. Merchants Nat'l Bank & Trust Co., 74 Misc. 2d 406, 410, 345 N.Y.S.2d 263, 268 (Sup. Ct. 1972), aff'd mem., 41 A.D.2d 1030, 344 N.Y.S.2d 828 (1973). Under the Code, the bank's acceptance in the form of certification is final in favor of a holder in due course. U.C.C. § 3-418. Whether the drafters of the Code intended to treat good faith reliance on acceptance differently from good faith reliance on payment is unclear. Section 3-418, dealing with finality of payment or acceptance, after stating that payment or acceptance is final in favor of the holder in due course, concludes that it is also final in favor of "a person who has in good faith changed his position in reliance on the payment." Id. (emphasis added). This clause was added to the 1957 version of the Code "to make clear the continued application where appropriate of a general principle of law." [1978] 6 BENDERS U.C.C. SERV. § 3-418, at 1-282 (1965). It thus appears that it was not the drafters' intent to treat persons relying on acceptance less advantageously than those relying on payment. Therefore, the person in the position of AP or Bank-2 who relies in good faith on the certification ought to be able to assert its finality, even though certification is not payment.
237. See id. § 7.9, at 158; id. § 7.10, at 160-61.
238. See generally id.
239. See id.
240. See id.
This is clearly an appropriate situation for an estoppel, since the certifying bank has acted in such a fashion as to lead subsequent persons to take the instrument in reliance on the certification. By its certification, the bank indicated to all that it was primarily liable to pay the instrument. The certification was expected to influence third persons to accept the instrument, and it probably would influence AP and Bank-2, particularly since the check lacks a payee's indorsement. Finally, AP and Bank-2 have no way of knowing that the certifying bank desires to cancel its certification, and this desire is not likely to be manifested until after the check is presented by Bank-2. AP and Bank-2 in good faith changed position in reliance on the certification to their substantial detriment. Even if the general rule that withdrawal of certification comes too late after an innocent third person acquires rights in an instrument is not applicable, the certifying bank ought nevertheless to be estopped from asserting its right to cancel the certification.

VII. RIGHTS ADJUSTMENT AND DISPUTE SETTLEMENT

If a funds redirection has occurred, and the certifying bank in fact pays the alternative payee, the bank may then charge the drawer's account. Any certifying bank which pays such an instrument would be engaging in less than prudent banking unless the redirection is accomplished without making the check appear irregular. The question then becomes how the various rights of the parties may be protected. In reality the question is how to protect AP and/or Bank-2 for, as has been shown earlier, the certifying bank has no interest

241. The Code provides that "[u]nless displaced by the particular provisions of this Act, the principles of law and equity, including the law . . . relative to . . . estoppel . . . shall supplement its provisions." U.C.C. § 1-103.

242. See Jamestown Terminal Elevator Inc. v. Hieb, 246 N.W.2d 736 (N.D. 1976). In Hieb, the court stated:

[T]he basic elements of an equitable estoppel, insofar as it relates to the person being estopped, are: (1) conduct . . . which is calculated to convey the impression that the facts are otherwise than those which the party subsequently attempts to assert; (2) the intention, or at least the expectation, that such conduct will be acted upon by, or will influence, the other party or persons; and (3) knowledge, actual or constructive, of the real facts. Insofar as related to the party claiming the estoppel, the elements are: (1) lack of knowledge and of the means of knowledge of the facts in question; (2) reliance, in good faith, upon the conduct . . . of the party to be estopped; and (3) action . . . based thereon, of such a character as to change the position or status of the party claiming the estoppel, to his injury, detriment, or prejudice.


243. See U.C.C. § 3-411(1).

244. See text accompanying notes 236, 238 & 239 supra.
other than its own nonliability, and the account of the drawer has already been debited.

Obviously, the easiest and least costly alternative is a private adjustment of rights, which can be accomplished formally. For example, the certifying bank can insist that the drawer correct the asserted impropriety and make a proper presentment or the certifying bank can demand an indemnity or other agreement from the drawer. A private adjustment can also be accomplished less formally by the certifying bank merely accepting the drawer's assurance that his intent has been effectuated. Where the drawer is on the verge of insolvency or the certifying bank desires to withdraw the certification and exercise a right of set off, however, the bank may refuse not only to pay the check, but also to privately adjust the rights of the parties. In that situation, the rights of Bank-2 and AP to proceed both up to the drawer and down to the certifying bank will become crucial. It is clear that Bank-2 can require AP's indorsement and equally clear that AP can require the drawer's, pursuant to section 3-201(3) of the Code. Where the check has been redirected impliedly, however, indorsement is not what is needed. Rather, the insertion of the drawer's name as alternative payee or the addition of bearer words is required. Although the Code is silent as to whether this modification can be compelled, the better policy would be to read section 3-201(3) to suggest that the "unqualified indorsement" language entails the concept that the transferor engages that he will do what is necessary to effectuate a proper transfer or negotiation. Without this expansive reading, it will be necessary to invoke equity and the principles of contract reformation to avoid an unjust result.

Where the redirection is made by means that make the instrument look irregular or where the certifying bank attempts to withdraw its certification, it may become necessary for AP and Bank-2 to litigate to protect their rights. At that point, the question becomes which parties they should name as defendants and what the underlying theory of recovery should be.

The drawer may assert that because the certifying bank is primarily liable on the instrument, an action against D would be premature. D would contend either that the certified check has not been dishonored or that he has been discharged by the certification.

\[\text{245. See text accompanying notes 157 & 184-86 supra.}\]
\[\text{246. See text accompanying note 144 supra.}\]
\[\text{247. U.C.C. } \S\ 3-201(3).\]
\[\text{248. Id. } \S\ 3-411.\]
A careful reading of the Code, however, indicates that the drawer and/or the certifying bank are proper parties to the action.\textsuperscript{249}

The initial provision of the Code governing the contract liability of the drawer and acceptor of a check is section 3-413,\textsuperscript{250} which provides in part:

(1) The . . . acceptor engages that he will pay the instrument according to its tenor at the time of his engagement or as completed pursuant to Section 3-115 on incomplete instruments.

(2) The drawer engages that upon dishonor of the draft and any necessary notice of dishonor or protest he will pay the amount of the draft to the holder or to any indorser who takes it up.\textsuperscript{251}

Since the bank has accepted the check by certifying it,\textsuperscript{252} it is apparent that the action against the certifying bank is proper, unless “its tenor” in section 3-413 refers to more than merely amount. If it does, by analogizing the check to an incomplete instrument, it could be argued that the certifying bank engaged to pay the instrument to D’s designate.

Pursuant to section 3-507 of the Code,\textsuperscript{253} the liability of the drawer is dependent upon the dishonor of the draft: “(1) An instrument is dishonored when (a) a necessary or optional presentment is duly made and due acceptance or payment is refused . . . ; or (b) presentment is excused and the instrument is not duly accepted or paid. . . . (3) Return of an instrument for lack of proper indorsement is not dishonor.”\textsuperscript{254}

The drawer could assert that the instrument had not been dishonored when it was returned for lack of proper indorsement in cases of implied funds redirection or for having been altered in cases of other redirection, and that therefore action against him was premature. Dishonor, however, also occurs when presentment has been excused and the instrument has not been paid.\textsuperscript{255} Presentment is excused, according to section 3-511(2) of the Code,\textsuperscript{256} when “(a) the party to be charged has waived it expressly or by implication either before or after it is due; or (b) such party has himself dishonored the instrument or has countermanded payment or otherwise has no rea-

\textsuperscript{249} See text accompanying notes 250-59 supra.
\textsuperscript{250} U.C.C. § 3-413.
\textsuperscript{251} Id. § 3-413(1), (2).
\textsuperscript{252} “Certification of check is acceptance.” Id. § 3-411(1).
\textsuperscript{253} Id. § 3-507.
\textsuperscript{254} Id. § 3-507(1), (3).
\textsuperscript{255} Id. § 3-507(1)(b).
\textsuperscript{256} Id. § 3-511(2).
son to expect or right to require that the instrument be accepted or paid . . . ." 257

Where the drawer has ordered a bank to pay an instrument, the bank must be looked to first. 258 If the drawer has acted in such a manner that presentment will not be effective or has done something so that the drawee certifying bank may not be liable, presentment is excused. 259 Here, where the drawer either indorsed the check or attempted to change the recipient of the funds represented thereby, he should not be able to prevent AP or Bank-2 from receiving reimbursement on the technicality that a dishonor has not occurred. The drawer’s actions show either that he waived presentment by implication or that he had no reason to expect that the check as currently drawn would be paid. Both the drawer and the certifying bank are therefore proper parties to an action.

The statutes also make clear that the drawer has not been discharged. 260 The Code provides that a drawer is discharged when a necessary presentment is delayed only if the drawee bank becomes insolvent during the delay. 261 Since the certifying bank is not insolvent here, no discharge would occur. In addition, a drawer is discharged by the act of certification only when the certification is procured by the holder. 262 The drawer who procures certification remains liable. 263 Since the drawer has not been discharged from his obligation to pay the instrument, and the instrument has not yet been paid, he is a proper party to an action. Moreover, the drawer who, through his representations and actions, created the dispute, should not be able to claim that he is not a proper party to an action. The certifying bank not having been prejudiced, it is still bound to its contract and is also a proper party. Full and equitable relief can thus be assured only if both parties are included in an action.

Once the parties and the legal theory for recovery have been established, one must consider the arguments which can be raised by the drawer and the certifying bank. Both will be prevented from prevailing on most factual arguments by an estoppel. The bank will be unable to withdraw its certification and the drawer will be unable to assert the improper form of the check against AP or Bank-2. Both parties may argue that technically no dishonor occurred, but, as has

257. Id. § 3-511(2)(a)-(b) (emphasis added).
258. See id. § 3-413. See also J. White & R. Summers, supra note 92, § 13-9, at 411.
259. U.C.C. § 3-511.
260. See text accompanying notes 261-63 infra.
261. U.C.C. § 3-501(1)(c); id. § 3-502(1)(b).
262. Id. § 3-411.
263. See id., Comment 1.
been suggested, dishonor is not necessary to trigger the drawer's liability if he has no reason to expect payment. 264 The certifying bank may have waived its right to insist upon proper presentment to the extent that its cancellation attempt after the first attempted by Bank-2 evidenced an intent to refuse to pay, even if the asserted impropriety is cured. 265 Where the certifying bank has clearly indicated that it will not honor its certification, neither AP nor Bank-2 need follow through on the procedure of presentment for "[t]he purpose of presentment is to determine whether or not the maker, acceptor or drawer will pay or accept; and when that question is clearly determined the holder is not required to go through a useless ceremony." 266 Whether or not there has been a technical dishonor is therefore immaterial, and AP and Bank-2 would be entitled to prevail against both the drawer and the certifying bank.

VIII. FUNDS REDIRECTION AS A PLANNING TOOL

The final area to be explored is the utility of funds redirection as a planning device. Basically, it has no role whatsoever in preplanning; it is solely a device for adjusting the rights of parties after an attempt has been made to achieve a legitimate end in an unorthodox fashion. This does not mean that funds redirection is either useless or simply theoretical. Because problems like the hypothetical do arise, some method of rights adjustment other than litigation is necessary, although that clearly is an option.

The only prudent advice of counsel to a bank presented with a redirected check would be to refuse payment. It is likely that the attempted redirection by the addition of a payee will escape unnoticed, unless it is less than neat. If the attempt is sloppy, therefore, refusal to pay is in order, but only after checking with the redirector. 267 Ordinarily, the redirection will be discovered by the first bank to take the check, if at all. Although it may seem unreasonable and costly to check with the customer, it will probably be less expensive than refusal and subsequent litigation. Where the defect is the fact that the check looks irregular, the first step should thus be to contact the redirector.

Where the attempted redirection is only implied by indorsement, the first step would be to check any signature card on file. If

264. See text accompanying notes 253-59 supra.
265. See U.C.C. § 3-511(2)(b).
266. Id., Comment 7.
267. As posited, the redirector would be the drawer. In other cases the redirection might be attempted by the payee or an indorsee.
the drawer's indorsement matches closely the signature on file, the next step would be to contact him. Obviously, the check should be treated as a forged indorsement check if the signatures do not match.

Where the redirection has gone unnoticed, so that the check has been paid, or where AP is still in possession of the check, it may become necessary to ascertain whether the check should be treated as bearer or order paper. If the check bears the genuine indorsement of the drawer, his initials, or something similar next to an alteration, it is probably preferable to treat the paper as bearer paper capable of negotiation by delivery alone.\textsuperscript{268} This has the advantage of constituting subsequent takers as holders, thus allowing them to prevail against the certifying bank if they can show they qualify as holders in due course.\textsuperscript{269} It has the disadvantage of surrendering the certainty associated with a rule of no payment on irregular instruments. Although the probability of recovery is left to chance, that can be minimized to the extent that the taker at least inquired of the transferor about the redirection. More importantly, the number of times such a situation presents itself warrants the continued use of the bearer analogue. The alternative, to deny recovery by the good faith for value transferee because of the refusal to adopt a bearer analysis, is both unreasonable and unjust. This analysis requires the transferee to perform the essentially useless act of seeking formal alteration of the check. Moreover, it unjustly enriches either the certifying bank or the drawer at the expense of a good faith, though admittedly negligent, transferee.

It must be stressed that the use of the bearer analogue does not facilitate AP's task of proving the genuineness of the signatures, good faith, or value. It does deprive the certifying bank of the opportunity to assert that the negligence of AP constituted notice of a claim or defense, since AP should have realized that the improper indorsement or seeming alteration suggested a defense or claim. Holder in due course status may not be necessary, however, and the use of the bearer analysis only addresses the redirection irregularity. Other possible irregularities may still preclude holder in due course status.

It should be clear that one ought to try to avoid the problem of funds redirection. Since certified checks invariably deal with larger sums than other checks, it may be necessary to resolve disputes surrounding certified check redirection more often than those involving redirection of other checks. Although the only planning for the transaction that can be done is to advise avoidance and care, once the redirection attempt does occur it can be dealt with sensibly.

\textsuperscript{268} See U.C.C. § 3-202(1).
\textsuperscript{269} See notes 211-31 and accompanying text supra.
IX. Conclusion

The certified check remains viable despite the problems which surround it and despite its treatment at the hands of courts like those in *Tonelli*. In the area of funds redirection, where the certified check is likely to appear more often than its noncertified counterpart, the problems presented by certification are not so different from those presented by other, less secure paper. To ascertain who prevails in a funds redirection case, it is necessary to determine the intent of the drawer. This intent is not the fictional intent arrived at by inspecting the words of the drawer on his check. Rather, it is his expressed intent which can be discovered by his actions and words at the time of redirection and thereafter. Regardless of how the redirection is effected, or who the beneficiary is, or what type of accepted or unaccepted instrument is at issue, both policy and justice will be satisfied if strict attention is paid to the redirector's intent.

Funds redirection can never be used from a planning point of view, for advising clients to use less than fully accepted means of transferring paper or to accept improperly indorsed paper would invite dispute. It is equally obvious, however, that people often pursue courses of action that are expedient but not advisable. When funds redirection does occur, therefore, and counsel's advice becomes necessary, redirection should be given effect as long as the client can be fully protected.

270. See *Farmer's Bank v. Humphrey*, 36 Vt. 554 (1864). In *Humphrey*, the court held that an instrument made payable to one payee but delivered to another with no indorsement whatsoever was enforceable by the payee, so long as he gave consideration for the transfer. *Id.* at 557.