

HEY, BUT IT'S MY MONEY!
OWNERSHIP AND THE ENFORCEMENT OF CONVERSION LIABILITY
UNDER U.C.C. § 3-420

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* Professor of Law, DePaul University College of Law; J.D., Cornell Law School, 1973; B.A., Rutgers, The State University of New Jersey, 1970. I would like to thank my colleague and friend, Professor Steven Resnicoff, for his keen insights and helpful suggestions during the development of this article. It is appropriate to note that I acted as a consultant for plaintiff in *American National Insurance Co. v. Citibank, N.A.*, 543 F.3d 907 (7th Cir. 2008), a case prominently featured in this article, and participated in the writing of briefs and preparation for oral argument before the United States Court of Appeals for the Seventh Circuit. For that opportunity and the confidence he showed in me, I would like to thank William A. Chittenden, III of the law firm, Chittenden, Murday & Novotney, LLC. Many of the arguments set forth in this article were developed in discussions with Bill and attorneys Jennifer Stegmaier, with whom I worked closely on the briefs, and Elizabeth Doolin, who presented the oral argument. I thank them for their contributions as well. Last, but certainly not least, I thank my wife Judy, for her love and support, not only during the writing of this article, but also during the long and late hours put in working on the case.

** LL.M., New York University School of Law, 2011; J.D., DePaul University College of Law, 2008; B.A., Colgate University, 2005. I am extremely grateful for the helpful comments and insights of Professor Steven Resnicoff, and as always for the love and support of my wife Emily.

Abstract

One of the driving engines of the American economy is the creativity of the businesspeople that build the new and unique commercial arrangements which foster society-wide growth. The only limit on that growth engine should be the imagination of the business community. The Uniform Commercial Code ("Code") regulates commerce in a way that ensures such visionary thinking will not be stymied and new, unique commercial arrangements will flourish. This Article concerns one section of the Code which courts and practitioners wrongly have interpreted to undermine the intent of the Code's drafters and impede American business.

The Code's provision for conversion, section 3-420, creates a broad understanding of liability for conversion of an instrument under the statute. When written, it meaningfully broadened the category of potential conversion defendants. That section should thus be read to ensure that the parties able to enforce conversion liability include all of its potential victims, such as the entity to whom an instrument's proceeds were due and owing on account of services it had rendered. This may not always be the payee or indorsee on the instrument in commercial arrangements vital to the health of the broader economy, such as modern commercial insurance underwriting and a variety of trustee-beneficiary relationships.

In this Article, we take a unique case-by-case view to examine how courts have gone wrong in their understanding of section 3-420. By closely following the evolution of the misguided judicial limitation on the proper party plaintiffs to a statutory conversion action, the Article demonstrates how seemingly logical statements of law led later courts to reach illiberal understandings of conversion contrary to the design of the Code. The Article then argues that a proper understanding of section 3-420 should permit an instrument's true owner to enforce a party's liability for converting that instrument, even when the true owner is not the named payee or indorsee. Finally, in light of the prevalence of judicial misunderstanding of section 3-420, we recommend a simple amendment to that section's language that would correct those errors and ensure the smooth flow of commerce in the future.

Introduction

The rule of law is at the heart of a modern, complex economy. Before they can pursue the intricate transactions that drive growth throughout society, commercial actors must be assured that their property rights will be respected and, when those rights are violated, the legal system will provide a forum where they can be vindicated. This includes ownership of all forms of property, including, as is the focus of this Article, negotiable instruments. But as this Article notes, those rights are threatened by judicial interpretations of the Uniform Commercial Code (“U.C.C.” or “Code”), which needlessly limit the ability of instruments’ true owners to uphold their interests when they have been the victims of conversion.¹ We will argue that these rights cannot be abrogated and that *all* injured parties should be permitted to enforce conversion liability against wrongdoers under the U.C.C.

“A conversion imports an unlawful act, or an act that cannot be justified or excused in law.”² It has been defined as “wrongful control or dominion over personal property in a way that repudiates an owner’s right in the property in denial of or in a manner inconsistent with such right.”³ Such wrongful dominion thus amounts to an interference with an *owner’s* rights; it is the person or entity with the bundle of rights implied by ownership that is truly a conversion’s victim. In the negotiable instruments context, the owner whose rights are repudiated by a conversion may not always be the payee on an instrument. As we discuss below, a conversion’s victim may instead be the entity to whom the proceeds were due and owing on account of services it had rendered, while the payee on the payment instrument was merely that owner’s representative. This is frequently so in two contexts: modern commercial insurance arrangements and a variety of trustee-beneficiary relationships. Failing to recognize that such a true owner has been the victim of conversion and must be able to enforce conversion liability is particularly damaging to the free flow of commerce.

¹ See, e.g., *Am. Nat’l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 910 (7th Cir. 2008); *Fine v. Sovereign Bank*, No. 06cv11450-NG, 2010 WL 3001194, at *3 (D. Mass. July 28, 2010).

² 18 AM. JUR. 2D *Conversion* § 20 (2004).

³ *Id.* § 1.

U.C.C. section 3-420 unequivocally establishes the liability of converters for their actions.⁴ It begins by defining conversion: an instrument is converted either under the law applicable to personal property or “if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment.”⁵ Then, rather than specifying which parties can enforce that liability, the provision delineates those parties who may *not*: “(i) the issuer or acceptor of the instrument or (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.”⁶ Quite simply, that is all section 3-420(a) says about the proper party plaintiff in a conversion action. What courts and practitioners must acknowledge is that other parties not specifically mentioned in section 3-420(a), such as a party not named on the instrument that maintains an ownership interest in it and its proceeds, are not precluded and thus should be able to enforce the liability of a converting party.

This Article seeks to defend such parties’ rights. Misinterpretations of the Code have limited the would-be plaintiffs in a conversion case to only the payee (or indorsee)⁷ on such instruments.⁸ No such language exists anywhere in the Code or its comments. It should not be implanted there by judicial fiat. We will argue that the Code currently does not exclude such true owners from enforcing conversion liability and further suggest revisions to the Code’s language to alleviate any doubt about the rights of a true owner in a conversion action.

This Article proceeds as follows. Part I focuses on the specific language of section 3-420 and its predecessor section 3-419, using a discussion of the evolution of conversion claims under the Code to explain the drafters’ choice of language in the current version of Article 3. Part II turns to the judicial application of that

⁴ See U.C.C. § 3-420 (2002).

⁵ § 3-420(a).

⁶ *Id.*

⁷ Throughout this Article, references to “payees” may fail to designate “indorsees” as well. It should be assumed that such references intend to include “indorsees.”

⁸ See, e.g., *Am. Nat’l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 910 (7th Cir. 2008); *Fine v. Sovereign Bank*, No. 06cv11450-NG, 2010 WL 3001194, at *3 (D. Mass. July 28, 2010).

language to the conversion of negotiable instruments. We argue that most courts' interpretations of section 3-420 have needlessly restricted the category of proper party plaintiffs to a statutory conversion action to only named payees, while a broader understanding of the category that includes true owners hews to the spirit of common law conversion and would not be unduly burdensome on the banking industry, as some have asserted.⁹ Part III identifies other sections of the Code that support a non-payee's right to bring a conversion suit. Part IV then details the broad group of important commercial actors whose rights to enforce the liability of converters would be eviscerated if courts continue to follow a misguided understanding of section 3-420. Finally, Part V makes a few brief suggestions for changes to the Code's language to clarify the proper plaintiffs to a conversion action for courts and practitioners.

I. History and Background of U.C.C. § 3-420

The formulation of section 3-420 is very simple. After first specifically defining what constitutes conversion and those who may be defendants in a conversion action, the section uses negative language to describe potential plaintiffs.¹⁰ The section reads as follows:

An instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment. An action for conversion of an instrument may not be brought by (i) the issuer or acceptor of the instrument or (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.¹¹

The meaning of this language is clear. The first sentence, by referencing common law conversion actions for personal property,

⁹ See *Citibank*, 543 F.3d at 909–10.

¹⁰ § 3-420(a).

¹¹ *Id.*

identifies thieves and persons who initially exercise unlawful dominion over found instruments as potential defendants in an Article 3 conversion action.¹² The second sentence specifically identifies takers of instruments, payor banks, depository banks, and other collecting banks who engage in transactions with persons not entitled to enforce such instruments as potential defendants as well.¹³ Importantly distinct from this definition of conversion liability are the last sentence's limitations on the parties that can enforce such liability, which are themselves quite circumspect. Only an issuer or acceptor of an instrument or a payee or indorsee who did not receive delivery of the instrument is prohibited from bringing a conversion action.¹⁴ Just as important as what this sentence says is what it does not say. This section does not reserve the enforcement of conversion liability to chosen parties, such as the payee; instead, it strips certain named parties of the right to bring a conversion suit.¹⁵ We contend then that the right to sue for conversion under Article 3 is preserved for others not described in section 3-420, including parties not named on an instrument that maintain an ownership interest in it and its proceeds.

The current provision of Article 3 of the Code dealing with conversion, section 3-420, was part of the 1990 Code revisions and replaced the former section 3-419.¹⁶ The history of the revision process and the drafters' commentary make it very clear what the drafters intended to accomplish with their chosen language.¹⁷

First, they intended to expand the definition of conversion to include defendants and circumstances not clearly delineated in the prior provision. Under former section 3-419(1) of the code, an instrument was converted when

- (a) a drawee to whom it is delivered for acceptance refuses to return it on demand or;
- (b) any person to whom it is delivered for payment refuses on demand either to pay it or to return it; or

¹² *See id.*

¹³ *See id.*

¹⁴ *WWP, Inc. v. Wounded Warriors, Inc.*, No. 8:07CV370, 2009 WL 2259974, at *3 (D. Neb. July 24, 2009).

¹⁵ *See* § 3-420(a).

¹⁶ § 3-420 cmt. 1.

¹⁷ *See* U.C.C. § 3-420 cmts. 1-3 (1990).

(c) it is paid on a forged indorsement.¹⁸

Paragraphs (a) and (b) were deleted in the revision because they were too narrow, and the drafters deemed them inappropriate under certain circumstances.¹⁹ Instead, the drafters determined that the general law of conversion applicable to personal property should govern when the right of possession had been denied under the Code.²⁰ Thus, converters would include the actual thief of an instrument or any party who initially exercised unlawful dominion over the instrument, parties not specified in the earlier version.

Under paragraph (c) of former section 3-419, conversion only occurred when an instrument was *paid* on a *forged* indorsement.²¹ Technically, this meant that only a drawee or a person obligated on the instrument (a maker, drawer, or indorser) could convert it because they are the only parties who *pay* an instrument.²² All others to whom an instrument is transferred and who give money in return are merely *taking it for consideration*—they are not paying it and thus would not be converting the instrument. This would include a depository bank that cashed a stolen check for its customer.

Even more importantly, the drafters of the revised section 3-420 wanted to clarify that a depository bank taking an instrument for deposit from a customer who was not a person entitled to enforce and obtaining payment for him *was* converting that instrument.²³ The issue had been confused not only by the language in section 3-419 referring to instruments being converted when *paid*, but also by additional language releasing from conversion liability representatives, including depository banks, acting in good faith who no longer held the funds involved.²⁴ Former section 3-419(3) “drew

¹⁸ U.C.C. § 3-419(1) (1989).

¹⁹ Specifically “in cases of non-cash items that may be delivered for acceptance or payment in collection letters that contain varying instructions as to what to do in the event of nonpayment on the day of delivery.” U.C.C. § 3-420 cmt. 1 (2002).

²⁰ *Id.* (“It is better to allow such cases to be governed by the general law of conversion that would address the issue of when, under the circumstances prevailing, the presenter’s right to possession has been denied.”).

²¹ U.C.C. § 3-419(1) (1989).

²² *Id.*

²³ U.C.C. § 3-420 cmt. 1 (1990).

²⁴ Former section 3-419(3) read:

criticism from the courts,” which found many ways to interpret the facts to ensure that the provision did not apply.²⁵ Some courts found that the depository bank was not a “representative,”²⁶ some that the bank had not acted in good faith²⁷ or in accordance with reasonable commercial standards,²⁸ some that the bank still held the proceeds,²⁹

Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depository or collecting bank, who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.

U.C.C. § 3-419(3) (1989). *See also* *Knesz v. Central Jersey Bank & Trust Co.*, 457 A.2d 1162, 1166–70 (N.J. Super. Ct. App. Div. 1984), *rev'd*, 477 A.2d 806 (N.J. Sup. Ct. 1984); *Moore v. Richmond Hill Sav. Bank*, 502 N.Y.S.2d 202, 206–07 (N.Y. App. Div. 1986) (describing cases using this language to insulate a depository bank from liability for conversion).

²⁵ U.C.C. § 3-420 cmt. 3 (1990).

²⁶ “One line of cases has held that a depository or collecting bank cannot be a ‘representative’ within the meaning of this subsection. These courts have reasoned that section 4–201 makes a collecting bank an agent only of the owner of the instrument and not of the forger/depositor; therefore, the bank is not acting as a representative when it deposits or pays an instrument over a forged endorsement. These courts have also relied upon the common-law principle that a bank’s agency status is brought to an end upon collection of the paper.” *Matco Tools Corp. v. Pontiac State Bank*, 614 F. Supp. 1059, 1063 (E.D. Mich. 1985) (collecting cases); *see also Knesz*, 457 A.2d at 1169.

²⁷ *See, e.g., Landmark Bank v. Hegeman-Harris Co.*, 522 So. 2d 1051, 1051–52 (Fla. Dist. Ct. App. 1988) (“[W]hether the bank acted intentionally and in bad faith, or negligently but in good faith, the true payee would still have a prima facie cause of action for conversion against the collecting bank.”).

²⁸ *Moore*, 502 N.Y.S.2d at 205 (citing *Tette v. Marine Midland Bank*, 435 N.Y.S.2d 413 (N.Y. App. Div. 1981) (“Some courts have found the depository or collecting bank liable by finding that it has failed to act in accordance with reasonable commercial standards.”); *Belmar Trucking Corp. v. Am. Trust Co.*, 316 N.Y.S.2d 247, 254 (N.Y. Civ. Ct. 1970); *Salsman v. Nat’l Cmty. Bank*, 246 A.2d 162, 168 (N.J. Super. Ct. App. Div. 1968).

²⁹ *Moore*, 502 N.Y.S.2d at 205 (citing *Cooper v. Union Bank*, 507 P.2d 609 (Cal. 1973)) (“The Supreme Court of California, by using certain elements

and some just ignored section 3-419(3) altogether.³⁰ The likely motivation for such judicial acrobatics was the judges' realization that the depositary bank would ultimately absorb the liability anyway, but only after a circuitous route of unnecessary litigation. Under section 3-419, the owner of the instrument would first have to bring a conversion action against the drawee bank that paid the instrument and then the defeated drawee bank could sue the depositary bank for breach of presentment warranty.³¹ If a thief stole several checks written by numerous drawers on different drawees, forged the payees' indorsements, and deposited the checks in her depositary bank, a multitude of actions could result in an effort to ultimately hold the depositary bank accountable.³² The drafters made it clear that there was no reason to require such wasteful litigation³³ and provided instead, under section 3-420(c),³⁴ the opportunity for

of pre-UCC law, reasoned that a depositary or collecting bank held the 'proceeds' of the check for the true owner's benefit as if it were a constructive trustee.").

³⁰ *E.g.*, *Lund v. Chemical Bank*, 797 F. Supp. 259, 272 (S.D.N.Y. 1992) (holding that section 3-419(3) did not apply because it would lead to the plaintiff's unjust enrichment through double compensation).

³¹ Under sections 3-417 and 4-208, the person presenting the instrument and obtaining payment or acceptance (and all prior transferors) warrants to the drawee that she is either a person entitled to enforce the instrument or authorized to obtain payment or acceptance on behalf of a person entitled to enforce the instrument. Thus, each drawee bank would be able to recover the monies paid out from the single depositary bank that presented the instrument to each drawee bank because the depositary bank obtained payment on behalf of its depositor who was not a person entitled to enforce the instrument. U.C.C. §§ 3-417, 4-208 (2002).

³² *See, e.g.*, *Whalen v. Chase Manhattan Bank*, No. 99 Civ. 11161, 2000 WL 1801839, at *3 (S.D.N.Y. Dec. 7, 2000); *Grieshaber v. Mich. Nat'l Bank of Detroit*, No. 4 254 187, 1976 WL 23723, at *1255 (Mich. Com. Pl. Mar. 22, 1976).

³³ § 3-420 cmt. 3; *see also Grieshaber*, 1976 WL 23723, at *1255 ("We hardly think that the Code, with its avowed purpose of simplifying commercial transactions, intended that the same final result as under pre-Code law be reached, but only at the expense of redundant and burdensome litigation.").

³⁴ "A representative, *other than a depositary bank*, who has in good faith dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion to that person beyond the amount of any proceeds that it has not paid out." § 3-420(c) (emphasis added).

the instrument's owner to bring just one action against the depository bank.³⁵

The other reason for revising the Code's definition of conversion was that the language in former section 3-419(1)(c) required a *forged indorsement*.³⁶ Such language misses the point that an instrument lacking a necessary indorsement could be converted as well because, without that indorsement, an instrument would not be properly negotiated, thus making parties in possession non-holders.³⁷ Despite the language in the Code, courts enforcing section 3-419 would find conversion where an indorsement was completely missing³⁸ or where less than all of the joint payees had indorsed the instrument,³⁹ even though there was no *forged* indorsement. Accordingly, the language of section 3-420(a) nowhere refers to forgeries, instead referring to "transfers other than by negotiation" and "persons not entitled to enforce."⁴⁰

Secondly, former section 3-419 was revised specifically to resolve conflicts in the cases where questions arose as to whether a drawer of a check with a forged indorsement or a payee who never received the instrument were proper plaintiffs in a conversion action.⁴¹ It is for this reason that the current Code language

³⁵ § 3-420 cmt. 3.

³⁶ See U.C.C. § 3-419(1) (1989).

³⁷ Where an instrument is payable to a specified person, that person's indorsement is necessary to negotiate the instrument. When an instrument is payable to two or more persons and the payees are joint rather than alternative payees, section 3-110(d) requires that all payees sign for the instrument to be negotiated. § 3-110(d).

³⁸ See, e.g., *Capital Dist. Tel. Emps. Fed. Credit Union v. Berthiaume*, 432 N.Y.S.2d 435, 439 (N.Y. Sup. Ct. 1980) (holding that where a customer deposited a check without the indorsement of a copayee, the customer's unauthorized negotiation of the check was a conversion).

³⁹ See, e.g., *Great Am. Ins. Cos. v. Am. State Bank of Dickinson*, 385 N.W.2d 460, 465 (N.D. 1986) (holding that a bank that pays a draft without obtaining endorsement of a copayee may be liable to copayee for conversion of draft).

⁴⁰ § 3-420(a).

⁴¹ § 4-401 cmt. 1. Among those cases that held that a drawer could sue for conversion were *Wymore State Bank v. Johnson Int'l Co.*, 873 F.2d 1082, 1088-89 (8th Cir. 1989) (applying Nebraska law); *Justus Co. v. Gary Wheaton Bank*, 509 F. Supp. 103, 105 (N.D. Ill. 1981); *Tedesco v. Crocker Nat'l Bank*, 148 Cal. App. 3d 1211, 1217 (Ct. App. 1983); *Thornton & Co. v. Gwinnett Bank & Trust Co.*, 260 S.E.2d 765, 767 (Ga. Ct. App. 1979); *Douglass v. Wones*, 458 N.E.2d 514, 519-20 (Ill. App. Ct. 1983). Among

articulates who *cannot* bring a conversion, rather than defining specifically who *can*.⁴² If the drafters had intended to limit conversion plaintiffs to payees who had received delivery, they could have simply said that—but they did not. With respect to drawers,⁴³ section 3-420(a)(i) follows the rule stated in *Stone & Webster Engineering Corp. v. First National Bank & Trust Co.*, which held that there was no reason why a *drawer* should have an action in conversion.⁴⁴ *Stone & Webster* found that a check represents an *obligation* of the drawer to pay, rather than property of the drawer, and, therefore, the drawer did not have the requisite possessory interest in the checks to bring a claim for conversion.⁴⁵ The instruments that drawers have issued are no longer in their control, and so what is not “theirs” cannot be “converted” to another’s possession.⁴⁶

those cases that held that a payee could sue in conversion despite never receiving delivery were *Lund's Inc. v. Chemical Bank*, 870 F.2d 840, 851 (2d Cir. 1989); *Bloempoort v. Regency Bank of Fla.*, 567 So.2d 923, 924 (Fla. App. 1990) (holding that a constructive delivery occurs when a drawer surrenders control of the instrument, such as when drawer gave the instrument to the party who subsequently forged it); *Burks Drywall, Inc. v. Wash. Bank & Trust Co.*, 442 N.E.2d 648, 653 (Ill. App. Ct. 1982); *Sony Corp. of Am. v. Am. Express Co.*, 455 N.Y.S.2d 227, 230 (N.Y. Civ. Ct. 1982).

⁴² See § 3-420(a).

⁴³ Section 3-420 actually uses the word “issuer” rather than drawers (or makers). However, section 3-105 states that “‘Issuer’ applies to issued and unissued instruments and means a maker or drawer of an instrument.” § 3-105.

⁴⁴ 184 N.E.2d 358, 362 (Mass. 1962); see also § 3-420 cmt. 1.

⁴⁵ *Brandy v. Fifth Third Bank*, No. 1:08-CV-1064, 2011 WL 4463415, at *7 (N.D. Ohio Sept. 27, 2011); see also *Crawford Supply Grp., Inc. v. Bank of Am.*, No. 09-C-2513, 2011 WL 1131292, at *12 (N.D. Ill. Mar. 28, 2011) (quoting U.C.C. § 3-420 cmt. 1 (2002)) (“There is no reason why a drawer should have an action in conversion [against a depository bank]. The check represents an obligation of the drawer rather than property of the drawer.”); *Great Lakes Higher Educ. Corp. v. Austin Bank of Chi.*, 837 F. Supp. 892, 897 (N.D. Ill. 1993) (“[B]ecause the checks represent a debt of [the plaintiff drawer/drawee] rather than an asset, [the plaintiff drawer/drawee] could not have had the requisite possession or interest in them to claim conversion.”); *Stone & Webster*, 184 N.E.2d at 362.

⁴⁶ White and Summers explain why a drawer is not a proper party plaintiff in a conversion action by noting that “[o]ne’s own check is an obligation, not a right. It is a liability that cannot be stolen, not an asset that can be

Furthermore, drawers have alternative remedies under the U.C.C. should an instrument bearing their name be converted. Under section 4-401, banks are empowered only to charge against a customer's account items that are "properly payable."⁴⁷ Banks may not make such charges on an item which is not properly payable, including one paid to a person not entitled to enforce the instrument.⁴⁸ Should the bank charge the drawer's account for an instrument wrongfully paid, the drawer has a right to have his account recredited under section 4-401(a).⁴⁹ Drawers are therefore protected from wrongdoers who would co-opt one of their instruments. Thus, the U.C.C.'s drafters (and courts alike) have recognized that there is no need to grant drawers access to the additional remedy of enforcing conversion liability.⁵⁰

Before the revision, courts also disagreed as to whether a payee who never received the instrument was a proper party to sue in conversion.⁵¹ Section 3-420 makes it clear that such a party does *not* have a right to sue in conversion (this is the other specifically excluded class of potential plaintiffs).⁵² First, since the instrument was never delivered to the payee, she never had possession or ownership of it and thus could not be a holder or a person entitled to enforce under section 3-301.⁵³ Like drawers, the payee who never received the instrument did not have the requisite possessory interest for a claim in conversion. Secondly, also like drawers, the payee does not need the conversion action, because she has another

stolen." 2 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 18-4 (5th ed. 2000). Incidentally, since the definition of "issuer" includes drawers of "unissued" instruments, as well as those that are issued, it can be said that a drawer or maker may not sue in conversion under section 3-420, even if the instrument is stolen from his possession before it has been issued.

⁴⁷ § 4-401 cmt. 1.

⁴⁸ *Id.*

⁴⁹ *See id.*

⁵⁰ *See, e.g., Brandy*, 2011 WL 4463415, at *7; *Crawford*, 2011 WL 1131292, at *12.

⁵¹ § 3-420 cmt. 1 ("There was also a split of authority under former Article 3 on the issue of whether a payee who never received the instrument is a proper plaintiff in a conversion action.").

⁵² § 3-420(a).

⁵³ *See id.*

remedy. Since the obligation that gave rise to the instrument is still unpaid, the payee can sue on the underlying obligation instead.⁵⁴

Although the drafters resolved the specific *existing* conflicts about parties with standing to sue for conversion, they neglected to identify potential plaintiffs in positive terms. It is thus left to the courts to grapple with specific issues that arise under section 3-420, including cases where the payee on an instrument is merely acting as a representative of the true owner of that instrument who gave the consideration for which the instrument was issued. Some of the court decisions regarding such common commercial arrangements are discussed in the next Part.

II. *Judicial Views on the Conversion of Instruments and Personal Property*

The overwhelming majority of courts have suggested that the *only* proper party plaintiff to a conversion action under the Code is a payee or indorsee on the instrument at issue. But in almost all of those cases, the assertion is made in the context of a competing party who clearly does not have standing to sue. A typical example is *Great Lakes Higher Education Corp. v. Austin Bank of Chicago*, where the United States District Court for the Northern District of Illinois held that “payees were the only ones who had the requisite possessory interest in the checks [at issue] to bring a claim of conversion.”⁵⁵ *Great Lakes* concerned a drawee bank’s effort to bring a conversion action under former section 3-419 against the depository bank that had taken for collection a number of the drawee bank’s checks without an indorsement by the payee.⁵⁶ The court was right to hold that the drawee’s “only interest in the checks at the time of the alleged wrongdoing was an obligation

⁵⁴ Section 3-310 only suspends or discharges the underlying obligation when an instrument is *taken* for an obligation. When the instrument is never delivered to the payee, the underlying obligation to the payee is unaffected. See § 3-420 cmt. 1.

⁵⁵ 837 F. Supp. 892, 897 (N.D. Ill. 1993).

⁵⁶ The court in *Great Lakes* said that each check was “presented for payment” to the depository bank and “accepted” by it. *Id.* at 894. This is another common example of a court misusing Article 3’s technical language. A check is only presented to a drawee bank for payment and can only be accepted by a drawee bank. And in any event, it is not accepted when it is paid.

or debt to the payees,” and hence the drawee did not have a sufficient possessory interest in the checks to sue for conversion.⁵⁷ But the court added, unnecessarily, that *only* the payees had such a right.⁵⁸ While it is true enough that the payee’s interest in a check is superior to the drawee’s, the payee may not necessarily be the only party with such a possessory or ownership interest. The *Great Lakes* court’s opinion, though sufficient to resolve the drawee versus payee conflict in that case, improperly laid the groundwork for future exclusion of other legitimate parties from the class of proper party plaintiffs to a U.C.C. conversion case.

A similar pattern emerged in *Pamar Enterprises v. Huntington Banks of Michigan*.⁵⁹ In that case, the plaintiff general contractor drew a \$50,000 check payable to two parties, a subcontractor and its supplier, intending that all the proceeds of that check be eventually paid only to the supplier.⁶⁰ When the payee subcontractor deposited the check without its co-payee’s indorsement, the defendant depository bank presented the check to the defendant drawee bank which paid it, and the subcontractor took the funds and never paid the supplier as intended by the drawer.⁶¹ The drawer general contractor then brought a claim in conversion against the depository and drawee banks.⁶² The court held that the drawer of the check could not maintain a claim in conversion because “the check represents an obligation of the drawer rather than property of the drawer.”⁶³ The court reached that decision because it held that “[a] conversion action may be brought by the intended payee against either the depository bank or the drawee bank.”⁶⁴ Again, while the rule is true enough, it is incomplete; it suggests that *only* the payee has a sufficient interest in a check to maintain a conversion action.

Nearly every case dealing with conversion suggests that a plaintiff must demonstrate her ownership of, interest in, or right to

⁵⁷ *Id.* at 897.

⁵⁸ *Id.*

⁵⁹ 580 N.W.2d 11, 13 (Mich. Ct. App. 1997).

⁶⁰ *Id.*

⁶¹ *Id.* at 14.

⁶² *Id.*

⁶³ *Id.* at 16.

⁶⁴ *Id.* at 15.

possession of the instrument.⁶⁵ As the cases discussed above well illustrate, in almost all of those cases the payee *is* the proper party plaintiff. Commonly, the payee either provided the consideration for which the instrument was issued (services, goods, or property) to the issuer, or the payee was the intended recipient of a gift from the issuer, thereby making the payee the true owner of the instrument and its proceeds. But as this Article illustrates, in many commercial arrangements, the payee is merely a representative of the true owner of an instrument and its proceeds.⁶⁶ Only a few cases have dealt with that issue, which is far from unusual in today's commercial marketplace. Those cases have largely held that non-payees cannot sustain an action in conversion, following the misleading rule statements made in the more numerous payee vs. drawee or drawer cases.⁶⁷

The United States Court of Appeals for the Seventh Circuit in *American National Insurance Co. v. Citibank, N.A.* denied standing to a non-payee who claimed to be the true owner of the proceeds of an instrument that had been converted by a depository bank.⁶⁸ In that case, plaintiff American National Insurance Company ("ANICO"), an insurer, engaged another company, National Accident Insurance Company ("NAIU"), to act as its managing general underwriter.⁶⁹ Under that now common commercial arrangement, NAIU would issue insurance policies and collect premiums on ANICO's behalf.⁷⁰ One of NAIU's employees, Robert Carter, began altering premium checks made payable to NAIU (but representing premiums owed in total to ANICO), by adding himself or his shell corporation "Sherman Imports" as an alternative payee

⁶⁵ See, e.g., *Am. Nat'l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 909 (7th Cir. 2008); *Cont'l Cas. Co. v. Am. Nat'l Bank & Trust Co. of Chi.*, 768 N.E.2d 352, 361 (Ill. App. Ct. 2002); *Clients' Sec. Fund of State of N.Y. v. Goldome*, 560 N.Y.S.2d 84, 86–87 (N.Y. Sup. Ct. 1990).

⁶⁶ As discussed in greater detail below, these would include instruments made payable to "managing general agents" hired by insurance companies to handle premiums and claims of the insurance companies' customers, to the trustee of a trust, or to lawyers acting on behalf of a client entitled to a judgment or settlement. See *infra* Part IV.

⁶⁷ See, e.g., *Citibank*, 543 F.3d at 910.

⁶⁸ *Id.* at 908.

⁶⁹ *Id.*

⁷⁰ *Id.*

on the instrument.⁷¹ Carter deposited some forty-four altered checks worth over \$15 million with defendant Citibank, which converted those instruments by obtaining payment on his behalf, despite the fact that Carter, in either his own name or as an officer of the shell corporation added to the check, was not a person entitled to enforce them.⁷²

When ANICO sued Citibank for its conversion of the checks of which ANICO claimed it was the true owner, the Seventh Circuit held that ANICO could not enforce that conversion liability under the U.C.C.⁷³ The court began its analysis by detailing three elements a plaintiff in a U.C.C. conversion case has the burden to prove: “(1) her ownership of, interest in, or right to possession of the check; (2) the fact that her apparent endorsement of the check was forged or unauthorized; and (3) the fact that the defendant bank was not authorized to cash the check.”⁷⁴ The court relied upon its previous rule statement in *Rodrigue v. Olin Employees Credit Union*, an instrument conversion case where the plaintiff was a named payee.⁷⁵ The Seventh Circuit expressed wariness in allowing any non-payee to enforce conversion liability for fear of opening a Pandora’s Box for the banking industry:

Instead of being able to look at the payee line and to verify that the person presenting the check was indeed entitled to do so, banks . . . would need to conduct a full-blown investigation every time to make sure that a party with an equitable interest in the check was not lurking in the background. Such a system would bring commercial transactions to a grinding halt.⁷⁶

⁷¹ *Id.* (“In 2002, [NAIU] discovered that one of its vice presidents, Robert Carter, had been intercepting premium checks, altering the payee line to make them payable to himself or his company “Sherman Imports,” and depositing them in a Citibank account over which he had control. Citibank accepted forty-four altered checks, from five different drawers, for a total face value of \$15,813,964.84.”).

⁷² *Id.*

⁷³ *Id.* at 910–11.

⁷⁴ *Id.* at 909 (citing *Rodrigue v. Olin Emp. Credit Union*, 406 F.3d 434, 439 (7th Cir. 2005)).

⁷⁵ *Id.* at 909 (citing *Rodrigue*, 406 F.3d at 435–36).

⁷⁶ *Id.* at 909–10.

The Seventh Circuit held that ANICO's action was based on its intangible rights in the underlying contract it had with NAIU.⁷⁷ The court reasoned that, while the rights involved with commercial paper merge into the document, ANICO's intangible rights in the underlying contract did not merge with the checks at issue and could not form the basis for a conversion suit.⁷⁸ The court thus created a distinction between the checks themselves as a piece of property and "the funds backing the checks," finding that ANICO's claim to the latter did not entitle it to maintain a claim for conversion of the former.⁷⁹

The Seventh Circuit committed three significant errors in its reasoning. The first came in the court's quotation of the seemingly innocuous rule statement in *Rodrigue*, which precludes multitudes of worthy plaintiffs from enforcing conversion liability.⁸⁰ It assumes that the proper plaintiff must have been the party whose name appeared on the instrument and whose signature was forged or unauthorized, in turn implying that the plaintiff in a conversion case was necessarily the payee, as was the plaintiff in *Rodrigue*.⁸¹ That implication is improper. There is a logical disjunction between the first sentence of that rule statement, which permits any party with an ownership interest in a check to bring a conversion action, and the second, which implicitly limits would-be plaintiffs to only those who both have such an interest *and* are named on the instrument. Those categories are not mutually exclusive. The Seventh Circuit's extra-textual limitation improperly identified the two,⁸² and in the process wrongfully prohibited plaintiffs like ANICO from enforcing conversion liability against a bank that has converted an instrument of which it was the rightful owner.

The Seventh Circuit's second error was its assumption that finding in ANICO's favor would unduly burden banks, requiring

⁷⁷ *Id.* at 910.

⁷⁸ *Id.*

⁷⁹ *Id.* ("Unless ANICO can show a possessory interest in the checks, it cannot sue for conversion, because its only interest is a derivative claim to the funds, not a claim to the instruments themselves.")

⁸⁰ *Id.* at 909 (citing *Rodrigue v. Olin Emp. Credit Union*, 406 F.3d 434, 439 (7th Cir. 2005)).

⁸¹ *Id.* at 909–10; see *Rodrigue*, 406 F.3d at 439.

⁸² As explained above, proof of a forged endorsement is no longer a prerequisite to conversion liability under section 3-420's revisions of former section 3-419. See *supra* Part I.

them to “conduct a full-blown investigation” with every check they have paid “to make sure that a party with an equitable interest in the check [is] not lurking in the background.”⁸³ That is simply not so. It is important to understand that when Citibank took these checks from Carter based on his indorsement in his own name or that of the shell corporation, Citibank converted the instruments because neither Carter nor the shell corporation was the payee on those instruments.⁸⁴ Only an authorized signature of NAIU could negotiate the instrument and make Carter, Citibank, or anyone else a holder of the instrument.⁸⁵ There was no such signature.⁸⁶ Thus, Citibank converted the instruments regardless of whether it knew or should have known of its customer’s illegal activities or that there was someone who could assert an interest in the checks’ proceeds. On the other hand, *had the instrument been signed by Carter in the name of NAIU, regardless of whether that employee was authorized to sign on behalf of NAIU and despite his intention to wrongfully misappropriate the funds, there would have been no conversion by Citibank and thus no liability, since banks are only liable for checks they have actually converted.*⁸⁷ In this case, there was no question that Citibank violated the Code and incurred some liability by converting the instruments brought to it by Carter. The only issue was whether ANICO, the true owner of those checks and the proceeds they represent and thus a victim of Citibank’s conversion, could enforce Citibank’s conversion liability.⁸⁸ Allowing ANICO and others similarly situated to do so would not create new liability for conversion by the depository bank on even a single additional

⁸³ *Citibank*, 543 F.3d at 909–10.

⁸⁴ “The person to whom an instrument is initially payable is determined by the intent of the person . . . signing as . . . the issuer of the instrument.” U.C.C. § 3-110(a) (2002). In this case, the issuers of the checks were the policyholders who intended their checks to be payable to NAIU, the managing agent for ANICO. *Citibank*, 543 F.3d at 908.

⁸⁵ *See Citibank*, 543 F.3d at 908.

⁸⁶ *See id.*

⁸⁷ If Carter were authorized to sign on behalf of NAIU, which he probably was, then there was no forged indorsement. If he was not authorized to sign on behalf of NAIU, the indorsement would still negotiate the instrument under section 3-405, which makes an indorsement “effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person” and if it is made by an employee entrusted by his employer “with responsibility with respect to that instrument.” § 3-405(b).

⁸⁸ *Citibank*, 543 F.3d at 909.

check.⁸⁹ Banks would not be required to add any new investigatory procedures to uncover the true owner of a check when the instrument is presented for payment, cashed, or deposited—that inquiry would only be relevant to a bank *after* the bank had already transacted business with a person who was not entitled to enforce it.⁹⁰ The banking industry already goes to great lengths to avert precisely that scenario by checking the identification of the person negotiating the instrument to ensure that she is the named payee, indorsee, or someone authorized to sign for the named payee or indorsee.⁹¹ The true ownership we have discussed does not affect whether there *is* conversion liability, but only which party can *enforce* and recover damages for that liability.⁹²

Third, the Seventh Circuit improperly distinguished the checks at issue from “the funds backing the check.”⁹³ That distinction fails. The checks themselves are not a piece of property separate and apart from the proceeds they represent; both the checks and their proceeds belong to the true owner, in this case ANICO.⁹⁴

⁸⁹ A bank’s liability is strict when it pays an instrument to someone that was not the named payee. *See* § 3-420(a). The Code makes that clear. And the enforcement of section 3-420 should be permitted by both the actual named payee *and* the owner of the instrument and its proceeds. This does not expand the category of paid checks for which a bank is potentially liable, but instead expands the category of potential enforcers of that liability.

⁹⁰ Although banks need not investigate the matter when negotiating checks at the retail window, it is worth noting that banks will often have notice that such non-payee owners exist. In the trustee-beneficiary scenario described in this Article, the relationship between the payee and the check’s true owner is often apparent on the face of the instrument. *See infra* Part IV.B. The same may frequently be true in the insurance industry, where agency relationships may be indicated on the face of premium checks. Thus, even the parade of horrors imagined by the Seventh Circuit is hardly appalling when true ownership of a check becomes relevant. Our statutory proposal in Part V deals with the situation where a bank that has converted an instrument may have a question as to whom a remedy is due, especially where it seeks to enter into a settlement agreement.

⁹¹ *See, e.g.*, § 3-501(b)(2) (“Upon demand of the person to whom presentment is made, the person making presentment must . . . (ii) give reasonable identification and, if presentment is made on behalf of another person, reasonable evidence of authority to do so . . .”).

⁹² *See supra* note 89 and accompanying text.

⁹³ *Citibank*, 543 F.3d at 910.

⁹⁴ *See* Brief and Required Short Appendix of Plaintiff-Appellant at 27–32, *Citibank*, 543 F.3d 907 (No. 07-3746).

“Conversion of a document, such as a check, promissory note, or negotiable instrument, includes ‘the full value of the intangible rights identified with’ the document.”⁹⁵ That undoubtedly includes the rights to the proceeds of the check. The very fact that the checks’ proceeds were due and owing to ANICO on account of the insurance services it provided made ANICO the checks’ true owner, and likewise made ANICO the victim of Citibank’s conversion.⁹⁶ This would similarly be the case regarding checks made payable to a trustee but whose proceeds are due and owing to a beneficiary, as we will discuss in more detail below.⁹⁷

The United States District Court for the District of Massachusetts, in *Fine v. Sovereign Bank*, took an approach similar to the Seventh Circuit’s.⁹⁸ In that case, the plaintiffs were defrauded by their investment advisor, who deposited checks representing money owed to the plaintiffs with the defendant bank despite that bank’s knowledge of the fraud and the lack of proper indorsements on some checks made payable to the plaintiffs.⁹⁹ Although the Court denied the defendant’s pretrial motion to dismiss, it noted that the plaintiffs likely could not sustain an action for conversion under the U.C.C. for those checks on which no plaintiff was named as a payee or co-payee.¹⁰⁰ The court hewed to the logic of the Seventh Circuit in *Citibank*.¹⁰¹ It reasoned that because “[i]t [was] not sufficient for the [plaintiffs] to assert that they ‘beneficially owned’ certain checks,”¹⁰²

⁹⁵ *Decatur Auto Ctr. v. Wachovia Bank, N.A.*, 583 S.E.2d 6, 8 (Ga. 2003) (quoting RESTATEMENT (SECOND) OF TORTS, § 242 cmt. a (1965)). It is this very “theory that the intangible right is merged into a specific document” which makes the conversion of commercial paper possible in the first place. *In re Oxford Mktg., Ltd.*, 444 F. Supp. 399, 404 (N.D. Ill. 1978) (citing *Hayes v. Mass. Mut. Life Ins. Co.*, 18 N.E. 322 (Ill. 1888)).

⁹⁶ Brief and Required Short Appendix of Plaintiff-Appellant, *supra* note 94, at 27.

⁹⁷ See *infra* Part IV.B. This is especially so where a bank itself is acting as the trustee, a common scenario.

⁹⁸ No. 06cv11450-NG, 2010 WL 3001194, at *3 (D. Mass. July 28, 2010).

⁹⁹ *Id.* at *1.

¹⁰⁰ *Id.* at *3 (stating that “the intervenors will not be able to prevail on their claims with respect to checks on which they are not named as a drawer, payee, or indorsee”).

¹⁰¹ *Id.* (citing *Am. Nat’l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907 (7th Cir. 2008)).

¹⁰² *Id.* In support of this assertion the court wrote,

the plaintiffs “[would] not be able to prevail on their claims with respect to those checks on which they [were] not named as drawer, payee, or indorsee.”¹⁰³

Although it may not have been dispositive in the *Fine* case because the facts did not clarify whether the plaintiffs were named as payees or co-payees on all of the converted checks, the court’s misguided logic laid the foundation for future misinterpretations of section 3-420. Just as the rule announced in *Rodrigue*, while not prejudicial to the rights of any party in that case, misstated the law in a way that led the Seventh Circuit to issue a misguided decision under the facts of *Citibank*,¹⁰⁴ the District Court of Massachusetts may soon find itself bound by the logic announced in *Fine* when a case involving a non-payee who is the true owner of an instrument arises in its jurisdiction.

To avoid that outcome, some courts have announced a more careful and appropriate construction of section 3-420. For instance, New York courts have taken an expansive view of the category of potential plaintiffs to a conversion action. In *Clients’ Security Fund of the State of New York v. Goldome*, the defendant attorney

Obviously, if I promise to transfer my next paycheck to a creditor in consideration for him refraining from immediately collecting on an overdue loan, the creditor cannot sue my bank for conversion if I decide to deposit the check into my bank account instead of indorsing it over to the creditor. The creditor’s claim is against me, not my bank. To assert claims under the Uniform Commercial Code (“U.C.C.”), the intervenors must show that they have some legally cognizable interest in the checks themselves, not merely in the funds backing the checks.

Id. In the court’s example, the check it is referring to was intended to pay wages for services provided to the drawer by the payee. The drawer had no obligation to or relationship with the intended transferee. As such, the intended transferee does not have any interest in the obligation the check represents, but only in its proceeds. But in the situations we are addressing, the party asserting ownership is the person who actually provided the services for which the *check specifically* was issued and the proceeds that check represents were intended by the drawer to compensate that party. As such, the party we assert is the true owner does have a “legally recognizable interest in the checks” themselves. *Id.* See also *infra* text accompanying notes 119–22.

¹⁰³ *Fine*, 2010 WL 3001194, at *3.

¹⁰⁴ See *supra* text accompanying notes 74–82.

converted a check for the net proceeds of a sale of his client's real property.¹⁰⁵ The defendant bank took the check, which was made payable to the attorney's father, but whose signature was forged by the attorney, and deposited it to the attorney's account.¹⁰⁶ The plaintiff Clients' Security Fund, as assignee of the client's rights, sued the defendant bank for conversion under the U.C.C.¹⁰⁷ The defendant moved for summary judgment, arguing that the plaintiff lacked standing to bring such a conversion claim under the Code.¹⁰⁸

The New York Supreme Court was more circumspect in describing a conversion plaintiff's burden: "[t]o state a cause of action for conversion, a plaintiff need only allege either an ownership interest or a right of possession in any specifically identifiable funds."¹⁰⁹ The implication for conversion of an instrument was clear. "The mere fact that [a plaintiff] was not named as payee on the check is of no consequence since the 'rightful owner' of a check, although not named as payee, has standing to sue."¹¹⁰ Thus, the court denied the defendant's motion for summary judgment.¹¹¹

Rather than conflating payees and those with an ownership interest in a check, this approach maintains the distinction.¹¹² All parties in the latter, broader category can bring a suit to enforce conversion liability.¹¹³ Additionally, the requirement of the *plaintiff's* forged indorsement is properly eschewed as a facet of the conversion plaintiff's burden of proof.¹¹⁴ Courts in other jurisdictions have suggested that they will take a similar approach in U.C.C. conversion cases.¹¹⁵

¹⁰⁵ 560 N.Y.S.2d 84, 86 (N.Y. Sup. Ct. 1990).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 86–87

¹⁰⁸ *Id.* at 86.

¹⁰⁹ *Id.* at 86–87.

¹¹⁰ *Id.* at 87.

¹¹¹ *Id.*

¹¹² *See id.*

¹¹³ *Id.*

¹¹⁴ *See supra* Part I.

¹¹⁵ For instance, the United States Bankruptcy Court for the Western District of Pennsylvania announced the possible right of a doctor to enforce conversion liability regarding checks issued to an insured to pay the doctor for his services, although the facts of the case did not clarify whether the insured or the doctor was named as the payee. *In re Lavitsky*, 11 B.R. 570, 571 (Bankr. W.D. Pa. 1981). Similarly, in *Tubin v. Rabin*, the United States

This approach is also well-harmonized with the common law definition of conversion. There are three generally accepted elements to a conversion action at common law: “(1) the plaintiff’s ownership or right to possession of the property at the time of the conversion; (2) the defendant’s conversion by a wrongful act or disposition of property rights; and (3) damages.”¹¹⁶ Conversion is thus distinguished from a traditional action for trespass to chattels by the severity of the convertor’s interference with the plaintiff’s ownership interest in the property at issue.¹¹⁷ Thus, the plaintiff’s ability to demonstrate her right to possession of the property is the primary requirement she must meet to sustain a conversion action.¹¹⁸

In the case of instruments, a clear right to possession is not exclusive to named payees. The plaintiff in the *Citibank* case is typical. ANICO was the true owner of all premium payments made to its managing general underwriter, NAIU, under the contract between them.¹¹⁹ The checks that formed the basis of ANICO’s suit were written to pay premiums on insurance policies for which ANICO was the sole insurer.¹²⁰ ANICO was therefore the true owner of those checks because it provided the insurance for which the premium checks were written.¹²¹ Because ANICO would have been obligated to pay on any claims by the insureds who issued those checks,¹²² it was likewise entitled to the premiums collected from those insureds. That another party, NAIU, collected and held those premiums and was named as payee on the premium checks at issue in no way divested ANICO of its true ownership of the instruments.

District Court for the Northern District of Texas held that the “rightful owner” of a cashier’s check could bring suit for conversion. 382 F. Supp. 193, 196–97 (N.D. Tex. 1974). In that case, the collecting bank was liable for conversion where it paid a check made out to the rightful owner’s attorney on a forgery of that attorney’s endorsement. *Id.* at 194–96.

¹¹⁶ 18 AM. JUR. 2D *Conversion* § 2 (2004).

¹¹⁷ See John R. Faust, Jr., *Distinction Between Conversion and Trespass to Chattel*, 37 OR. L. REV. 256, 265 (1958).

¹¹⁸ See *id.*

¹¹⁹ *Am. Nat’l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 908 (7th Cir. 2008).

¹²⁰ *Id.*

¹²¹ Brief and Required Short Appendix of Plaintiff-Appellant, *supra* note 94, at 27.

¹²² See U.C.C. § 3-310(b)(1) (2002).

III. *Other Sections of the Code Supporting a Non-Payee's Right to Bring Suit*

Various provisions of Article 3 of the Code can be construed to support the policy (and our position) that a non-payee plaintiff, such as an instrument's true owner, has the right to bring an action for conversion under section 3-420.¹²³ The Code's language unequivocally defeats the most prevalent argument used to dismiss the right of true owners to bring an action in conversion—that the party with a claim to the proceeds of an instrument is distinct from the party who owns the instrument itself, the payee, and it is only the payee as that instrument's owner who can sue in conversion.¹²⁴ In *Citibank*, the plaintiff ANICO had hired an agent to manage an account into which premium checks for policies provided by plaintiff were deposited.¹²⁵ ANICO's customers were directed to make their checks payable to the managing agent.¹²⁶ When the checks were converted, ANICO argued that since the checks were payments for services it had provided, ANICO should have standing to sue the depository bank that had converted the instruments.¹²⁷ The court wrote that the plaintiff's claim to “at least an equitable interest in the checks, no matter what the ‘Pay To the Order Of’ line might have said” was a “novel interpretation of the familiar drawer-drawee-indorsee-payee relationship [and] unprecedented.”¹²⁸ In fact, section 3-110 of the Code deals with situations in which checks are made payable to parties whose names are not on the “Pay To The Order” line and presents a different picture.¹²⁹

The basic premise of section 3-110 is that the person to whom an instrument is payable is determined by the intent of the person signing as the issuer.¹³⁰ The instrument is payable to such person even if the name on the payee line is not that of the person the issuer intended to be paid.¹³¹ In *Citibank* and cases like it, it might be argued that the policyholders who, as issuers, made their checks

¹²³ See, e.g., §§ 3-110, -306, -307, -420.

¹²⁴ See *Citibank*, 543 F.3d at 910.

¹²⁵ *Id.* at 908.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* at 909.

¹²⁹ See U.C.C. § 3-110(a) (2002).

¹³⁰ *Id.*

¹³¹ *Id.*

payable to the managing agents as they were directed nevertheless intended that the proceeds be received by the insurance company who provided their policy coverage. But that is not the point we make here. Rather, we emphasize that the name on the payee line is not always the person who has an ownership interest in an instrument and its proceeds; under the statutory scheme, such a result would not be “unprecedented.”¹³²

Further support for the argument that a person other than the named payee may have an ownership interest in the instrument or its proceeds is found in the treatment of instruments payable to a trustee under section 3-110(c)(2)(i).¹³³ It provides that:

(2) If an instrument is payable to (i) a trust, an estate, or a person described as trustee or representative of a trust or estate, the instrument is payable to the trustee, the representative, or a successor of either, *whether or not the beneficiary or estate is also named . . .*¹³⁴

The comment to subsection (c)(2) explains that this provision “merely determines who can deal with an instrument as a holder.”¹³⁵ “*It does not determine ownership of the instrument or its proceeds.*”¹³⁶

Section 3-110 draws a distinction between a holder—the person to whom the instrument is payable—and the owner of the instrument or its proceeds.¹³⁷ Thus, ownership of a check or its proceeds remains a viable possibility for a represented party *even if* an instrument has been made payable directly to a trust itself or a

¹³² See, e.g., Elec. Distrib., Inc. v. SFR, Inc., 166 F.3d 1074, 1087 (10th Cir. 1999) (holding that although the only plaintiff was named as payee, the issuer’s intent that three other individuals receive payments on the note controlled).

¹³³ § 3-110(c)(2)(i).

¹³⁴ § 3-110(c)(2) (emphasis added).

¹³⁵ § 3-110 cmt. 3.

¹³⁶ *Id.* (emphasis added).

¹³⁷ Section 3-301 also makes that same distinction. It defines a “person entitled to enforce an instrument,” noting that “a person may be a person entitled to enforce the instrument even though the person is *not the owner* of the instrument.” § 3-301 (emphasis added).

person described as a trustee.¹³⁸ This distinction supports the claim that a non-payee who has true ownership rights in the instrument may be able to enforce the liability of a party that converts that instrument. For instance, if a trustee has absconded with trust funds by fraudulently altering a check payable to the trust and making it payable to someone other than him as trustee, the beneficiary, though not the holder, may still claim ownership of the instrument or its proceeds. Those rights should give the beneficiary standing to sustain a cause of action against the bank or any other party that converted that instrument. Thus, in section 3-110, the drafters appear to have contemplated a suit by a non-payee who is the true owner of the check and its proceeds, though not its holder.

Section 3-306 is another provision of the Code that supports the argument that non-payees can assert an ownership interest in an instrument. Specifically, section 3-306, makes a person “taking an instrument, other than a person having rights of a holder in due course, . . . subject to a claim of a property or possessory right in the instrument *or its proceeds* including a claim . . . to recover the instrument *or its proceeds*.”¹³⁹ Significantly, this section tells us that a party who is not the holder of an instrument nevertheless has rights with respect to that instrument, including the ability to recover the proceeds of that instrument unless the current holder is a holder in due course.

The Code also allows parties represented by fiduciaries to assert that certain holders of instruments cannot claim the rights of a holder in due course when those parties have notice of a breach of a fiduciary duty.¹⁴⁰ Section 3-307 first defines the “fiduciary” as “an agent, trustee, . . . or other representative owing a fiduciary duty with respect to an instrument”¹⁴¹ and the “represented person” as “the principal, beneficiary, . . . or other person to whom the duty . . . is owed.”¹⁴² The Code then provides the outcome “[i]f (i) an instrument is taken from a fiduciary for payment or collection or for value, (ii) the taker has knowledge of the fiduciary status of the fiduciary, and (iii) the represented person makes a claim to the instrument *or its*

¹³⁸ See § 3-110(c)(2)(i). Or, for that matter, any other fiduciary named as the payee. *See id.*

¹³⁹ § 3-306 (emphasis added).

¹⁴⁰ § 3-307.

¹⁴¹ § 3-307(a)(1).

¹⁴² § 3-307(a)(2).

*proceeds . . .*¹⁴³ Where the instrument is payable to the fiduciary itself and taken to satisfy a personal debt of the fiduciary, or for her “personal benefit,” or “deposited to an account other than an account of the fiduciary, as such, or an account of the represented person,” the taker is said to have “notice of the breach of fiduciary duty.”¹⁴⁴ In those situations, the taker cannot be a holder in due course and will be subject to the claim of the represented person to the instrument *or its proceeds*.¹⁴⁵ The official comments to section 3-307 make it clear that the person dealing with the fiduciary may be a depository bank that takes the instrument for collection.¹⁴⁶ This is not to say that in all instances the taker will meet the necessary knowledge requirements to sustain such a claim, but rather to show once again that a person other than the payee can be said to have possessory or ownership rights to an instrument or its proceeds. And if a true owner, though not the payee, can receive the proceeds of that instrument from its taker where there is no forged or missing indorsement, why should it not be able to do so when there is a forged indorsement and the taker has in fact engaged in conversion?

The Code does not support the position that an ownership interest in an instrument itself and an interest in its proceeds are separate and distinct concepts. As the discussion above illustrated, many sections of the Code speak of a person’s rights to the instrument or its proceeds in tandem.¹⁴⁷ Significantly, section 3-420 itself implies that ownership of a check provides the basis for a claim to that check’s proceeds.¹⁴⁸ Section 3-420(c) states that a collecting bank other than the depository bank that “has in good faith dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce” is liable for that conversion *in the amount of the proceeds of the instrument it still possesses*.¹⁴⁹ The same was true under former section 3-419(3), which specified that a collecting bank that had dealt with an instrument in good faith and in

¹⁴³ § 3-307(b) (emphasis added).

¹⁴⁴ § 3-307(b)(2).

¹⁴⁵ *Id.*

¹⁴⁶ § 3-307 cmt. 2 (“In the case of an instrument taken for deposit to an account, the knowledge [of a breach of fiduciary duty] is found in the fact that the deposit is made to an account other than that of the represented person or a fiduciary account for the benefit of that person.”).

¹⁴⁷ *E.g.*, §§ 3-110 cmt. 3, 3-306, 3-307.

¹⁴⁸ *See* § 3-420(c).

¹⁴⁹ *Id.*

accordance with reasonable commercial standards “on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner *beyond the amount of any proceeds remaining in his hands.*”¹⁵⁰ The amount a conversion victim can collect, and hence the amount of the collecting bank’s liability, is the amount of the check’s proceeds.

Section 3-420 thus links a party’s ownership interest with standing to claim its proceeds. That position is perfectly logical. A right to the check itself, without the proceeds, is valueless. No party, be it the payee or the kind of true owner we have described,¹⁵¹ would have any reason to file suit to vindicate such a bifurcated right. An ownership interest in a check entitles one to no more or less than that check’s proceeds. The true owner of the proceeds of a check should be able to recover those proceeds from the party responsible for converting them.

IV. Implications in the Real Economy

Expanding the group of potential plaintiffs in a conversion action under the Code is far from trivial to the country’s real economy. Courts should take the broad view of section 3-420 this Article recommends in order to uphold the rights of a range of insurers and trust beneficiaries deserving of statutory protection. Absent such protection, the commercial arrangements devised and supported by these parties will become too risky for continued implementation. Concerns over both justice and the nation’s economic vitality counsel in favor of enabling these parties to bring a conversion action under the Code.

To understand why it is normatively desirable to protect these parties against would-be converters, consider an analogous (and perhaps more familiar) group of commercial actors: legal clients. Practicing attorneys are accustomed to the profession’s heightened concerns over the proper accounting for and distribution of clients’ money. The ethical quandaries encountered by generations of lawyers have motivated strident efforts to ensure that client funds are properly shepherded to their intended recipient without interference or delay. For instance, the Model Rules of Professional

¹⁵⁰ U.C.C. § 3-419(3) (1989) (emphasis added).

¹⁵¹ That is, a party who provided the goods or services for which the instrument was issued or was otherwise the intended specific beneficiary of the proceeds the instrument represents.

Conduct (“MRPC”), drafted by the American Bar Association and adopted in all but one state,¹⁵² unequivocally require a lawyer who receives funds in which a third person “has an interest” to notify that person and “promptly deliver” any such funds to the party “entitled to receive” them.¹⁵³ That duty is unqualified. Thus, under the MRPC, if a lawyer receives an instrument intended to be a settlement paid to a client, and thus that client “has an interest” in those funds, the lawyer must “promptly deliver” the funds to the client irrespective of the named payee on that instrument, even if the lawyer herself was the sole named payee.¹⁵⁴

Basic principles of justice require that a legal client’s right to receive funds intended for her should be protected by section 3-420 as well. A legal judgment is generally considered satisfied when a check is delivered to the attorney, even if that check is made out solely in the attorney’s name.¹⁵⁵ Once the check is delivered, the client cannot sue the other party. If the attorney has absconded with the funds after obtaining improper payment from a *converting* bank,¹⁵⁶ the client’s only recourse would be to enforce that bank’s conversion liability under the Code.

This likely would have motivated courts to take the appropriately broad view of the proper plaintiffs to a conversion action under the Code if settlement checks were frequently payable to the attorney alone. Fortunately, legal clients typically do not need to rely upon the Code as an added layer of protection because settlement checks are most commonly payable jointly to the attorney and the client. This ensures that the client, as joint payee, can sue a

¹⁵² *Model Rules of Professional Conduct*, AMERICAN BAR ASSOCIATION, http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct.html (last visited Dec. 14, 2013).

¹⁵³ MODEL RULES OF PROF’L CONDUCT R. 1.15 (2009).

¹⁵⁴ *Id.*

¹⁵⁵ *See In re Edl*, 207 B.R. 611, 612 (Bankr. W.D. Wis. 1997) (judgment satisfied by check delivered to attorney that is jointly payable to attorney and client); *see also In re Abolafia*, 801 N.Y.S.2d 546, 547 (N.Y. App. Div. 2005).

¹⁵⁶ That is, a bank that has either paid or obtained funds on behalf of a person not entitled to enforce the instrument. This argument is not intended to cover the situation where the bank provided funds to a dishonest attorney who was actually the payee on the instrument.

converting bank that makes or obtains improper payment of the check.¹⁵⁷

In two analogous situations, however, U.C.C. protection of the rights of a check's true owner is absolutely necessary. In the context of commercial insurers and trust beneficiaries, the *Citibank* court's illogically narrow reading of the Code would preclude the party with a rightful claim of ownership on the instrument and its proceeds from enforcing a bank's conversion liability. In each case, the Code's policy announced in section 1-103 to "liberally construe[]" its language in order to "simplify, clarify, and modernize the law governing commercial transactions; [and] to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties" would be best served by an appropriately broad understanding of the parties that can sustain a conversion suit under section 3-420.¹⁵⁸

A. The Insurance Context

The insurance industry is comprised of a vast series of interconnected agency relationships between large insurance companies and the various "agents" that represent them. The term "agent" itself is amorphous. Within the industry, the word "agent"

¹⁵⁷ For example, in *Hoppe v. First Midwest Bank of Poplar Bluff*, an attorney received a check in payment of a debt owed to the plaintiff-client which was made payable jointly to the plaintiff and the attorney. 899 S.W.2d 879, 881 (Mo. Ct. App. 1995). When the attorney forged the plaintiff's name and deposited it with defendant bank, the plaintiff-client was able to sustain an action in conversion under former section 3-419 as a joint payee on the check. *Id.* at 881-82. A similar result was reached in New Jersey in *Nutt v. Chemical Bank*. 555 A.2d 8, 12 (N.J. Super. App. Div. 1989).

¹⁵⁸ U.C.C. § 1-103(a) (2002). The comments to section 1-103 again emphasize the need for flexibility to stimulate commercial interaction. "The Uniform Commercial Code is drawn to provide flexibility so that, since it is intended to be a semi-permanent and infrequently-amended piece of legislation, it will provide its own machinery for expansion of commercial practices." § 1-103 cmt. 1. That stimulative policy should be kept in mind when reading any section of the U.C.C. "The Uniform Commercial Code should be construed in accordance with its underlying purposes and policies [T]he application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved." *Id.*

describes numerous intermediaries between the insurers themselves and their policy holders.¹⁵⁹

One specific pattern which has emerged within that vast framework is the relationship of a principal insurer with a “managing general agent,” or MGA.¹⁶⁰ MGAs commonly reduce or eliminate the interaction between the insurance company itself and their policyholders. In one common scenario, as illustrated by the plaintiff in *Citibank*, an MGA directly receives premium payments and makes payments on some or all of the claims from policyholders while maintaining an account balance for the principal insurer.¹⁶¹ Frequently, MGAs are also authorized to “underwrite” a given quantity of insurance policies, meaning that they may accept or reject risk on behalf of the principal insurer.¹⁶² This widely-used commercial arrangement has long historical roots and plays a vital role in modern insurance markets.¹⁶³ Today’s MGAs are able to pay

¹⁵⁹ For a description of the various meanings of the term “agency” in the insurance context, see 7 ERIC MILLS HOLMES, HOLMES’ APPELMAN ON INSURANCE 2D 2-19 (1998). Holmes notes that “much confusion as to the real principles underlying the insurance rules . . . [results from] fluid titles like ‘general agents,’ ‘soliciting agents,’ and ‘brokers.’” *Id.* at 2.

¹⁶⁰ This arrangement is so common that an established trade union, the American Association of Managing General Agents, maintains a website on behalf of such agents. See AM. ASS’N OF MANAGING GEN. AGENTS, <http://www.aamga.org> (last visited Dec. 14, 2013). Although sometimes also known as “managing general underwriters,” both the AAMGA and most state laws on the subject employ the term “managing general agent.”

¹⁶¹ SUBCOMM. ON OVERSIGHT & INVESTIGATIONS OF H. COMM. ON ENERGY & COMMERCE, 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES 27 (Comm. Print 1990) [hereinafter FAILED PROMISES]. The Subcommittee’s report included a case study on Integrity Insurance Company, which was described in testimony as a “quintessential MGA operation” that employed “eighty different MGA’s to conduct its business,” including “authority to appoint subagents, issue policies and endorsement, collect premiums, [and in some cases] adjust and pay claims, and . . . establish loss reserves.” *Id.* MGAs will sometimes play a similar role for reinsurers, selling reinsurance coverage to primary insurers seeking to spread risk. 7 HOLMES, *supra* note 159, at 213.

¹⁶² MODEL MANAGING GEN. AGENTS ACT § 2(c)-(d) (Nat’l Ass’n of Ins. Comm’rs 1991) [hereinafter MODEL ACT].

¹⁶³ The MGA model evolved in the early 20th century as insurance companies sought to efficiently spread to the Western and Southern U.S. MARK J. MCCARTHY, PROUD HISTORY—BRIGHT FUTURE: THE FIRST SIXTY-FIVE YEARS OF THE AMERICAN ASSOCIATION OF MANAGING GENERAL

insurers' accounts in a timely fashion while providing significant underwriting profits with minimal irritation for their principals.¹⁶⁴

In the late 1980s and early 1990s, states propounded increased regulations on MGAs in an effort to quell the tide of a string of bankruptcies declared by major insurers.¹⁶⁵ In 1991, the National Association of Insurance Commissioners published the Model MGA Act (the "Act"), which was subsequently adopted at least in part in all fifty states.¹⁶⁶ The Act provides significant insight into the contemporary role of MGAs.¹⁶⁷ In addition to requiring a written contract between MGAs and their principals,¹⁶⁸ the Act requires MGAs to settle their accounts with insurers on not less than a monthly basis, and to detail all transactions handled on behalf of the insurer for that period.¹⁶⁹

The Act does not, however, specify whether a premium delivered directly to an MGA should be made payable to the MGA itself or to the insurer to be held in trust by the MGA.¹⁷⁰ Either arrangement is permissible under the Act, and cases that describe common insurance agency relationships illustrate both patterns.¹⁷¹

AGENTS: 1926–1991, at 2–3 (1992). Insurance companies saw MGAs as a means to cover more territory with fewer people. *Id.* at 7. MGAs also reduced expenses for expanding insurers; they covered their own costs in the field, including "underwriting, inspections, travel, claims, and collections, which included the responsibility for unpaid retail agents' balances." *Id.* at 8. As the need for distant regional insurance representatives dwindled in the later half of the 20th century, MGAs quickly adapted by "provid[ing] needed lines of insurance protection in specialty, excess, and surplus fields . . ." *Id.* at 9.

¹⁶⁴ *Id.* at 61 (quoting Doug Snyder, Madison Wisconsin AAMGA member).

¹⁶⁵ MCCARTHY, *supra* note 163, at 21–23; *see also* Michael F. Aylward & Paul M. Hummer, *When Insurers Go Belly Up: Implications for Insurers, Policy Holders, and Guaranty Funds*, 70 DEF. COUNS. J. 448, 450 (2003).

¹⁶⁶ 7 HOLMES, *supra* note 159, at 190.

¹⁶⁷ *See generally* MODEL ACT, *supra* note 162.

¹⁶⁸ *Id.* § 4.

¹⁶⁹ *Id.*

¹⁷⁰ *See generally id.*

¹⁷¹ *Compare* *Fid. & Cas. Co. of N.Y. v. Bordelon*, 428 So. 2d 1162, 1163 (La. Ct. App. 1983) ("Fidelity states in its petition that it issued an insurance policy to Little Farms at the request of Bordelon and, more importantly, Fidelity further states that Little Farms made payments of premiums on this insurance policy to Bordelon."), *with* *Policy Funding Corp. v. Kings Cnty. Lafayette Trust Co.*, 334 N.Y.S.2d 448, 449 (N.Y. App. Div. 1972), *aff'd*, 33 N.Y.2d 776 (1973) (describing an arrangement

Importantly, irrespective of the payee on those premium checks, the receipt of premiums by an insurance agent such as an MGA is deemed to be receipt of those premiums by the insurer.¹⁷² The same holds true even in cases where the checks were addressed to the principal, rather than the agent, and the agent subsequently forged the name of the payee and retained the check's proceeds.¹⁷³

The fact that receipt of a premium by an MGA is deemed receipt by the principal insurer presents a potential quandary for the principal insurer. If an insured, simply by delivering a premium check made payable to an MGA, is thereby entitled to the benefit of his bargain with the insurance company—the services and coverage guaranteed under the insurance contract—then an insurer likewise must be entitled to the benefit of its bargain—the payment that the check, regardless of named payee, represents. To hold otherwise binds the principal insurer to the insured under the contract while withholding the benefits the insurer is owed under that same contract should the MGA fail to deliver the premium payment. That contract cannot be both enforceable and unenforceable. Under existing conventions in the insurance industry, all parties should expect the enforcement of such insurance agreements *in toto* once payment has been made. This should be the rule enforced by the courts.

Decisions like *Citibank*, however, threaten to undermine the basic bargain between insurer and insured in any case where an MGA receives a premium check on the insurer's behalf. Although the insurer is undoubtedly the true owner of the instrument delivered by the insured, *Citibank* would deny that insurer recourse through a conversion action against a bank that converted that check and disbursed the proceeds to a party who subsequently disappears with

wherein premium checks were delivered to an agent, though made payable to the principal insurer, and the agent stamped the checks in the principal-payee's name before depositing them in an account).

¹⁷² See, e.g., *Bordelon*, 428 So. 2d at 1163 (declaring that under Louisiana law, payment to the agent is deemed to be receipt by the principal insurer); see also *Spanish Transp. Serv. Corp. v. Hurd Ins. Agency*, No. L-3672-02, 2006 WL 3432858, at *1 (N.J. Super. Ct. App. Div. Nov. 30, 2006) (“Plaintiffs paid premiums to PRM, an agent of Universal. Such payments are as a matter of law payments to Universal regardless of whether Universal received them.”); *Sec. Nat’l Fire Ins. Co. v. Kimberlin*, 299 P.2d 163, 165 (Okla. 1956) (“Payment to the agent, Shoot, was payment to his principal, the defendant insurance company.” (citing *Ill. Valley Trust Co. v. Sherley*, 14 P.2d 385 (Okla. 1932))).

¹⁷³ *Policy Funding Corp.*, 334 N.Y.S.2d at 449.

the funds.¹⁷⁴ The insurer would be forced to honor its contract with the insured and provide coverage despite never receiving premium payment, simply because the insured made her premium check payable to the MGA rather than to a principal insurer she may not even know exists. Neither basic fairness nor the U.C.C. requires that result.

The reasoning in *Citibank* and of the courts that follow it is inconsistent with the basic principles of fairness that have guided courts in decisions concerning the predecessors to the modern MGA model. For instance, in *Hazelton v. Locke*, a 1908 case heard by the Maine Supreme Court, the plaintiff-insurer brought a conversion action against its former “manager,” who sold insurance on the plaintiff’s behalf and collected *cash* premiums from insureds.¹⁷⁵ When the defendant refused to deliver some of those cash premiums, he was found guilty of conversion.¹⁷⁶ The court reasoned that the plaintiff-insurer could sustain a conversion action because he had “a special property in the premiums collected [and thus] was entitled to receive them. This right gave him a remedy against the defendant upon his refusal to pay over the same.”¹⁷⁷

The implication of *Hazelton* in the modern MGA context is clear. Payments made in the form of a check are no less the property of the primary insurer than those made in cash.¹⁷⁸ The insurer, as the rightful owner of those premiums, should be able to sustain a claim against any party that is guilty of converting those premiums.¹⁷⁹

¹⁷⁴ *Am. Nat’l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 910 (7th Cir.) (“ANICO has no property interest in the checks at issue here: it is not a payee, indorsee, or any other entity recognized upon the instruments themselves.”).

¹⁷⁵ 71 A. 661, 662 (Me. 1908).

¹⁷⁶ *Id.* at 662–63.

¹⁷⁷ *Id.* at 663.

¹⁷⁸ *See Decatur Auto Ctr. v. Wachovia Bank, N.A.*, 583 S.E.2d 6, 8 (Ga. 2003).

¹⁷⁹ It should be noted that at least one court has come to the conclusion that an insurance company cannot sue for conversion of checks made payable to its agent. In *Guarantee Ins. Co. v. Merchants Employer Benefits, Inc.*, the court held that where payment of premiums is made to an agent corporation but intended to secure coverage by a parent insurer, which is actually obligated by those payments, the parent corporations proper remedy is an action sounding in breach of contract, not conversion. No. 5:07-cv-307 (CAR), 2010 WL 3937325, at *10 (M.D. Ga. Sept. 30, 2010).

Decisions like *Hazelton* clearly dictate a broad reading of the modern U.C.C. to allow insurers to vindicate their ownership rights in a premium check, even if it was made payable to their MGA.¹⁸⁰

¹⁷⁹ However, *Guarantee* is distinguishable from the situations we refer to in this article. In *Guarantee*, the relationship between the plaintiff and defendant was contractual, whereas, in the cases we discuss, there is no such relationship between the true owner and the depositary bank which has converted the instrument. As such, the court's determination of whether there was a conversion at all in *Guarantee* is guided by its conclusion that this was a contract rather than a tort issue. See *Guarantee*, 2010 WL 3937325, at *10. In the cases discussed earlier, the determination of whether there has been a conversion is defined by the Code and exists because the depositary bank has obtained payment on behalf of a person not entitled to enforce the instrument.

¹⁸⁰ An analogous situation arises in the case of a real estate agent or letting agent that secures a commercial or residential tenant for the benefit of a landlord. Such agents often accept initial security deposit or first month's rent payments on behalf of the landlord. While it is best practice for an agent to only accept checks made payable to the landlord herself and deposit them in a separate security account in the landlord's name, on some occasions, and especially in larger metropolitan areas, an agent will accept a check in her own name. Telephone Interview with Vincent Giffuni, Partner, JoAnne Giffuni, Partner, and Ida Greer, Counsel, Vincent Giffuni Real Estate (July 11, 2012). Ethical guidelines promulgated by the National Association of Realtors do not expressly prohibit that practice. NAT'L ASS'N OF REALTORS, CODE OF ETHICS AND STANDARDS OF PRACTICE OF THE NATIONAL ASSOCIATION OF REALTORS 1-2 (2012), available at <http://chicagorealtor.com/associations/6001/files/codeofethics2012.pdf>. In fact, the landlord and his agent may contractually agree that the agent, acting as a licensee managing the property, will collect not just the tenant's initial payment but also subsequent payments to be remitted to the landlord in exchange for the tenant's right to occupy the property. See *id.*

In such cases, the landlord is not the payee on the check although that check is meant to pay for the services that the landlord will provide. Just as an MGA acts as an intermediary between the insured and the insurer, such a managing licensee acts as a conduit between the landlord and tenant, facilitating their exchange of habitable property and rental payments. *Id.* And just as the MGA's receipt of a premium from the insured may be deemed receipt of that premium by the insurer, the real estate agent's receipt of the security deposit and rental check may be deemed receipt of that payment by the landlord. See *id.* This would both entitle the tenant to the benefit of his bargain and require the landlord to provide a habitable property.

B. The Trust Beneficiary

It is a well-established legal principle that when property or funds are held in trust for the benefit of a beneficiary, the beneficiary has an equitable ownership interest in the trust corpus.¹⁸¹ Thus, just as a legal client is the true owner of a settlement check delivered to her attorney and the principal insurer is the true owner of the premium check delivered to its MGA, the beneficiary's equitable interest in a trust corpus establishes her as the true owner of an instrument delivered to the trustee for inclusion in the trust.¹⁸² In each case, the recipient of the check is acting as an agent for another person for whose benefit that payment was delivered and who maintains a rightful claim to the proceeds of that check.

The beneficiary's equitable ownership interest in an instrument included in the trust corpus is equally strong whether that instrument is payable in part to the beneficiary or is solely payable to the trust itself or the trustee as such.¹⁸³ To see why, imagine that a

If that check is altered by the agent or an employee of the agent and then paid by a converting bank, it seems clear that the landlord should have a remedy against the bank which has improperly paid that instrument, given that the landlord is the check's true owner. This right is especially important in the all-too-likely scenario that the agent or employee who altered the check has subsequently absconded with the funds. However, a landlord may be left without a remedy under an inappropriately narrow reading of the Code. That reading would require the landlord to honor her lease despite never actually receiving the rent or security deposit funds. Although there is little case law on this specific scenario, courts following the misguided logic of the *Citibank* decision would also hold that the landlord cannot recoup those funds from the converting bank in a section 3-420 action simply because the check was originally made out to the real estate agent rather than the landlord. *See* *Am. Nat'l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 910 (7th Cir. 2008). For the reasons discussed above, this result is an intolerable restraint on commercial arrangements which would otherwise be convenient and potentially lucrative for all the parties involved. *See supra* notes 159–80 and accompanying text. Nothing in the U.C.C. or the text of section 3-420 requires that outcome. *See supra* notes 79–97 and accompanying text.

¹⁸¹ *See, e.g., Kesling v. Kesling*, 967 N.E.2d 66, 78–79 (Ind. Ct. App. 2012) (citation omitted), *transfer denied*, 974 N.E.2d 476 (Ind. 2012); *see also* RESTATEMENT (THIRD) OF TRUSTS § 43 cmt. a (2003) (asserting that a trust beneficiary takes and holds “equitable title” to the trust corpus).

¹⁸² *See id.*

¹⁸³ *See Scanlan v. Eisenberg*, 669 F.3d 838, 844 (7th Cir. 2012).

trustee accepts a check on behalf of the trust that is payable to the trust itself or even the trustee directly. That check's equitable owner is still the beneficiary for whose benefit it was drawn, not the trustee who has merely received delivery.¹⁸⁴ Now assume that the trustee or some other party, perhaps an employee of the trustee, forges or alters the check and obtains payment on that instrument at a converting bank, only to later abscond with the funds. The beneficiary should not be left without a remedy if the trustee was either acting in concert with the forger or is unwilling or unable to provide the necessary assistance.¹⁸⁵ Justice requires that the beneficiary be able to enforce the conversion liability of the converting bank despite not being the payee on the check.

In this scenario, the bank that has made or obtained payment for a person not entitled to enforce the instrument has undoubtedly committed conversion under section 3-420.¹⁸⁶ By paying on the forged check, which lacks the authorized signature of the entity acting as trustee (the payee in this scenario), that bank converted the check.¹⁸⁷ The only issue is which party can enforce that converting bank's liability. Again, that group should include not just the trustee-as-payee, who may be unwilling or unable to pursue the converting bank on the beneficiary's behalf, but also the beneficiary herself as the instrument's true owner. Yet under the *Citibank*-style misconstruction of the Code, the beneficiary would not be able to enforce conversion liability simply because the check was not made payable jointly to the trustee and the beneficiary, unlike typical settlement checks payable jointly to the attorney and her client as discussed earlier.¹⁸⁸ This is an unprincipled and inconsequential distinction upon which to base a significant limitation of the rights of trust beneficiaries across the country.

¹⁸⁴ ALAN NEWMAN ET AL., *THE LAW OF TRUSTS AND TRUSTEES* § 962.

¹⁸⁵ Remember that if the trustee signed his name to the instrument and absconded with the funds, the bank has no liability in conversion under section 3-420, since by paying the trustee or obtaining the funds on his behalf, it did engage in transactions with the person entitled to enforce the instrument. *See* U.C.C. § 3-420 cmt. 1 (2002). We are only positing about those situations where a bank has dealt with an instrument on behalf of a party who was not a holder (i.e., where there was a forged necessary indorsement or a missing necessary indorsement). *See id.*

¹⁸⁶ § 3-420(a).

¹⁸⁷ *Id.*

¹⁸⁸ *See* *Am. Nat'l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 910 (7th Cir. 2008).

There are distressing indications that courts would be willing to limit the ability of trust beneficiaries to enforce conversion liability under the Code in the hypothetical situation discussed in the preceding two paragraphs. For example, in *Coots v. Allstate Life Ins. Co.*, a deceased father's life insurance proceeds were to be paid to each of his minor children.¹⁸⁹ However, the insurer issued checks to the decedent's ex-wife as trustee for each of the children.¹⁹⁰ When the mother deposited those checks into a brokerage account and depleted the funds, the children's guardian filed suit against the insurer for conversion for its wrongful payment of the policy's proceeds.¹⁹¹ The United States District Court for the District of Maryland dismissed the case.¹⁹² The court reasoned that "[i]n order to bring an action for conversion of a check, the plaintiff must have been the payee."¹⁹³ Although under the facts of the case, the court correctly indicated that there was no conversion by any bank since the checks were made payable to the mother, the reasoning it used is misguided and dangerous. It suggested that because the ex-wife, as trustee, was the sole payee on those checks, the children could not sustain a conversion action at all.¹⁹⁴ But would the court have used the same language if the mother's indorsement had been forged by her boyfriend and deposited into his account at his bank? The court would then be holding that the children or their guardian have no right against the depository bank for conversion because only the mother would be a proper party plaintiff in that action.

Courts should not paint themselves into a corner with such reasoning, which will dictate future cases that undermine the right of a beneficiary to enforce section 3-420 conversion liability. Taken to their logical conclusion, decisions such as *Coots* prohibit trust beneficiaries from enforcing the liability of a bank that converts a

¹⁸⁹ 313 F. Supp. 2d 539, 540–41 (D. Md. 2004).

¹⁹⁰ *Id.* at 541.

¹⁹¹ *Id.* at 540–41.

¹⁹² *Id.* at 544.

¹⁹³ *Id.* The court was dealing with that part of section 3-420 that "makes the law applicable to the conversion of personal property also applicable to the conversion of negotiable instruments." *Id.* There were actually no banks involved in this case. *Id.* at 540–41.

¹⁹⁴ *Id.* ("The checks, however, were payable to Cassandra Wallace as trustee for each of the minor children. In order to bring an action for conversion of a check, the plaintiff must have been the payee.").

check payable solely to a trust or trustee under *any* circumstances.¹⁹⁵ Consequently, courts should not require that the beneficiary also be named on the face of the check. Under section 3-420, trust beneficiaries can and should be able to protect their rights as true owners of the instrument by sustaining a conversion action against a bank that improperly pays or obtains payment on that instrument.¹⁹⁶

V. *Proposed Changes to § 3-420*

Thus far, we have argued that the Code as written should allow true owners of a converted instrument to enforce conversion liability. As noted above, however, courts have by and large failed to acknowledge that true owners are proper party plaintiffs in a section 3-420 suit.¹⁹⁷ Given that failure, we suggest that some clarification of the Code's language to formally recognize the parties that are proper party plaintiffs to a conversion action could be helpful to courts and practitioners alike.

We therefore propose the following revision to section 3-420. Our suggestion deletes the last sentence of subsection (a) and adds new subsections (b) and (c) to the existing language of section 3-420, with current subsections (b) and (c) becoming subsections (d)

¹⁹⁵ Those circumstances might include where the converting bank acted in bad faith (e.g., based on knowledge it may have had at the time of its conversion) or negligently (e.g., based on the obviousness of the forgery) or even, possibly, in collusion with the trustee. While such conduct need not be alleged to sustain a conversion action, denying standing to the beneficiary (or any true owner, for that matter) would nevertheless ensure that certain egregious conduct by the bank would never come to a court's attention.

¹⁹⁶ Some older case law provides reasoning that would support a more expansive view of the proper plaintiffs to a conversion action. In *Templeton v. Bockler*, the plaintiff owned a sheep farm and allowed the defendant to act as his agent in selling the sheep. 144 P. 405, 497 (Or. 1914). When the defendant sold the sheep for \$10,000, he received only \$500 cash and a note payable to the defendant for the remainder, which the defendant then denied belonged to the plaintiff in any way. *Id.* at 505. The court held that the defendant received the sheep "in trust to take care of them and to sell them . . . and to return to the plaintiff all of the proceeds of such sale that remained . . ." *Id.* at 507. Thus, the defendant was liable for conversion of the balance of the note, and the plaintiff was able to enforce that conversion liability despite not being named on that instrument. *Id.*

¹⁹⁷ See *supra* Part II.

and (e) respectively. Our proposal would insert the following language into section 3-420:

(b) In an action under subsection (a), the proper party plaintiff is either:

- (i) a payee or indorsee who received delivery of the instrument either directly or through delivery to an agent or co-payee; or
- (ii) any true owner of the instrument or its proceeds, at the time the instrument was converted. If the last payee or indorsee of a converted instrument was, at the time of conversion, an agent or fiduciary for another person who (A) provided the goods or services for which the instrument was issued or transferred, or (B) was the issuer's or maker's intended recipient of a gift or obligation represented by the instrument, then such other person is a true owner.

(c) A person who converts an instrument and enters into a settlement with a proper party plaintiff payee or indorsee is not also liable to a true owner unless the converter had notice of the true owner's claim to the instrument or its proceeds at the time of the settlement. A person who converts an instrument and enters into a settlement with an instrument's true owner is not also liable to a proper party plaintiff payee or indorsee.

Our proposal utilizes positive language to identify the class of proper party plaintiffs that could bring a suit under section 3-420. Unlike the negative language in section 3-420(a),¹⁹⁸ this positive identification of proper conversion plaintiffs will provide clear guidance to courts and practitioners, rather than relying on the legal community to deduce which parties *can* bring such an action from a statement that identifies which parties *cannot*.¹⁹⁹ That positive definition will

¹⁹⁸ U.C.C. § 3-420(a) (2002).

¹⁹⁹ To ensure that there is no confusion about issuers and acceptors, parties who had previously been specifically excluded, the official comments should state that the policy to exclude those parties continues under the amended version of section 3-420.

promote uniformity in courts' interpretations of section 3-420 across the country.²⁰⁰ Thus, our revised section 3-420(b)(i) restates the previous exclusion from the category of proper party plaintiffs to a conversion action contained in the existing section 3-420(a)(ii) in positive terms. It simply *requires* payees or indorsees to have received either direct or constructive delivery in order to sue in conversion.²⁰¹

The second part of our subsection (b) introduces the "true owner" as a proper party plaintiff and defines the term. To further clarify the potential parties that could bring a conversion suit under our revision, official comments could be added to expound upon the definition of "true owners" in revised sections 3-420(b)(ii)(A) and (B). As we have noted, protecting the interests of such true owners is vital to commonplace commercial arrangements in the insurance industry and in myriad trustee-beneficiary relationships throughout the nation.²⁰² Our revision could note, in the official comments, that the "recipient of a gift represented by the instrument" would include beneficiaries of a trust. The "recipient of an obligation represented by the instrument" would include parties represented by attorneys who are receiving settlement proceeds, which as noted earlier might also be vulnerable to a conversion if a settlement check was made payable solely to the attorney. In addition, the comments could state that a represented person who "provided the goods or services for which the instrument was issued or transferred" would include a principal insurer that has utilized a managing general agent or underwriter of the sort discussed above.²⁰³

The prevailing trend among courts that have interpreted section 3-420 has been to ignore the rights of the true owner of an instrument or its proceeds, often by obfuscating the issue with a declaration that allowing such parties to bring conversion suits would

²⁰⁰ This is one of the specific purposes of the Code. *See* § 1-103(a)(3) ("[The U.C.C.] must be liberally construed and applied to promote its underlying purposes and policies, which are: . . . (3) to make uniform the law among the various jurisdictions.").

²⁰¹ The current version of section 3-420(a) states that "an action for conversion of an instrument may *not* be brought by . . . (ii) a payee or indorsee who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee." § 3-420(a) (emphasis added).

²⁰² *See supra* Part IV.

²⁰³ *See supra* Part IV.A.

hamstringing the banking industry.²⁰⁴ Our revision would no longer permit courts to rely on such reasoning in light of the clear positive language identifying an instrument's true owner as a proper party plaintiff in a conversion suit. To address those courts' concerns, however, our proposed subsection (c) would limit the exposure of banks in cases where a bank was truly unaware that the payee plaintiff was acting on behalf of an undisclosed true owner. It would not require that a bank "conduct a full-blown investigation every time to make sure that a party with an equitable interest in the check was not lurking in the background" even *after* it had converted an instrument.²⁰⁵ The first sentence of our revised subsection (c) would protect a converting bank from double-liability if it settles with a named payee or indorsee only to discover later that such a party was acting as an agent or fiduciary of an instrument's true owner. However, the bank cannot hide behind this provision in cases where it reaches a settlement with the named payee or indorsee whom the bank had notice was representing a true owner. To see how this would work in practice, consider again the facts of *Citibank*.²⁰⁶ There, Citibank converted checks originally made payable to and altered by an employee of NAIU, which was acting as a managing general agent for the checks' true owner, ANICO.²⁰⁷ If Citibank had no knowledge of ANICO's existence and reached a settlement on a conversion suit brought by NAIU, Citibank would face no further liability if ANICO later came forward in a conversion suit of its own. However, if Citibank had notice of ANICO's claim to those instruments or their proceeds, it could not use a settlement with NAIU as a shield against ANICO's conversion claim.²⁰⁸ Our revision

²⁰⁴ See, e.g., *Am. Nat'l Ins. Co. v. Citibank, N.A.*, 543 F.3d 907, 909–10 (7th Cir. 2008) ("Instead of being able to look at the payee line and to verify that the person presenting the check was indeed entitled to do so, banks in ANICO's world would need to conduct a full-blown investigation every time to make sure that a party with an equitable interest in the check was not lurking in the background. Such a system would bring commercial transactions to a grinding halt."). As we noted above, such concerns misperceive the banks' obligations under the Code as something other than simply avoiding the conversion of instruments deposited or cashed by persons not entitled to enforce. See *supra* Part II.

²⁰⁵ *Citibank*, 543 F.3d at 909–10.

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 908.

²⁰⁸ This is exactly what happened in *Citibank*. Despite the fact that ANICO had entered the case very early by joining the action as a plaintiff, Citibank,

thus strikes a balance between the rights of an instrument's true owner and the breadth of liability for a converting bank.

Conclusion

Great works of literature are at once intensely illuminating and frustratingly opaque. Visionary authors can convey thoughts with intense focus and clarity while only hinting at the broader meaning of the work through allusion and subtext. Statutory authors are often (unintentionally) as elusive as novelists. Legislators leave open to interminable discussion and analysis statutory texts that should clearly articulate legal standards for citizens to follow. The ignominious fate of such statutes is familiar to legal practitioners and legislators alike.

In this Article, we have argued that the drafters of the U.C.C., and specifically section 3-420, were precise enough to communicate the statute's meaning. The drafters utilized language intentionally designed to resolve conflicting case law about whether specific parties were proper party plaintiffs in conversion actions involving negotiable instruments. The language chosen explicitly prohibits particular parties that previously had been allowed to sue for conversion in certain jurisdictions from doing so. That language does not otherwise restrict potential plaintiffs *not* specified in the provision from asserting rights to compensation from persons and banks that convert instruments in which those plaintiffs can claim a possessory interest. We assert that parties injured by the conversion of an instrument, including the instrument's true owner, are, and should be, permitted to enforce the liability of the converting party under the Code.

Our review of the prevailing judicial interpretations of section 3-420, however, suggests that courts have needlessly restricted the proper party plaintiffs to a U.C.C. conversion action. As we have highlighted, a more expansive reading is completely consistent with other provisions of Article 3, as well as the Code's

with full knowledge of ANICO's claim, entered into a settlement with NAIU for substantially less than the amount of the damages claimed. While the *Citibank* court did not cite the settlement as a basis for its decision to affirm the judgment in favor of the bank, during oral argument one judge on the panel asserted that ANICO's claim was rendered moot by the settlement. Transcript of Oral Argument, *Citibank*, (No. 07-3746) (question of Justice Easterbrook).

policy to promote the ongoing expansion of commercial practices through a liberal construction of its terms.²⁰⁹ We also demonstrated how an appropriately expansive reading of section 3-420 would nurture rather than endanger novel commercial arrangements in the insurance industry and a wide variety of trustee-beneficiary relationships relied upon throughout our economy.

However, we have acknowledged that what little ambiguity exists in the language of section 3-420 has proved fertile ground for unsound judicial interpretations. Thus, we have also recommended revisions to the language to declare, in positive terms, the proper parties to a statutory conversion claim. This new language would reflect that an instrument's true owners, carefully defined, have the right to enforce conversion liability on an instrument that was in essence created for their benefit. Including such parties in the category of proper plaintiffs to a conversion action would place no additional burdens on the banking industry. Banks can avoid conversion liability simply by avoiding conversion in the first instance. Additionally, our revisions protect a bank from facing double-liability if it settles with a proper party plaintiff without notice of any true owner's claim to the instrument or its proceeds.

Section 3-420 substantially expanded the Code's definition of conversion and the parties potentially liable for it. By incorporating the common law applicable to the conversion of personal property and clarifying the breadth of situations in which a depository bank might engender conversion liability, the Code's authors meaningfully increased the category of potential conversion defendants. As we have argued, the language of section 3-420 should also be read to expand the category of proper statutory conversion plaintiffs, and if the Code has not clearly established such parties' rights it should be amended to do so. Unless those parties' rights are understood and enforced by the courts, the Code's intent will be frustrated and the myriad commercial arrangements relying upon its structure will be undermined irreparably.

²⁰⁹ U.C.C. § 1-103(a) cmt. 1 (2002).