Law Reform Commission of Canada
Commission de réforme du droit du Canada

REPORT

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THE CHEQUE

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Law Reform Commission of Canada | Commission de réforme du droit du Canada

January, 1979

The Honourable Marc Lalonde,
P.C., Q.C., M.P.
Minister of Justice,
Ottawa, Ontario.

Dear Mr. Minister:

In accordance with the provisions of Section 16 of the *Law Reform Commission Act*, we have the honour to submit herewith the report with our recommendations on the studies undertaken by the Commission on those parts of the *Bills of Exchange Act* relating to cheques and rights of deposit institutions collecting cheques.

Yours respectively,

Francis C. Muldoon, Q.C.
Chairman

Jean-Louis Baudouin, Q.C.
Vice-Chairman

Gerard V. La Forest, Q.C.
Commissioner

Judge Edward James Houston
Commissioner

REPORT

THE CHEQUE

SOME MODERNIZATION

Commission

Francis C. Muldoon, Q.C., Chairman
Jean-Louis Baudouin, Q.C., Vice-Chairman
Gerard V. La Forest, Q.C., Commissioner
Judge Edward James Houston, Commissioner

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Introduction

This Report concerns two related problems which were explored by the Commission in the course of its research on the payments system. The first problem has developed from the wide growth of non-bank chequing services; the second arises from the need to balance equitably the interests of all parties involved when a payment by cheque goes awry. The technical solution to the first problem is a re-definition of "cheque" to meet today's needs and practices. The technical solution to the second problem is a restatement of the rights of a collecting deposit institution to return to a position intermediate between the old law and that enacted by subsection 165(3) of the *Bills of Exchange Act*. As a consequence of our proposed solution to the first problem, the kinds of protection now extended to banks collecting cheques will be extended to all members of the Canadian Payments Association in the collection of both cheques and what are today known as "near-bank" payment orders — cheques on such institutions as trust companies, credit unions and the Alberta Treasury Branches.

PART I

The Definition of "Cheque"

A. Present Law

The *Bills of Exchange Act* presently defines the cheque, and sets out a few of the legal rules affecting it. The Act is by no means comprehensive; however, thorough-going reform would require very extensive review. Since it is likely that the entire Act should ultimately be replaced by a coherent code governing all payments transactions, paper or electronic, the following recommendation is simply a minimum change for the purpose of solving the problem created by non-bank "cheques".

The relevant sections of the statute provide:

PART III

CHEQUES ON A BANK

Cheque defined.

165. (1) A cheque is a bill of exchange drawn on a bank, payable on demand.

Provisions as to bills apply.

(2) Except as otherwise provided in this Part, the provisions of this Act applicable to a bill of exchange payable on demand apply to a cheque.

Cheque for deposit to account.

(3) Where a cheque is delivered to a bank for deposit to the credit of a person and the bank credits him with the amount of the cheque, the bank acquires all the rights and powers of a holder in due course of the cheque. R.S., c. 15, s. 165; 1966-67, c. 12, s. 4.

INTERPRETATION

Definition.

2. In this Act

"bank"

"bank" means an incorporated bank or savings bank carrying on business in Canada;

The weight of authority now establishes that "bank" in subsection 165(1) means chartered bank, and that similar instruments drawn upon a non-bank deposit institution are not cheques.[1] Several federal statutes accordingly contain verbose provisions designed to give such instruments the same treatment as cheques.[2] Such instruments, if otherwise conforming to the standards required for machine-processing and secure settlement, are treated by the Canadian Bankers' Association as cheques for clearing purposes. The average Canadian in fact believes them to be cheques. Institutions which offer a transferable deposit service customarily advertise it as "chequing privileges", even though they are not banks and the instruments used to transfer the deposits are not legally cheques. The deposit institutions, including the banks, are of the view that no useful purpose is served by the legal distinction between the cheque and the non-bank order.[3]

B. Difficulties Produced by Present Law

The separate treatment of non-bank demand instruments produces needless complication of the federal law. It results in complex legislation[4] and amendments to correct unintended omissions.[5]

The applicability of even the basic rules concerning cheques to these very similar instruments is doubtful and obscure.[6] Such simple problems as the effect of the drawee's insolvency and the existence of a right to stop payment provoke litigation.

When legislation or private contract only mentions the cheque as a means of payment, it is almost never clear whether the intent was to speak of cheques in the strict legal sense, or to include these non-bank instruments. The result is to create a series of legal traps for the users of such instruments.

This unfortunate result seems to be the product of the gradual growth in importance of the non-bank deposit institutions in the consumer market. Recent studies,[7] and policy pronouncements,[8] concerning competition in the financial sector argue the removal of competitive barriers between the banks and non-banks. The legal definition of a cheque is such a barrier for those who are aware of it, and a trap for those who are not.

C. Suggested Reform

Recommendation 1

The Commission recommends that the legal cheque should be re-defined. Any demand bill of exchange drawn upon a deposit institution should be a cheque.

At this level of generality, the problem that two important drawees of private cheques are Crown instrumentalities, but not technically deposit institutions, is not met.[9] Whatever government instruments drawn upon the Receiver General of Canada (or similar provincial instruments) may be, those instruments drawn by private account-holders who bank with the Alberta Treasury Branches and the Province of Ontario Savings Offices should be considered cheques. This technical problem is met by our proposed statutory change.

A second problem is raised by great differences in size among institutions that conduct a chequing business. Of these, some are very small; others giant. Not all of the small institutions are credit unions with access to a central or federation; some are unaffiliated, others are small trust companies. All these have of necessity developed correspondent relationships to clear these instruments. These inter-industry relationships may determine whether an instrument is clearable; they should not determine whether it is a cheque.

A cheque has certain legal properties that do not attach to a demand bill of exchange — indeed this is the whole reason for the reform. It is essential that the decision whether or not an instrument is a cheque be one that can be taken from the face of the instrument. The definition of a cheque must therefore be formal, not factual. It must be drawn to include the instruments drawn on all forms of near-bank. If such an institution conducts an unauthorized chequing business, that is a matter to be corrected by the provincial regulators concerned — not by penalizing innocent consumers and merchants who dealt with its customers or with it in good faith. This approach is a commonplace in modern corporate law's treatment of the problem of *ultra vires* conduct and requires no extended justification.

It should also be remembered that a cheque creates no legal rights against the bank on which it is drawn unless it is certified by that bank or paid. The issues raised by re-definition of the cheque are issues between drawers (people who write cheques) and payees or other subsequent holders of the instrument. The clarification of the governing law does not prejudice the position of deposit institutions.

It is possible to draw a cheque on a non-existent bank or account today. The re-definition does not create or facilitate a new risk. Nor does it prejudice the issues of whether an instrument is admissible to the clearings or how it will be cleared. Those issues are obviously within the competence of the authority regulating the clearings.

In the Commission's view, the law would be substantially improved if all domestic instruments drawn by private parties against demand deposits were brought unequivocally under the same regime. We turn to a discussion of the means by which this might be done.

There are two alternatives: to deal directly with the definition of a "cheque", or to achieve the same result by altering the definition of "bank" for the limited purpose of its use in the definition of a cheque. In the Commission's view, the first alternative is preferable.

The goal of the reform is to change the legal meaning of "cheque". There is something to be said for direct approaches to that goal. It is confusing to layman and lawyer alike to be told that a cheque is a demand bill of exchange drawn upon a bank, but that bank in this definition doesn't really mean bank — it means . . . Such learned arcana deserve to be banished from our law. Nice questions about whether when some other statute uses the term "cheque" it means cheque in the traditional sense, or cheque as re-defined by this fiction concerning banks, can be raised. The direct approach also avoids opening the question of whether such a special purpose definition of "bank" is really banking legislation at all.

It is clear by contrast that the federal Parliament has the power to deal with the near-bank instrument as a bill of exchange, and to declare which sub-classes of bills of exchange shall be "cheques". If cheque, so defined, is the only form of cheque in Canadian law, there is no opportunity for raising the sort of nice legal points that this reform hopes to consign into learned oblivion.

Wholly apart from the question of how "cheque" is defined, the Commission is of the view that public understanding of the term "bank" is probably not aided by starting a statutory process of multiplying definitions of *that* concept for various purposes. We have enough problems already with the possibility of different constitutional and statutory meanings of "bank"; we ought not compound confusion.

The Commission therefore could not recommend the approach contained in the current *Bank Act* revision legislation. This provides:[10]

Bills of Exchange Act

85. Part III of the *Bills of Exchange Act* is amended by adding thereto, immediately preceding section 165 thereof, the following section.

Definition of "bank".

"164.1. In this Part, "bank" includes every member of the Canadian Payments Association established under the *Canadian Payments Association Act* and every credit union, as defined in that Act, that is a member of a central, as defined in that Act, that is a member of the Canadian Payments Association."

The Commission suggests that this proposal has several disadvantages. First, it proceeds by way of confusing fiction, instead of directly addressing the problem. The problem is to re-define "cheque", not "bank". Secondly, it establishes a *factual*, rather than a formal, test. Scrutiny of the *Canadian Payments Association Act* proposal shows that for the near-banks, membership is not automatic — it requires certain steps.[11] There are of course sound reasons of policy for not forcing near-banks into the Association, and there is every reason to expect that the benefits of participation will induce them to join on the voluntary basis which is the philosophy of the current proposals. The Commission does not question that approach. It does question the legal wisdom of a factual test to define cheques.

The solution, in its view, is to approach the problem by way of eligibility for membership in the Canadian Payments Association — not by way of actual membership. The criteria for eligibility, stripped of their technicalities, are to be a Canadian deposit institution under a regime of inspection, regulation, and

deposit insurance.[12] On any reasonable view of the competence and vigour of the responsible regulators, this can be reduced to being a Canadian deposit institution. The factual questions raised by loopholes in regulatory schemes should be left to the regulators and to the Canadian Payments Association itself as the governing body for the clearings. From the point of view of ordinary people or the merchants with whom they deal, an instrument which purports to be drawn on such an institution is a cheque. Questions of fact should be left to those who are likely to have the information available to decide those questions.

Any other solution imposes risks on the ordinary person that he has no conceivable means of gauging. Keeping unauthorized items out of the clearings is the business of regulators and the deposit institutions themselves; it is not the role of the *Bills of Exchange Act* or the individual Canadian. This is the approach of present law. No regulatory approval is required to make an instrument drawn on a chartered bank a cheque today.

Recommendation 2

The Commission recommends that the test used to describe those institutions whose instruments will be "cheques" should be a formal one.

D. Statutory Changes

The Commission recommends that the *Bills of Exchange Act* be amended to read:

PART III

CHEQUES

Cheque defined.

165. (1) A cheque is a bill of exchange, payable on demand and drawn upon a deposit institution.
(New)

Provisions as to bills apply.

(2) Except as otherwise provided in this Part, the provisions of this Act applicable to a bill of exchange payable on demand apply to a cheque. (R.S.C. 1970)

Meaning of deposit institution.

(3) In this section, deposit institution includes a bank, a credit union, a trust or loan company, incorporated under the law of Canada or a province, an instrumentality of the Crown that accepts deposits from the public and any other organization, whether or not a legal entity, that accepts deposits from the public and that has the right to apply for membership in the Canadian Payments Association under the statute establishing that Association.
(New)

The Commission does not believe this definition can or should control which instruments can be passed through the clearings. That question is one which must be decided independently by the regulators and the members of the Canadian Payments Association.[13] Under an effective regulatory regime, the Commission believes that there would be no difference between the formal and the factual test. We believe no institution will be conducting a chequing business that has not made the arrangements for clearing accommodation which membership in the Association entails and is designed to provide. To conduct such a business without clearing accommodation would be difficult and inefficient, and would hardly be consistent with the goals regulatory authorities are likely to pursue. But the Commission believes that the risk of regulatory omission should not be placed on consumers or businessmen who come into possession of instruments drawn on the offending institution. There is a way to prevent them from bearing such risk — use a *formal* definition for "cheque".

PART II

Rights of a Collecting Institution

A. Present Law

Subsection 165(3) of the *Bills of Exchange Act* grants certain rights to banks collecting cheques which they have received on deposit. The subsection was enacted in 1967 and has been the cause of considerable adverse comment. To understand its effect, the general rules affecting negotiability must be briefly discussed.

The law respecting negotiable instruments classifies possessors of such instruments in a hierarchy of rights. The most favoured position in that hierarchy is that of the holder in due course. A holder in due course can collect from any prior party to the instrument under favourable procedural and evidentiary treatment: most common defences cannot prevail against a holder in due course.

To be a holder in due course, a person must acquire the instrument before it was overdue and without notice of dishonour. He must have given value for it, and he must take it in good faith and without notice of any defect in title of the person who negotiated it at the time of the negotiation. These requirements were developed at the time when negotiable instruments served as a medium of exchange, and were designed to facilitate that role. They are intended to insulate the holder in due course — who by application of these tests knows nothing

about the transaction in which the instrument was given — from defences arising out of the transaction.

For example, A buys a bicycle from B, giving B a cheque for $100 in payment. B endorses the cheque to C in settlement of a debt the next day. C knows nothing about the transaction between A and B, but knows that A is a local businessman and is therefore willing to take his cheque as payment. The bicycle is utterly worthless — a mass of rust — although B, who runs a cycle repair business, had described it to A as being in first-class shape and capable of withstanding hard use. If A stops payment on the cheque and is sued by C, C will win. None of the obvious rights which A has against B can be asserted against C, the holder in due course.

Suppose that A, an elderly man, is induced by Z, his lawyer, to make the lawyer a large gift of money in the form of a cheque. The lawyer endorses the cheque and uses it to purchase securities from X. A's relatives quickly discover the transaction and A is persuaded to stop payment. If X is found to be a holder in due course, he can collect the cheque in spite of the obvious legal and ethical impropriety of the lawyer's conduct.

In both these examples, the holder in due course wins the suit to enforce the cheque because the law has chosen to protect value in exchange as opposed to rights of contract or property. In these examples, A still has his remedies against the actual wrongdoer — B or Z. But in practice these remedies are often useless.

Let us take a third case. A gives B a cheque, payable to B's order, in payment. B loses the cheque; it is found by C who forges B's endorsement, impersonates B at the counter of the local grocery store, and uses it to pay his bill. The grocer attempts to collect the cheque, but B has notified A of its loss, and A has stopped payment. The cheque is returned to the grocer, who would like to sue A. But he will not win. There can be no *holder* after a forged endorsement; there can therefore be no holder in due course. The grocer's only remedy is against C — if he can find C.

In this third case, the law seems to have chosen to protect property concepts. B is treated as the "true owner" of the cheque and still has rights in it, even though its physical possession may have passed through the hands of several other people. But if the law did not take this view, the presence or absence of endorsements would not matter. A thief could give good title, and a cheque payable to order could pass from hand to hand as easily as a bearer bond or a $20 bill. By requiring proper endorsement, the law makes secure commercial and private payments possible.

Our third case can be explained in lawyer's terms by saying that a holder takes by negotiation, and that negotiation of an instrument payable to order or specially endorsed requires the endorsement of the individual to whom the instrument is payable or so endorsed. Mere transfer of possession is not good enough. Or we might take a business viewpoint. If a cheque payable to the order of John Smith Ltd. can be turned to cash successfully by any clerk in the order department, no endorsement required and no questions asked, the personnel managers of this world had best be infallible judges of character. The law has good reason for requiring proper endorsement.

Subsection 165(3), *Bills of Exchange Act*, provides that where a cheque is delivered to a bank for deposit to the credit of a person and the bank credits him with the amount of the cheque, the bank acquires all the rights and powers of a holder in due course of the cheque. It should be noted that the subsection says nothing about who has endorsed the instrument or how it has been endorsed — the issues raised in our third example. It says nothing about whether the cheque is overdue or not, whether the bank has notice of dishonour or of a defect in title, or even whether the bank takes in good faith. For the element of giving value, it substitutes crediting the individual with the amount of the cheque. For each and every other element of the status of holder in due course, it substitutes acceptance by the bank of delivery for deposit to the credit of a person.

In short, the subsection provides that a bank which meets the two conditions stated is a holder in due course — regardless

of what it knows from either the face of the instrument or its knowledge of the transaction in which it was given.[14] This statutory preferment is granted only to banks,[15] and only in respect of cheques. If it is necessary to protect the institutions of the clearing system, and the Commission does not accept that assertion, it should be extended equally to all collecting institutions and should apply to instruments of all the institutions — that is to "cheques" as re-defined in Part I of this Report, as well as bank cheques.

The subsection has been given very wide effect. In *Groves-Raffin Construction Ltd. v. Canadian Imperial Bank of Commerce*[16] the court used it to bar conversion claims against a collecting bank. The Company's account had been looted by one of its officers by drawing a cheque for $176,000 payable to himself personally which the defendant bank had collected. Mr. Justice Bull refused to limit subsection 165(3) to a case in which value had been given, found delivery for deposit to the credit of a person and stated subsection 165(3) was a complete defence to the action. He described it as the very antithesis of the former law. Justices Robertson and McIntyre did not decide the value issue, since the funds credited had been drawn on. They agreed that the conditions for application of the subsection were established, and that it was a complete answer to a claim for conversion.

Less controversial uses of the subsection occurred in *Bank of Nova Scotia v. Archo Industries Ltd.*,[17] and *Royal Bank v. Wild*.[18] In these cases the bank was held entitled to use the subsection to recover from the drawer, even though it had attempted unsuccessfully to collect from its former customer.

In neither of these cases was the court willing to find an estoppel. On facts showing actual prejudice arising from the bank's pursuit of its customer, this might bar the bank's rights under subsection 165(3). Such a development would encourage the bank to pursue the drawer, rather than the depositor, at an early stage. This development would be an undesirable departure from the normal practice of taking first recourse on the depositor.[19]

Subsection 165(3) was never intended to have such effects. It was introduced in 1967, apparently to overrule the decision in *Imperial Bank of Canada v. Hays and Earl Ltd.*[20] That case was an action by the collecting bank against the drawer. The payee had deposited a cheque with plaintiff collecting bank; the cheque was endorsed "deposit ONLY to the account of . . .". The payee then fraudulently informed the drawer that the cheque had been stolen, and requested it to stop payment. The drawer issued two new cheques in payment. Meanwhile the plaintiff had *both* credited the payee and allowed him to draw on the credit by certifying a cheque to a third party.

Returning to our three examples, this seems to be the sort of case in which the plaintiff bank should win. It has given value — the certification — and there was no evidence it had any knowledge of the payee's fraud. However, the court found for the defendant. It did so because, under rules applicable to negotiation of an instrument, the endorsement "*for deposit ONLY*" could not confer holder in due course status. Such an endorsement makes the endorsee the agent of the endorser to obtain collection, but leaves him subject to *any* defence good against the endorser. As the court put it: "[The Bank] would not, for example, have cashed the cheque on the strength of the endorsement. [The bank] was in duty bound first to endeavour to collect the [cheque], and if honoured credit the proceeds to the account of [the payee], and any private arrangement between the [bank] and [the payee] with respect to credit does not affect the matter."[21]

The particular form of endorsement used, "*for deposit only*" and like forms, such as "*for deposit and collection*" or "*deposit to the account of . . .*" are very common. They are almost invariably applied by businesses. Even private parties may use them, as where a husband, delivering his pay cheque to his wife to make a deposit to his account, endorses for deposit rather than to her specially or in blank. If he endorsed in blank, the cheque could be stolen and successfully negotiated. If he endorsed it to her specially, she could endorse and deposit to his account; she could also cash or further endorse the cheque. But if he endorses restrictively, she is a mere messenger. The cheque is "locked in" to the bank collection system by the form of

endorsement. It is submitted that those who use these forms of endorsement are well aware that they lock the cheque into the banking system; but that they are probably unaware that they produce the result of reducing the collecting bank to an agent for collection with power to sue on the cheque. This is not because the law is unclear; but because it is not well-known.

The manner in which banks treat deposits is not consistent with the result of *Imperial Bank v. Hayes and Earl Ltd.* They do not sort cheques to determine whether they are restrictively endorsed, and suspend credit for any cheques so endorsed until the time for returns has passed. A bank which did so would lose its commercial customers instantly. The practice of banks is that described in *Hayes and Earl* — they credit on deposit and the funds are normally available when the bookkeeping to indicate their deposit is complete. This is not a question of law, but of normal commercial practice. The ability to draw against uncollected deposits is not a matter of right — it is a concession normally made to customers.

Of course, this practice creates exposure to all risks of non-collection. It is not surprising that legislative reversal of *Hayes and Earl* was sought. The initial draft of subsection 165(3) spoke of "a cheque endorsed for deposit to the credit of the *payee*" and would have made banks the winners in the *Hayes and Earl* fact situation. The testimony of Mr. Elderkin, then Inspector General of Banks, in the face of pointed opposition questioning, was that the subsection was designed to overcome the effect of the "for deposit only" endorsement set out in that case.[22] However, in the form in which it was finally enacted subsection 165(3) did far more than negate the effect of a restrictive endorsement.

B. Difficulties Produced by Present Law

Subsection 165(3) has so completely altered the position of collecting banks that it is difficult concisely to outline its effect. It eliminates any requirement for title in or endorsement by the

depositor; it appears to dispense with any requirement that the bank give value apart from the bookkeeping entry of a reversible credit; and it permits any bank conduct short of actual dishonest conspiracy with the depositor.[23]

The present rule does not produce difficulties in the absence of substandard banking practice. If the collecting bank follows prudent practices, the effect of the present rule is to provide the user of restrictive endorsements with the practical protection of negotiation restricted to bank channels of collection, while protecting the bank against any risk through the use of conditional credit. However, as the *Groves-Raffin* case, *supra*, makes clear, prudence is too often a counsel of perfection.

The present rule is so excessively broad that it can only encourage the adoption of imprudent banking practices. Why should a bank concern itself with the slightest precautions concerning endorsement of its customers when it has the protection of such incredible powers?

C. A Comparison with Other Countries

As we have noted, subsection 165(3) creates an undue statutory preferment for collecting banks. Some comparison with other countries may be in order. In both the U.K. and Australia, legislation substantially similar to our *Bills of Exchange Act* is in force. Both jurisdictions make use of crossed cheques to a great extent, although they have never been used extensively in Canada. Thus, in both jurisdictions the collecting bank has never been exposed to risk to the extent that a Canadian bank is by virtue of our law respecting conversion and unauthorized endorsement.

Nevertheless, in both jurisdictions, the collecting banker is entitled to protection from the conversion action only if he receives payment for his customer (or recoups credit advanced) "in good faith and without negligence".[24] Prior to payment — that is, in a suit on a cheque on which payment has been stopped

— he is treated on the same terms as anyone else in respect of whether he has given value and takes without notice of defences and irregularities. However, if the payee[25] has *not endorsed* a cheque delivered for collection, the collecting banker is given "such (if any) rights as he would have had if, upon delivery, the payee had endorsed it in blank".[26] The effect of this is simply to allow him to recover in spite of the missing endorsement on the actual facts as to value, notice of defects in title and other irregularities (apart from the missing endorsement). In Britain, the statute supplies the same effect for the missing endorsement of any *holder*, as well as that of the payee. That is, in Britain the bank's customer need not be the payee for the missing endorsement to be cured. But the statute still *only* cures the missing endorsement of the bank's customer. It does not cure the missing endorsements of prior parties; it does not cure irregular endorsement.

Such defects are cured for a collecting banker only if he has received payment on the instrument in good faith and without negligence, and it seems that they are cured only in respect of actions for money had and received and for conversion. An equitable claim would probably lie to trace the funds remaining in the banker's hands.[27]

One can justifiably conclude that the protection of collecting bankers in Canada now substantially exceeds that given in the U.K. and Australia. This is unusual, since prior to enactment of subsection 165(3) Canadian law regarding the collecting banker left him exposed to consequences against which English law had long given protection — in particular the conversion liability for collecting on an unauthorized endorsement, and a common law and statutory liability to the paying bank for receiving the funds involved in such a case. It seems unlikely that an amendment for which such modest claims were made was intended to render the law the very antithesis of what it was.

The United States, under the Uniform Commercial Code (hereafter U.C.C.)[28], follows the Canadian rule in respect of forged and unauthorized endorsement. It is informative to compare the treatment given by Article IV of the Code to the position of a collecting bank. Throughout the following

discussion, it should be remembered that the Code lays an overriding obligation of good faith on all parties subject to it.[29]

Under U.C.C. section 4-205 a depositary bank may supply any endorsement *of its customer* necessary to title, unless the item contains words such as "payee's endorsement required". No variations from this rule exist in any of the enacting jurisdictions. The section frees intermediary and paying banks from the consequences of restrictive endorsement. Depositary banks (that is, the first bank in the chain of collection — the one in which the item is deposited) are bound by restrictive endorsements, including those of persons other than their immediate transferor.[30]

This rule does not protect a collecting bank from the consequences of forgery or abuse of authority. It does allow it to take free of defences if the only barrier to holder in due course status would be the missing endorsement of its customer.[31] To free itself from a restrictive endorsement, the collecting bank would be required to show that it had paid or applied value given for, or on the security of, the instrument in accordance with the endorsement.[32] That is, if the endorsement is "*for deposit only*" the bank must have given deposit credit to the endorser; if it is "*for credit to the account of X*" then X must be credited. This is not normally a difficult showing, but it is an important one. Without this requirement, the bank can treat the instrument as though it owns it, and this is exactly what the depositor sought to prevent from happening by his restrictive endorsement. Banks are perhaps more trustworthy than every man in the street, but they are not perfect. Even subsection 165(3) contains a requirement that the customer be given deposit credit before the bank's rights are invoked.

Under the U.S. rule, the depositary bank is not freed from the consequences of forged or unauthorized endorsement; it is freed from a missing endorsement of its customer if it supplies that endorsement in good faith; and it is freed from the effect of a restrictive endorsement on its ability to become a holder in due course — *if it in good faith applies value consistently with the restrictive endorsement*. Under subsection 165(3), a depositary bank is freed from all of the above by the act of crediting its

customer, whether or not it acts in good faith. Subsection 165(3) requires bank conduct which is appropriate in considering whether the bank should be freed from the effect of restrictive endorsement, but gives the bank rights and remedies far beyond those needed to deal with restrictive endorsements. The rights given are so broad that they render the whole question of proper endorsement irrelevant.

The U.C.C. position can also be contrasted with subsection 165(3) on the issue of whether a simple bookkeeping entry of credit to the depositor is enough to give the bank its rights, and what the extent of those rights are. At common law, it is essential that credit given against an item in the process of collection be drawn against if the bank is to claim that value has been given.[33] If the bank has discounted a bill or note, or cashed a cheque, value is given.[34] A certification at the customer-drawer's request would be value. The bank can also give value by taking a cheque as security for, or to be applied in payment of, the depositor's antecedent debt.[35] But simply crediting a cheque on deposit is not enough until the proceeds are drawn on or applied to the depositor's use.[36] In the normal transaction of deposit into a current account, value is not given until the funds are drawn on by the depositor and is given only to the extent that they are drawn on.[37]

The U.C.C. codified this position in sections 4-208 and 4-209. Under 4-208(1)(a) a depositary bank gives value "to the extent to which credit given for the item has been withdrawn or applied". This is the rule of the common law, codified, for deposit and collection items.[38] Under 4-208(1)(b) if the depositary bank makes credit available for withdrawal as of right, value is given to the extent of the credit extended, whether or not it is drawn on and regardless of a right to charge back. This is the common law position where an item has been discounted by the bank.[39] The cases involving cheques taken on deposit are dealt with under 4-208(1)(a).[40]

Having given value, a depositary bank acquires a security interest under section 4-209 to the extent that value has been given, and can become a holder in due course to the extent of that interest — if it can meet the normal requirements of good

faith, no notice the instrument was overdue or dishonoured, and no notice of any claim with respect to the instrument. This means, and the cases establish, that the bank can be freed from defences to the extent of its security interest, but subject to them in respect of the excess between the face value of the instrument and its interest.[41] In the event that it collects the full value of the instrument, it is accountable for it to the customer.

The advantage of the U.C.C. is that it presents, in two relatively clear-cut provisions, a conclusion which must otherwise be arrived at from the synthesis of the governing case law, and which, without a full analysis of that law, is far from obvious.

Contrast the U.C.C. position with the apparent result under subsection 165(3). Suppose that a cheque is deposited and credit given to the customer. Payment is stopped by the drawer for reasons which are no defence against the bank, if it is a holder in due course, but which are a good defence against the payee-customer. When the cheque is charged back to the account, it produces a one dollar overdraft. On the plain language of subsection 165(3), the bank is entitled to sue the drawer for the face amount of the cheque and recover it. Now, one dollar of that recovery can obviously be applied by the bank to the overdraft. What should it do with the rest of the money? If it is to be credited to the payee's account, the common law rule against circuity of action should bar its recovery in the first place.[42] If the bank is to keep the rest of the money, it must be on the theory that the bank is the owner of the cheque. Banks normally resist this theory, which can be fatal to their claim of recourse on their depositor. Subsection 165(3) appears to permit the bank to keep the rest of the money; if sound, such a conclusion is completely at variance with the normal understanding of the bank-customer relationship.

Under the U.C.C. the result is simple. The bank can recover its one dollar as holder in due course. It has power as holder to sue for the remainder, but it must stand in the payee's position, subject to any defence good against him.[43]

Consider the example again. On the face of subsection 165(3) it makes no difference whether or not an overdraft was produced. If the cheque were returned dishonoured because payment had been stopped, the bank does not need to charge it back to the account. Even if there have been no intervening transactions, so that the chargeback would simply cancel the credit originally given — even if there have been further deposits but no withdrawals — the holder in due course status is obtained by simple credit to the account. This means that the bank can, if it elects to do so, sue on the instrument as holder in due course, and recover its value. It can protect its wrong-doing customer, and force the drawer to sue him, even though it is not presently out of pocket.

Why would a bank do that, when it could charge the instrument back to the account? Probably because it holds other, unmatured obligations of its customer which will shortly fall due and are capable of exhausting his current account. In any event, deposit institutions do on occasion pursue the drawer in preference to taking a charge-back on their customer.[44] The U.C.C. rule thus has the advantage over subsection 165(3) that the bank must be out-of-pocket in a real, rather than a mere bookkeeping, sense before it can pursue the drawer. U.C.C. 4-208(1)(b) is an exception to this statement, but it is restricted to the relatively uncommon discount situation.

In summary, the Canadian law under subsection 165(3) is far more favourable to the collecting bank than the law of the United States, Australia, or the United Kingdom. In none of those jurisdictions would a collecting bank receive holder in due course status prior to payment without an opportunity for the drawer to raise the facts concerning value or defects in title. It is true that in Australia and the U.K. collecting and paying banks are protected from liability for conversion after payment of a cheque — but that situation dates from before the turn of the century in respect of crossed cheques, which are the common payments instrument in those countries. Such protection also requires good faith and payment in ordinary course or collection without negligence on the bank's part — requirements absent from subsection 165(3) of the Canadian Act. In the United States, where crossed cheques are not used, banks are exposed

to the same sorts of conversion liability to which they are subjected in common law provinces of Canada apart from subsection 165(3).

D. Suggested Reform

The Commission concludes that subsection 165(3) confuses the law governing the collection of negotiable instruments by deposit institutions, that it grossly overstates the rights of collecting institutions, and that it invites the growth of unsound practices. As commentators have pointed out, the subsection is so overbroad that it invites judicial intervention to restore the balance between the bank and its customer.[45] It cannot be defended by a comparison with other common law countries' law. Fairness to the public requires correction of this imbalance. The Commission believes that it is possible to state a more equitable basis for the law of collections, and that it would be desirable to do so.

We begin with a recommendation flowing from the policy of institutional neutrality discussed in Part 1. Combined with the re-definition of cheque there proposed, this recommendation would protect all collecting institutions handling cheques and like instruments — instead of only banks collecting cheques drawn on banks.

Recommendation 3

The Commission recommends that all members of the clearing system should be entitled to protection on an equal basis — not merely collecting banks.

We have referred in detail to the undue protection given by present law to the rights of collecting institutions. However, these institutions do deserve protection against the risk that subsection 165(3) and similar legislation in other countries were

designed to meet. They should not be barred by a technicality of their customer's endorsement from recouping funds advanced in good faith and normal course of business to that customer's account. A person who draws a cheque in payment should expect that others may acquire rights in it, and if those rights are in fact acquired for value, in good faith and without notice, the drawer should be required by the law to honour his promise to pay. Collecting institutions are thus entitled to protection against loss in many cases in which funds are actually advanced or applied against restrictively endorsed deposits.

Recommendation 4

The amount of protection extended to collecting institutions should be substantially reduced; automatic holder in due course status is far too favourable to the collecting institutions. Protection should be extended to institutions which have received a restrictively endorsed instrument in otherwise regular circumstances; and they should be allowed to claim as holders rather than as agents. The kind of holder they are should be determined by the standards applicable to everyone else.

Special problems can be raised for collecting institutions by such technical defects as the missing endorsement of their customer, because of the number of instruments which they handle in a business day. At the same time, respect for the rights of drawers forbids wholesale validation of every piece of questionable paper which can be foisted on a busy teller. In the Commission's view, the restriction of protection to instruments deposited to the account of the payee strikes the proper balance. This raises an immediate practical problem respecting joint accounts where either holder may sign. In many such cases, one account-holder will be unwilling or unable to defend because of personal relationships with the co-holder. That fact does not justify institutional carelessness with any account-holder's rights.

Recommendation 5

The Commission recommends that a deposit institution collecting instruments deposited to the account of the payee should be protected against missing endorsements. However, the protection should not extend to a situation where the proceeds of a cheque are misappropriated by deposit to a joint account by another individual with signature authority over the account.

The Commission believes, in light of the split decision in the *Groves-Raffin* case, that it is desirable to clarify the circumstances in which a collecting institution has given value, and the effect of value, in statutes dealing with the rights of collecting deposit institutions. The problems are recurring and obvious, and guidance should be given the courts in resolving them. The "security interest" concept introduced by the U.C.C. has been incorporated in provincial legislation, and has gained wide currency in the legal literature. It is embodied in current federal bankruptcy reforms. Use of the concept allows a concise statement of the principles upon which the courts are to resolve the cases. Our recommendations are restricted to the deposit of cheques; the withdrawal as of right provisions of the U.C.C., designed to meet the discount of other items, are not included.

Recommendation 6

The Commission recommends that a security interest in the instrument should exist in favour of the collecting institution, and value be treated as present, when and to the extent that, credit given is withdrawn or applied.

Finally, the Commission notes that the additional rights extended to collecting institutions through these reforms are justified by the importance of the payment system functions

which these institutions perform. It is not because an institution is a bank, credit union or trust company that it should be given this protection, but because as such an institution it performs an important social role in facilitating — through private means — the operation of the Canadian monetary system. The *Bank Act* revision proposals create for the same purposes a new organization — the Canadian Payments Association — for the management of the clearings. It is hoped that this organization will include all deposit institutions conducting a chequing business. Membership is, however, voluntary.

Recommendation 7

The Commission recommends that the additional rights given collecting institutions be conditioned on their participation in the Canadian Payments Association.

E. Statutory Changes

The Commission recommends that the following subsections be added to the *Bills of Exchange Act* to effectuate its suggested reforms in the rights of collecting institutions:

Endorsement for deposit: effect on certain collecting institutions.

165. (4) Endorsement of a cheque "for deposit", "for deposit to the account of the payee", or to like effect does not prevent a member of the Canadian Payments Association which is acting consistently with the endorsement from acquiring the rights and powers of a holder.
(New)

Missing endorsement of payee — effect on certain collecting institutions

(5) A member of the Canadian Payments Association, in collecting a cheque deposited for credit to the account of the payee without endorsement, for which it has given value as provided in this section, has such (if any) rights as it would have if, upon delivery, the payee had endorsed the cheque in blank.
(New)

— joint accounts.

(6) Nothing in subsection (5) shall affect any claim or defence which could otherwise be asserted by a payee in respect of cheques deposited without his endorsement to an account over which another person or persons exercise signature authority.

(New)

Security interest

— certain collecting institutions

(7) A member of the Canadian Payments Association has a security interest in a cheque deposited to an account to the extent to which credit given for that cheque is withdrawn or applied, or to which certification in reliance on such credit is made at the customer's request in respect of a cheque drawn by him.

(New)

— partial withdrawal or application

(8) Where credit is given for several cheques on a deposit, any withdrawal, application or certification mentioned in subsection (7) creates a security interest in all cheques in the deposit to the extent there stated, and the interest continues until the collection of all is complete.

(New)

— enforceability and perfection.

(9) The security interest created by subsection (7) or (8) is enforceable without written security agreement, and is perfected by possession of the member or another member or deposit institution acting under the clearing by-laws of the Canadian Payments Association.

(New)

Value given by certain collecting institutions.

(10) A security interest under subsection (7) or (8) is value, to the extent of the interest, for the purpose of determining whether a member of the Canadian Payments Association is a holder in due course or for value.

(New)

Status of certain credit unions.

(11) For the purposes of this section, a credit union which is a member of a central which is a member of the Canadian Payments Association is deemed to be a member of that Association.

(New)

PART III

Recommendations

A. Policy Changes

Recommendation 1

The Commission recommends that the legal cheque should be re-defined. Any demand bill of exchange drawn upon a deposit institution should be a cheque.

— *See* page 5

Recommendation 2

The Commission recommends that the test used to describe those institutions whose instruments will be "cheques" should be a formal one.

— *See* page 9

Recommendation 3

The Commission recommends that all members of the clearing system should be entitled to protection on an equal basis — not merely collecting banks.

— *See* page 23

Recommendation 4

The amount of protection extended to collecting institutions should be substantially reduced; automatic holder in due course status is far too favourable to the collecting institutions. Protection should be extended to institutions which have received a restrictively endorsed instrument in otherwise regular circumstances; and they should be allowed to claim as holders rather than as agents. The kind of holder they are should be determined by the standards applicable to everyone else.

—*See* page 24

Recommendation 5

The Commission recommends that a deposit institution collecting instruments deposited to the account of the payee should be protected against missing endorsements. However, the protection should not extend to a situation where the proceeds of a cheque are misappropriated by deposit to a joint account by another individual with signature authority over the account.

—*See* page 25

Recommendation 6

The Commission recommends that a security interest in the instrument should exist in favour of the collecting institution, and value be treated as present, when and to the extent that, credit given is withdrawn or applied.

—*See* page 25

Recommendation 7

The Commission recommends that the additional rights given collecting institutions be conditioned on their participation in the Canadian Payments Association.

—*See* page 26

B. Statutory Changes

Bills of Exchange Act

PART III

CHEQUES

Cheque defined.

165. (1) A cheque is a bill of exchange, payable on demand and drawn upon a deposit institution.

(New)

Provisions as to bills apply.

(2) Except as otherwise provided in this Part, the provisions of this Act applicable to a bill of exchange payable on demand apply to a cheque. (R.S.C. 1970)

Meaning of deposit institution.

(3) In this section, deposit institution includes a bank, a credit union, a trust or loan company incorporated under the law of Canada or a province, an instrumentality of the Crown that accepts deposits from the public and any other organization, whether or not a legal entity, that accepts deposits from the public and that has the right to apply for membership in the Canadian Payments Association under the statute establishing that Association.

(New)

Endorsement for deposit: effect on certain collecting institutions.

(4) Endorsement of a cheque "for deposit", "for deposit to the account of the payee", or to like effect does not prevent a member of the Canadian Payments Association which is acting consistently with the endorsement from acquiring the rights and powers of a holder.

(New)

Missing endorsement of payee

— effect on certain collecting institutions

(5) A member of the Canadian Payments Association, in collecting a cheque deposited for credit to the account of the payee without endorsement, for which it has given value as provided in this section, has such (if any) rights as it would have if, upon delivery, the payee had endorsed the cheque in blank.
(New)

— joint accounts.

(6) Nothing in subsection (5) shall affect any claim or defence which could otherwise be asserted by a payee in respect of cheques deposited without his endorsement to an account over which another person or persons exercise signature authority.
(New)

Security interest

— certain collecting institutions

(7) A member of the Canadian Payments Association has a security interest in a cheque deposited to an account to the extent to which credit given for that cheque is withdrawn or applied, or to which certification in reliance on such credit is made at the customer's request in respect of a cheque drawn by him.
(New)

— partial withdrawal or application

(8) Where credit is given for several cheques on a deposit, any withdrawal, application or certification mentioned in subsection (7) creates a security interest in all cheques in the deposit to the extent there stated, and the interest continues until the collection of all is complete.
(New)

— enforceability and perfection.

(9) The security interest created by subsection (7) or (8) is enforceable without written security agreement, and is perfected by possession of the member or another member or deposit institution acting under the clearing by-laws of the Canadian Payments Association.
(New)

Value given by certain collecting institutions.

(10) A security interest under subsection (7) or (8) is value, to the extent of the interest, for the purpose of determining whether a member of the Canadian Payments Association is a holder in due course or for value.
(New)

Status of certain credit unions.

(11) For the purposes of this section, a credit union which is a member of a central which is a member of the Canadian Payments Association is deemed to be a member of that Association.
(New)

Consequential Amendments

As consequential amendments resulting from the re-definition of "cheque" proposed above, the Commission recommends that in subsection 166(1) and section 167 of the *Bills of Exchange Act*, the word "drawee" be substituted for the word "bank" wherever the latter occurs. In subsection 166(2) the phrase "usages of trade and of the members of the Canadian Payments Association" should replace "usage of trade and of banks". Paragraph 189(1)(*d*) of the Act should be deleted as superfluous, together with the words "or (*d*)" in lines 3 and 4 of subsection 192(1) of the Act.

Subsections 320(5) and 322(3) of the *Criminal Code* can also be deleted as superfluous.

Endnotes

1. *Collings v. Calgary* (1917), 55 S.C.R. 406, 10 W.W.R. 974; *Rogers v. Calgary Brewing and Malting Co.* (1918), 56 S.C.R. 165; *Winnipeg Trustee v. Kenny*, (1924) 1 D.L.R. 952 (Man, K.B.); *Cowie v. Richards* (1965), 50 M.P.R. 107 (N.B.C.A.).

2. *Criminal Code*, R.S.C. 1970, c. C-34, s. 320(5), 322(3); *Bills of Exchange Act Amendment*, R.S.C. 1970 (1st Supp.) c. 4, s. 1, (s. 189(1)(*d*)). *See also* Cheque Issue Regulations T.B. 691189 (27/viii/1969), s. 2(*c*).

3. Correspondence on file — L.R.C.

4. The sole purpose of the indicated language below is to bring near-bank orders for payment under the same rules as are applied to the present cheque as legally defined:

Consumer bill defined.

189. (1) A consumer bill is a bill of exchange

(*a*) issued in respect of a consumer purchase, and

(*b*) on which the purchaser or any one signing to accommodate him is liable as a party,

but does not include

(*c*) a cheque that is dated the date of its issue or prior thereto, or at the time it is issued is post-dated not more than thirty days, or

(*d*) a bill of exchange that

(i) would be a cheque within the meaning of section 165 but for the

fact that the party on which it is drawn is a financial institution, other than a bank, that as part of its business accepts money on deposit from members of the public and honours any such bill of exchange directed to be paid out of any such deposit to the extent of the amount of such deposit, and

(ii) is dated the date of its issue or prior thereto, or at the time it is issued is post-dated not more than thirty days.

[*Bills of Exchange Act Amendment*, R.S.C. 1970 (1st Supp.) c. 4, s. 1.]

5. *R. v. Hall* (1960), 33 C.R. 154 (Alta. Mag. Ct.) (order on Alberta Treasury Branch not cheque under the false pretence section, *Criminal Code*). The *Code* was amended to bring near-bank orders within the reach of sections 320 and 322.

6. In *Cowie v. Richards* (1965), 50 M.P.R. 107 (N.B.C.A.) the court held an instrument enforceable against the drawer after a stop-order without deciding whether it was a bill or a common law cheque. *Winnipeg Trustee v. Kenny*, *supra* note 1, treated the instrument as a cheque under the law merchant. In *Rogers*, *supra* note 1, the court divided equally on the issue, cheque or bill, with Duff J., silent. In *Collings*, *supra* note 1, the court held a trust company instrument not a cheque.

Collings, like *R. v. Hall*, *supra* note 5, involved characterization for the purposes of another statute, rather than to decide a problem of negotiable instruments law.

If these instruments are "common law cheques" or "cheques under the law merchant" the governing law consists largely of pre-1882 decisions of the English courts. If they are demand bills of exchange, the law is more current; but the factual fit of the cases is poor. Such bills are not normally drawn against funds on deposit.

Cases squarely raising the issue are *Revelstoke Sawmill Co. Ltd. v. Fawcett* (1915), 8 W.W.R. 477 (Alta. Dist. Ct.) and *Caron v. Caisse Populaire de Granby* (C.A.M. 12487, 28 Nov. 1973), *noted* (1974) 34 Rev. du Barreau 82. The *Revelstoke Sawmill* case involved application of present subsection 166(2), but was decided in the alternative since the plaintiff simply sued on the instrument and led no evidence of the drawee's status. He made no attempt to recover on the original consideration for which the instrument had been given. Defendant successfully resisted the action on the instrument on either theory of the status of the Dominion Trust Company. *Caron*'s case held such an order not a cheque, and paragraph 167(*a*), *Bills of Exchange Act*, inapplicable. The right of countermand was accordingly governed by the Civil Code. The commentator in *Revue du Barreau*, M^e^ Michel Deschamps, argues

that paragraph 167(*a*) announces a rule of common law agency. The proper reference, since it is inapplicable to a bill, is to the Civil Code rather than the law merchant. Cf. Falconbridge, Banking and Bills of Exchange 44-45, 448-57 (7th ed. 1969).

The main respects in which the bill of exchange and cheque differed at common law were summarized by Parke, B., in *Ramchurn Mullick v. Luchmeechund Radakissen* (1854), 9 Moo. P.C. 46, 69-70, 17 E.R. 215, 223-24:

> If this had been a decision on a regular Bill of Exchange, payable on or after sight, it would have been a strong authority for the Plaintiff in error. It is not, however, the case of a Bill of Exchange, but of a banker's cheque, which is a peculiar sort of instrument, in many respects resembling a Bill of Exchange, but in some entirely different. A cheque does not require acceptance; in the ordinary course it is never accepted; it is not intended for circulation, it is given for immediate payment; it is not entitled to days of grace; and though it is, strictly speaking, an order upon a debtor by a creditor to pay a third person the whole or part of a debt, yet, in the ordinary understanding of persons, it is not so considered. It is more like an appropriation of what is treated as ready money in the hands of the banker, and in giving the order to appropriate to a creditor, the person giving the cheque must be considered as the person primarily liable to pay, who orders his debt to be paid at a particular place, and as being much in the same position as the maker of a promissory note, or the acceptor of a Bill of Exchange, payable at a particular place and not elsewhere, who has no right to insist on immediate presentment at that place.

See Serle v. Norton, 2 M. & Rob. 402, 174 E.R. 331 and the note thereto. The language concerning appropriation must be read in the light of *Hopkinson v. Forster*, (1894) L.R. 19 Eq. 76 denying any equitable assignment is involved in a cheque and section 127 *Bills of Exchange Act*.

7. Economic Council of Canada, Efficiency and Regulation; a Study of Deposit Institutions 102-05 (1976).

8. Department of Finance, White Paper on the Revision of Canadian Banking Legislation 17-18 (August 1976).

9. The Alberta Treasury Branches are organized as accounts segregated from the Consolidated Revenue Fund and operated by the Provincial Treasurer under the authority of the Treasury Branches Act, R.S.A. 1970, c. 370. The deposits therein, and interest, are "guaranteed by the Crown in right of Alberta". *Treasury Branch Deposits Guarantee Act*, R.S.A. 1970, c. 369, s. 2. Since the deposit contract is a Crown obligation in any event (*Treasury Branches Act*, s. 3(4)(*b*)) the guarantee amounts to gilding of the lily.

   The Province of Ontario Savings Office is organized under the Ministry of Revenue of Ontario. Deposits with it are obligations of the Province of Ontario.

10. Bill C-57 (3rd Sess., 30th Parl., 1977-78).

11. *Ibid.*, s. 52, 78.

12. *Ibid.*

13. *Ibid.* s. 53, 54, 67(1)(*c*)-(*d*), 67(2)-(3), 68. Note that the Chairman who acts as Umpire under s. 68 is an appointee of the Bank of Canada under s. 57, 64.

14. *See* Scott, *The Bank is Always Right: Section 165(3) of the Bills of Exchange Act and Its Curious Parliamentary History*, (1973), 19 McGill L.J. 78.

15. *Provincial Treasurer of Alberta v. Quinte-Canlin Ltd.* [1974] Que. S.C. 565, held that the Alberta Treasury Branch system, a branch of which had been delivered cheques on deposit and had credited them to the depositor's account, was not entitled to the protection of s. 165(3) because the Provincial Treasurer was not a chartered bank.

16. (1976) 64 D.L.R. (3d) 78, 1976 2 W.W.R. 673 (B.C.C.A.).

17. (1970), 11 D.L.R. (3d) 593, (Sask. Q.B.).

18. (1974), 5 O.R. (2d) 628, 51 D.L.R. (3d) 188 (C.A.)

19. In *Huron and Erie Mortgage Corporation v. Rumig* (1970) 2 O.R. 204, (1969) 10 D.L.R. (3d) 309 Laskin J.A. (as he then was), dissenting, would have found gross negligence in *failure* to take recourse on the depositor who was then in funds, and would have barred an action against the drawer by an acknowledged holder in due course.

20. (1962) 35 D.L.R. (2d) 136, 38 W.W.R. 169.

21. 35 D.L.R. (3d) at 139, 38 W.W.R. at 173.

22. *Id.*, at 80, 85. House of Commons (1st Sess., 27th Parl., 1966) Standing Committee on Finance, Trade, and Economic Affairs, Proceedings, #4, 24 Mar. p. 189.

23. *See* Scott, *supra* note 14.

24. *Cheques Act, 1957 (U.K.)*, 5 & 6 Eliz. II, c. 36, s. 4; *Bills of Exchange Act (Aust.) as amended* 1971, c. 4, Acts of Parliament, s. 88D.

    The English legislation was largely based upon the Report of the Committee on Cheque Endorsement (Mocatta Report), Cmd. 3 (1956 - HMSO). The Report sets out a short and lucid explanation of the sources in stamp tax and business practice of the English preference for crossed cheques. *Id.*, at 2-3.

25. In England, the holder. However by banking practice only the payee's endorsement is allowed to be omitted. See Notice of the Committee of London Clearing Bankers, 23 Sept. 1957.

Banks do not uniformly adhere to this practice. In *Westminster Bank, Ltd. v. Zang*, [1966] A.C. 182 (H.L.) cheques were deposited by Tilley, as holder, to the account of his company, Tilley's Autos Ltd. The bank was given the benefit of the section. Lord Reid agreed with the remarks of Denning, M.R. as to the obvious inconvenience of such a decision in his judgment below, but could not see his way to construe a limitation to collection for the amount of the payee into the section.

The Australian statute, adopted after the decision in *Zang*, requires collection for the payee, as well as deposit by or on his authority.

The Report of the Committee on Cheque Endorsement would have given protection in cases of irregular, as well as missing, endorsements and would have restricted that protection to banks collecting for the account of the payee, Report, *supra* note 24, at 11-12. It rejected any protection where the cheque was deposited to a joint or partnership account in which the payee was one of several persons with control over the account. *Id.*, at 11.

26. *Bills of Exchange Act (Aust.), as amended* 1971, c. 4, Acts of Parliament, s. 88E.

27. *See* the judgment of Diplock L.J. in *Marfani and Co. Ltd. v. Midland Bank Ltd.* [1968] 2 All E.R. 573 (C.A.).

28. Citations are to the 1972 official text of the Code. The Articles dealing with negotiable instruments other than securities (Art. 3) and bank collections (Art. 4) are in force in all 50 states, the District of Columbia and the Virgin Islands. There are no significant variations from the official text in any adopting jurisdiction with respect to the sections hereafter discussed.

The Report of the Committee on Cheque Endorsement, *supra* note 24, discusses the American practice of collecting bank responsibility and guarantee of prior endorsement under the Negotiable Instruments Law and Bank Collection Code, precursor statutes to the U.C.C. But it omits crucial observations respecting that practice. American banks were never protected by legislation equivalent to section 60 of the English *Bills of Exchange Act* in paying on a forged endorsement of an order cheque. In English law, such payment if in good faith and ordinary course of business leaves the bank protected. Nor did American courts ever rigorously apply the rule of *Cocks v. Masterman*, (1929) 9 B&C. 902, 109 E.R. 335 to the case of a forged endorsement. In England the rule was applied, *London and River Plate Bank v. Bank of Liverpool*, [1896] 1 Q.B. 7.

The concern of collecting banks in the U.S. with endorsement can be traced to these factors, as well as the extremely involved network of collection through correspondent banks which predated the Federal Reserve System's clearing facilities. In such a network, a paying bank and an intermediary collecting bank sought some guarantee of protection against conversion liability.

Even today, it is clear that the paying bank in the U.S. is both exposed to liability for paying on a forged endorsement, and entitled to take recourse on prior collecting banks or their transferors and that transferees have recourse on prior transferors. *See* U.C.C. sections 3-417(1)(*a*), 3-417(2), 4-207(1)(*a*), 4-207(2); for cases under the N.I.L. *see* Beutel, Brannon on Negotiable Instruments 448-50 (7th ed. 1971).

Canada follows the same rule for forged endorsements as the U.S. *Bills of Exchange Act*, sections 49, 50. *Cocks v. Masterman*, *supra* has been followed in Canada, even after its limitation by the Privy Council in *Imperial Bank v. Bank of Hamilton*, [1903] A.C. 49. *See Eccles v. Merchants Bank*, (1922) 52 O.L.R. 138 (C.A.). The statutory recovery, however, was quite clear until the enactment of section 165(3).

29. U.C.C. s. 1-102, 1-203.

30. *Salsman v. National Community Bank*, 246 A. 2d 162 (1968) (N.J. Super. Ct.).

31. *Cole v. First National Bank of Gillette*, 433 P. 2d 837 (Wyo. C.A. 1967) (semble); *see* Willer & Hart U.C.C. Reporter Digest ss. 4.205 A2 (Mathew Bender & Co.).

32. U.C.C. 3-206 (3).

33. The case law was greatly confused by an uncritical dictum of Lord Macnaughten in *Capitol and Counties Bank v. Gordon*, [1903] A.C. 240 (H.L.). The result of that case was legislatively reversed by the *Bills of Exchange (Crossed Cheques) Act, 1906* (U.K.). Briefly, *Capitol and Counties Bank* denied protection of section 82 of the English *Bills of Exchange Act* to a banker who had given a customer credit prior to collecting the deposited crossed cheques. Although the credit had been drawn on, neither Lord Macnaughten nor Lord Lindley relied on that fact in their reasons for judgment.

The dictum was to the effect that extension of deposit credit made a bank holder for value of the cheque deposited. The so-called principle had been qualified to death by 1924. *A.L. Underwood, Ltd. v. Barclays Bank*, [1924] 1 K.B. 775, 804-5 (C.A.), denied the bank protection in a case where the bank had not allowed the funds to be drawn on until the cheques had cleared. The court included Lord Justices Scrutton and Atkin. The revolt had started much earlier in the trial courts. *Bevan v. National Bank, Ltd.*, (1906) 23 T.L.R. 65 (K.B. Div.); *Akrokerri (Atlantic) Mines, Ltd v. Economic Bank*, (1904) 2 K.B., 465 (argued for the bank by Scrutton, K.C.); Re Farrow's Bank, Ltd., [1923] 1 Ch. 41 (K.B.).

See generally *Halsburys Laws of England*, 3 Banking ss. 109-10 (4th ed.).

34. *Miller v. Harvey*, (1881) 6 O.A.R. 203 (note). But in *Owens v. Quebec Bank* (1870) 30 U.C.Q.B. 382 a cheque payable to plaintiff or *bearer*, receipted for as cash by the bank on deposit, and stamped as the bank's property was treated as a collection item.

35. *Canadian Bank of Commerce v. Rogers*, (1911) 23 O.L.R. 109, 118-19 (C.A.); *Bank of British North America v. Warren*, (1909) 19 O.L.R. 257 (C.A.).

36. *Capitol and Counties Bank*, *supra* note 33, has had an inconclusive career in Canada. Shortly after its decision, it was used by Anglin J. at trial in *R. v. Bank of Montreal* (1905), 10 O.L.R. 117. The banks in that case had not allowed the credit to be drawn on until after collection was completed — they sought agency status in hope of using a defense of payment over. They were denied this status in reliance on *Capitol and Counties*, but *succeeded* in the result through an estoppel based on payment by the drawee and the rule of *Price v. Neal*.

In the Court of Appeal, 11 O.L.R. 595 at 608, *Capitol and Counties* was applied without discussion by one judge; on further appeal to the Supreme Court of Canada, Davies J., the only judge who considered *Capitol and Counties*, refused to apply it to two out of three banks (which had notice clauses in their account agreements) and limited it to the facts in respect of the third, (1907), 38 S.C.R. 258 at 277-78.

In view of this less than enthusiastic use of the case by Canadian courts and its subsequent English record, it seems fair to take the case as establishing no more in Canada than it does in England. *See* Scott, *supra* note 14 at 90-92, 95-97 for a contrary view.

In *Dominion Bank v. Union Bank*, (1908) 40 S.C.R. 366 a collecting bank was again treated as holder with reference to *Capitol and Counties* and *Kleinwort Sons & Co. v. Dunlop Rubber Co.*, 23 T.L.R. 696. However, the bank had allowed a small drawing immediately and allowed the greater part of the funds to be withdrawn prior to its suit. The account was also apparently a notice account.

37. *See Westminster Bank v. Zang* [1966] A.C. 182 (H.L.); special facts can always be shown, thus in *Barclays Bank, Ltd. v. Astley Industrial Trust, Ltd.*, [1970] 2 Q.B. 527, [1970] 1 All E.R. 719 the bank showed value on three separate grounds:

(1) its lien, to the extent of overdraft credit allowed;
(2) reduction of the overdraft against deposit of the cheques, conditional on their honour. The court treated this as equivalent to giving time, since the bank had been pressing the customer to reduce his overdraft;
(3) honour of 2 cheques which would not have been honoured but for the deposit of the cheques claimed on.

38. *Universal C.I.T. Credit Corp. v. Guaranty Bank and Trust Co.*, 161 F. Supp. 790 (D. Mass. - 1958) (per Wyzanski J.).

39. *Washington Trust Co. v. Fatone*, 104 R.I. 426, 244 A. 2d 848 (1968) (promissory note, endorsed for discount).

40. In the current edition and supplement to Bailey, Brady on Bank Cheques ss. 6.4 (Warren, Gordon & Lamont - 1978) over eight pages are devoted

to discussion of cases involving value under U.C.C. 4-208. *Fatone*, *supra* note 39, is the only case cited dealing with withdrawal as of right. The remaining cases, and they are legion, are dealt with under 4-208(1)(*a*), and the issue turns upon whether the credit was withdrawn or applied. *See Patterson v. First National Bank of Huntsville* 251 So. 2d 230 (Ala. 1971) where a bank failed to establish withdrawal as of right and was denied holder in due course status for want of value. Deposit credit had been given and was proved.

41. *Security Bank v. Whiting Turner Contracting Co.*, 277 A. 2d 106 (D.C. Ct. App. 1971).

42. *Bank of British North America v. Warren*, (1909) 19 O.L.R. 257 (C.A.) suggests this result, with the qualification that the customer-payee is a necessary party to an action where the drawer so defends. But there are other devices to safeguard the customer's rights, and one questions why the drawer should be forced to implead the customer, when the normal problem is that the customer is either fraudulent or in breach of his contractual obligation to the drawer. It is easy to understand protecting an innocent bank against out-of-pocket loss — more difficult to understand protecting a recovery for which it is accountable to an allegedly defaulting payee.

43. *Supra*, note 41.

44. *See Huron and Erie Mortgage Corp. v. Rumig*, *supra* note 19.

45. *See* Scott, *supra* note 14.