



LAW OFFICES OF BURTON L. RAIMI, P.A.

8499 South Tamiami Trail • Suite 266 • Sarasota, Florida 34238 • (941) 927-1603 • (941) 927-1703 (fax)

Bank Regulatory Law

Check Fraud[1]

A Growing Problem for Banks and Businesses

Scope of the Problem

Financial institutions and businesses are losing billions of dollars each year because of check fraud. A survey conducted by the American Bankers Association, 54 % of community banks, 94% of mid-large banks sustained losses from check fraud in 1993. It has been estimated that banks will lose \$12 billion in 1996. Banks are not the only businesses suffering significant losses from check fraud. The FBI estimates annual losses of financial institutions, government agencies and corporations are between \$12 billion and \$15 billion. Troubling, losses from check fraud are dramatically increasing each year. In 1996, 55 percent of institution criminal referrals to the Justice Department related to check fraud. This compares to 40 percent in 1994.

Most check fraud is paper-based, falling into one of three categories: checks altered as to the payee or amount, counterfeit checks and forged checks. Computer technology has been key to the growth of check fraud. Computers capable of producing professional quality graphics, document scanners, color copiers and printers are now readily available to criminals. Today it is relatively easy to produce counterfeit checks that appear more authentic than the original.

Low-Cost But Effective Deterrents

Reacting to the dramatic increase in check fraud, the government, private industry and trade associations are working groups to combat check fraud. These groups have been actively developing low-cost but effective deterrents to check fraud.

American Bankers Association (ABA) Check Fraud Task Force. This group has been tracking the industry and has published 1994 ABA Check Fraud Survey. One effective system to detect check fraud, recommended by the ABA Check Fraud Task Force, is "Positive Pay". Appropriate for corporations and businesses issuing checks, Positive Pay involves a cooperative effort between the corporation and its payor bank. The corporation electronically transmits to its bank a list of all checks issued on a particular day. The

received for payment against the list supplied by the corporation and pays only checks on that li

Florida Bankers Association (FBA). FBA has recommended to its members that they participate in the Check Fraud Prevention Program. Under this program, when a non-customer requests a bank to cash a check, the bank must place an imprint of his/her thumbprint on the face of the check. The mere making of this request is a deterrent to check fraud. More information on this program may be obtained from FBA at 904-271-1111.

Federal Government Interagency Working Group. The Check Fraud Working Group, a subgroup of the Check Fraud Working Group, consists of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors, Office of Thrift Supervision, Federal Bureau of Investigation, Justice Department, Postal Inspection Service, and the United States Postal Service. The Check Fraud Working Group recently produced a booklet, Check Fraud: A Guide to Preventing and Recovering from Check Fraud. The booklet describes the mechanics of certain types of check fraud schemes, but emphasizes that the key to preventing check fraud is diligence on the part of bank personnel, particularly bank tellers, in identifying suspicious checks. The booklet provides a number of practical pointers to do this. The booklet also recommends specific internal controls that banks should adopt to prevent or discourage check fraud. For a free copy of this booklet, contact McCaffrey & Associates, Inc., 10000 Westpark Drive, Suite 100, Dallas, Texas 75243; telephone: 214-343-1111.

Financial Stationers Association (FSA). FSA is a trade organization whose members are companies that produce and sell personal checks. Working through the Accredited Standards Committee, FSA is developing standards for check security. FSA's efforts have concentrated on identifying features that stop fraud as early as possible in the check's life cycle. FSA has been rated as to whether it is overt or covert, effective in preventing alteration and effective in preventing counterfeiting. In 1994, FSA adopted Guideline to Enhanced Check Security. The guidelines, which are applicable to all checks, are recommended for both members and non-members of FSA. They define the minimum security features that checks should contain and emphasize no cost/low cost features. Checks that comply with the guidelines are called "secure checks." The presence of these security features is indicated by a padlock icon on the face of the check. A "warning box" which describes the security features present. A copy of FSA's check security guidelines may be obtained by contacting FSA, 1200 19th Street, N.W., Suite 300, Washington, DC 20036-2401; telephone: 202-462-1111. Additionally, John H. Harland Co., a member of FSA, has developed a training program for banks called Check Fraud Exposure. Information on this training program may be obtained by contacting Karen Schmitt, Director of Training, John H. Harland Co., Video Training Department, P.O. Box 721800, Houston, Texas 77072; telephone: 1-800-345-2222.

Liability for Counterfeit or Forged Checks

As between a bank and its customer, liability for losses resulting from a counterfeit or forged check is governed by Articles 3 and 4 of the Uniform Commercial Code. In most situations, the loss will fall upon the depositor. However, depending upon the actions and behavior of the customer, the loss may fall upon the bank.

A check is an unconditional order drawn on a bank to pay money on demand. The validity of this order depends upon the genuineness of the signature appearing on the check. [3] A "forged check" is a check on which the signature is forged or unauthorized. A forged or unauthorized signature is wholly inoperative, and a check containing a forged or unauthorized signature is not properly payable by the drawee or payor bank. [4] As explained by the UCC, a check codifies the underlying contract implied between a bank and its customer that the bank will charge the check to the depositor's account only on the order of the depositor or his authorized agent. [5] "Counterfeit" has no meaning in this context other than "forged". [6]

When a drawee or payor bank pays a forged or counterfeit check, ordinarily it will bear the loss. [7] The payor bank may not charge the check to the account of its customer, the purported drawee.

general rule, the conduct of the bank customer can shift the loss from the bank to the customer if the customer has been negligent or has failed to exercise ordinary care and this negligence substantially contributed to the loss. [9] On the other hand, if the customer has also failed to follow reasonable commercial standards in paying a forged or counterfeit check, the bank may still remain liable for payment of such a check. [10]

The bank's liability for payment will also be excused if the customer has not exercised reasonable care after the receipt or the availability of a bank statement in both discovering the payment of a forged check and notifying the bank of the payment. [11] If the customer proves, however, that the bank exercised ordinary care in paying the check, the bank may still remain liable for its payment. [12]

Under Revised Article 3, which has been adopted by a number of states including Florida, if the bank and the customer have both failed to meet the foregoing standards of care, any resulting loss may be allocated between them on a comparative negligence basis. [13] Regardless of the care or lack of care of the bank or the customer, the bank is not liable for loss if the customer does not discover and report the customer's unauthorized signature on or alteration of a check within one year after the statement or items are made available to the customer. [14]

Revised Article 3 also makes an employer liable for the fraudulent endorsement by a "responsible person" of an employee entrusted with responsibility with respect to the instrument. [15] Thus, if an employee who is entrusted with incoming checks forges the employer's name on a check made payable to the employer and absconds with the check, the resulting loss will fall upon the employer not the bank. [16] As explained in the official comments, "the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged endorsement on instruments payable to the employer." [17] Again, however, if the bank fails to exercise ordinary care in paying a check, the loss will shift back to the bank to the extent that this failure contributed to the loss. [18]

To encourage bank customers, particularly corporate customers which issue a large volume of checks, to adopt check security procedures, such as "Positive Pay", banks can enter into agreements with its customers under the provisions of the UCC. [19] Under such a written agreement, a bank would be protected in paying checks under such security procedures and would be justified in refusing to pay checks that do not satisfy the security procedures. [20] Such agreements prohibit a bank from disclaiming its responsibility, or limiting its damages, for lack of good faith or ordinary care; however, the parties may determine by agreement the standards by which the bank's performance is to be measured if those standards are not manifestly unreasonable. [20] Such agreements, if they become widespread, should become a far more efficient method to resolve disputes over forged or altered checks than litigation.

[1] This article is based upon a proposal titled "Crimes Against Businesses and Financial Institutions" presented at the 1996 Spring Meeting of the American Bar Association in Nashville, Tennessee.

[2] "Payee" is the person entitled, upon the creation of a check, to receive the funds from the drawee bank, usually a bank, that must pay out the money when a check is presented. Ordinarily, the "Drawer" is the person writing the check.

[3] *MBTA Employees Credit Union v. Employers Mutual Liability Insurance Co.* (DC Mass. 1974) 388 F.2d 1011.

[4] UCC §§ 3-404(1) (1962) and 3-403(a) (1990).

[5] *Taylor v. Equitable Trust Co.* (1973) 269 Md. 149, 304 A.2d 838.

[6] *MBTA Employees Credit Union v. Employers Mutual Liability Insurance Co.*, *supra*. See also *C Girard Bank* (DC Pa. 1981) 522 F. Supp. 414, 417.

[7] UCC §§ 4-401(1) (1962) and 4-401(a) (1990).

[8] UCC § 3-404(1) (1962) and UCC § 3-403(a) (1990).

[9] UCC §§ 3-406 (1962) and 3-406(a) (1990).

[10] See UCC § 3-406 (1962) on failure of the bank to observe reasonable commercial standards (1990) on failure of a bank to exercise ordinary care.

[11] UCC §§ 4-406(2) (1962) and 4-406(d) (1990).

[12] UCC §§ 4-406(3) (1962) and 4-406(e) (1990).

[13] UCC §§ 3-406(b) and 4-406(e) (1990).

[14] UCC §§ 4-406(4) (1962) and 4-406(f) (1990).

[15] UCC § 3-405(b) (1990).

[16] UCC § 3-405(b) (1990).

[17] Comments to UCC § 3-405 (1990).

[18] UCC § 3-405(b) (1990).

[19] UCC §§ 4-103(1) (1962) and 4-103(a) (1990).

[20] UCC §§ 4-103(1) (1962) and 4-103(a) (1990).

© 1997 McCaffrey & Raimi, P.A.

