

FIGHTING CHECK FORGERY IN THE NEW ECONOMY:
IS COMPUTER-GENERATED CHECK FRAUD COVERED
UNDER THE FINANCIAL INSTITUTION BOND?

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I. INTRODUCTION

We hear a lot these days about the “New Economy.” This phrase can mean different things to different people. For most, however, it brings to mind a rapidly changing global economy that advances in computer technology are, in large part, driving. Pundits pontificate about these advances and offer their theories on how our society and economy are changing or will change as a result. For the claims attorney handling financial institution bond claims, however, one issue rises to the forefront -- increasing claims for fraudulent computer-generated check copies.

In the last five years, most insurance companies that offer financial institution bond coverage have seen a steady rise in these claims.² At least for the moment, such losses seem here to stay. Technological advances have transformed the banking industry, changing how banks do business, but also changing the ways in which they can be defrauded. Banks must respond to these technological advances both to remain competitive and to protect themselves and their customers from new fraud schemes.

For example, technological advances have ushered in numerous changes in the services banks provide to customers. These changes can be positive and can create new ways to reduce traditional check fraud. Some changes include:

1. replacing traditional paper check books with “debit” cards (which can reduce customer reliance on paper checks);
2. allowing customers to access checking and savings accounts over the Internet (which can help customers monitor their accounts on a daily basis and spot potential fraud more quickly);
3. allowing customers to authorize monthly payments, like mortgage and car payments, to be electronically deducted from their account each month (reducing the opportunity for paper checks to be intercepted); and

¹ The author would like to acknowledge Ronald Mund, Senior Claim Attorney, St. Paul Fire and Marine Insurance Company, for his contributions to this paper.

² Although no available statistics break down these types of claims, anecdotal evidence from discussions with various claim handlers supports this statement.

4. offering customers the opportunity to pay other bills electronically, often through an Internet site (again, reducing the opportunity for paper checks to be intercepted).

These advances are convenient for customers and, at the same time, reduce the opportunity for traditional check fraud.

Notwithstanding these developments, however, many individuals, businesses, and government entities still rely on the paper check to negotiate debit payment. It should then be no surprise that check fraud remains a serious problem in the United States. In fact, the same technological advances driving the "New Economy" are also creating more sophisticated criminals who use such advances to find better ways to defraud. In particular, technological advances have significantly increased losses from check fraud.

Advances in computer technology now allow just about anyone with access to a scanner, computer, color printer, and the right software to generate a very convincing copy of an original check, with a perfectly duplicated authorized signature. A fraudulent payee and/or amount is then inserted into the duplicate check. These checks are becoming more difficult to detect and are significantly increasing check fraud losses, as the Office of the Comptroller of the Currency³ clearly outlined in a 1996 report:

Check fraud is one of the largest challenges facing financial institutions. Technology has made it increasingly easy for criminals, either independently or in organized gangs, to create increasingly realistic counterfeit checks and false identification that can be used to defraud banks.

The scope of the problem can be shown by some recent statistics. According to the FBI's 1994 Financial Institution Fraud and Failure Report, 60 percent of all criminal referrals relate to check fraud. Further, a 1994 survey by the American Bankers Association found that 54 percent of community banks, 94 percent of mid-sized banks, and 88 percent of large banks sustained losses from check fraud in 1993. Between 1991 and 1993, the number of fraudulent checks submitted increased 136 percent, from 537,000 to 1,267,000. Over the same period, annual losses from those frauds increased to reach \$815 million for 1993. That amounts to more than 12 times the amount banks lose annually because of bank robberies. Conservative estimates are that banks will lose \$1

³ Hereinafter OCC.

billion to check fraud in 1996; less optimistic experts believe losses may be double or triple that amount.

Thrifts, savings banks, and other financial institutions, retail merchants, government agencies, and large corporations are also victims of check fraud. A recent survey of more than 2,000 large U.S. corporations concluded that, on average, they lost approximately \$360,000 a year to check fraud. The FBI estimates that if commercial banks and other institutions combined their check fraud losses, the total would be \$12 billion to \$15 billion annually.⁴

The problem has only increased since the OCC issued its report in 1996. For example, that same OCC report, revised as of the May 1997 issuance, was financial institutions had lost \$1 billion to check fraud related schemes between April 1996 and September 1997.⁵ Similarly, the American Bankers Association found that in 1997 alone 288,546 check fraud cases occurred, with total check fraud perpetrated against commercial bank accounts exceeding \$1 billion.⁶

Banks are fighting back in an effort to stem these losses. For example, more banks are now offering customers “positive pay” agreements.⁷ A positive pay agreement allows a bank customer to detect check fraud before the item is paid. Most often, the customer electronically transmits to its bank a list of all checks it issued on a particular day.⁸ The bank then verifies checks received for payment against that list. The bank will reject any check that is not on the list and checks whose number does not match its dollar amount. The system can also work in reverse, where the bank electronically transmits the check list to the customer, who then has an affirmative duty to reject any suspect checks within a specified time period (usually the next business day).⁹

⁴ *Id.*

⁵ COMPTROLLER OF THE CURRENCY, CHECK FRAUD: A GUIDE TO AVOIDING LOSSES! (1999).

⁶ AMERICAN BANKERS ASSOCIATION, ABA 1998 CHECK FRAUD SURVEY REPORT 8, 3d Ed. (hereinafter ABA 1998 CHECK FRAUD SURVEY).

⁷ The American Bankers Association reported that banks offer positive pay services to corporate customers as follows: 4% of banks with less than \$500 million in assets; 17% of banks with \$500 million to \$1.5 billion in assets; 55% of banks with \$5 billion to \$50 billion in assets; and 100% of banks with over \$50 billion in assets. ABA 1998 CHECK FRAUD SURVEY REPORT at 17. *See also Detering Check Fraud: The Model Positive Pay Services Agreement and Commentary*, 54 BUS. LAW. 637, 644 (1999) (hereinafter *Detering Check Fraud*).

⁸ *See Detering Check Fraud*, supra note 7, at 644-45.

⁹ *Id.*

Banks are also making checks more difficult to duplicate. In its 1996 report, the OCC identified the following "Check Security Features":

Watermarks. Watermarks are made by applying different degrees of pressure during the paper manufacturing process. Most watermarks make subtle designs on the front and back of the checks. These marks are not easily visible and can only be seen when they are held up to light at a 45-degree angle. This offers protection from counterfeiting because copiers and scanners generally cannot accurately copy watermarks.

Copy Void Pantograph. Pantographs are patented designs in the background pattern of checks. When photocopied, the pattern changes and the word "VOID" appears, making the copy nonnegotiable.

Chemical Voids. Chemical voids involve treating check paper in a manner that is not detectable until eradicator chemicals contact the paper. When chemicals are applied, the treatment causes the word "VOID" to appear, making the item nonnegotiable. Checks treated with chemical voids cannot be altered without detection.

High-Resolution Microprinting. High-resolution microprinting is very small printing, typically used for the signature line of a check or around the border in what appears to be a line or pattern to the naked eye. When magnified, the line or pattern contains a series of words that run together or become totally illegible if the check has been photocopied or scanned with a desktop scanner.

Three-dimensional Reflective Holostripe. A holostripe is a metallic stripe that contains one or more holograms, similar to those on credit cards. These items are difficult to forge, scan, or reproduce because they are produced by a sophisticated, laser-based etching process.

Security Inks. Security inks react with common eradication chemicals. These inks reduce a forger's ability to modify the printed dollar amount or alter the designated payee because when solvents are applied, a chemical reaction with the security ink distorts the appearance of the check. This makes such items very difficult to alter without detection.¹⁰

¹⁰ CHECK FRAUD, *supra* note 5, at 10.

Notwithstanding such check security features and increased positive pay agreement opportunities, paper check fraud losses continue. This article discusses bank liability for fraudulent computer-generated check copies and whether banks have coverage for such losses under the Standard Form No. 24 Financial Institution Bond.¹¹ Section II discusses how contemporary check fraud losses occur. Section III discussed bank liability for such losses. Finally, Section IV discusses coverage under the Bond for such losses.

II. CHECK FRAUD SCHEMES

Check fraud is perpetrated by many different schemes. Three general schemes are discussed herein. The first two, check alteration and forgery on an original instrument, are the two more traditional check fraud schemes. The third scheme, check duplication by computer, is a product of the New Economy. And it is, for the moment, the future of check fraud.

A. Altered Checks

Check alteration has been around as long as people have been using checks to negotiate debt and it continues to be a major source of check-fraud losses today. It first requires an original check drafted to a legitimate payee to negotiate a legitimate debt. The intended payee and amount information are already present on the check. The correct information can be either handwritten or mechanically imprinted, depending on the nature of the account holder. The criminal intent on perpetrating a fraud can generally do one of two things to alter the check.

First, chemicals or other means can be used to strip or erase the correct information as to amount and/or the payee. The criminal can then use an ink pen, typewriter, laser printer or other imprinter to add new information, depending on how the original correct information was first added.¹² If done correctly, this method can create a very convincing alteration. The second common alteration method is to add new language or alter existing language (for example, changing a \$100 check to a \$1,000 check by adding a zero). Check alteration still occurs frequently today; but it has its obvious limitations.

According to the OCC, here are two common check alteration examples:

¹¹ Hereinafter the Bond. See the Financial Institution Bond, Standard Form No. 24 (Revised to January 1986), in Standard Forms of the Surety Association of America. The Bond was drafted by the Surety Association of America. The 1986 Revision replaced the 1980 edition of the Bankers Blanket Bond, Standard Form No. 24. Because many insurance companies model their bank bonds after the Standard Form 24 1986 Revision, the terms of that form are discussed herein. A copy of the Bond is attached to this article.

¹² CHECK FRAUD, *supra* note 5, at 10.

Example 1: A door-to-door salesman sells a set of encyclopedias for \$69.99. The customer pays by check, writing \$69.99 to the far right on the line for the amount in figures, and the words "sixty-nine and 99/100" to the right far on the amount in text line. The criminal uses the blank spaces on both lines to alter the check by adding "9" before the numbers line, and the words "Nine Hundred" before the text line. The \$69.99 check is now a fraudulent check for \$969.99, which the criminal cashes.

Example 2: A small company that provides service to several small clients is paid by checks payable to "Johnson Co." or "Johnson Company." Criminals steal a number of those payment checks and use a chemical solution to erase the word Co. or Company, then type in the word Cooper. They subsequently cash the checks using false identification.¹³

Check alteration schemes are most successful when bank customers are careless and banks fail to check payee identification properly.¹⁴ Obviously, customers need to take care when writing checks. They should not leave large blank spaces in the check's amount or number areas. Banks also need to make sure that their personnel are properly trained to detect check alteration.¹⁵

B. Forgery

The second traditional check fraud scheme is forgery on an original instrument. There are two primary forgery schemes: (i) forging the payee's signature (i.e., a forged endorsement); and (ii) forging the account holder's (maker's) signature.

The forged endorsement scheme is quite common and causes millions of dollars in loss each year. It simply involves forging the name of the payee on the back of a check or other instrument. Often, a forged endorsement scheme involves fraud by an employee. The employee intercepts a check payable to his or her employer. The employee then forges the corporation's endorsement, perhaps with a corporate endorsement stamp to which the employee has access. The employee can then deposit the check in an account the employee has opened in the corporation's name. The employee can also simply add a fraudulent endorsement on the check directing that it be paid to the employee rather than the corporation.¹⁶

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See Alvin C. Harrell, *Impact of Revised UCC Articles 3 and 4 on Forgery and Alteration Scenarios*, 51 CONSUMER FIN. L.Q. REP. 232, 237 (1997) (hereinafter *Impact of Revised UCC*).

Forgery can also be accomplished by forging the account holder's signature. The simplest example is check theft. A perpetrator can steal original blank checks and make them payable to whomever he or she wants. The perpetrator may have access to the account holder's signature. For example, a stolen check book will often have a driver's license or credit card that will have the account holder's signature attached.

Employees are also common perpetrators of large-scale check forgery. The employee with access to corporate checks can make checks payable to the employee, family members, credit card companies, or even fictitious payees. The faultless employee can either forge the corporate signature in writing or make an unauthorized use of a corporate signature stamp or check imprinting device.¹⁷ These types of schemes can go unnoticed for long periods. Many insurance companies have seen numerous claims where employees have used forged corporate checks to pay credit cards, mortgages, and other debts over two, three, or even more years.

C. Computer-Generated Check Copies

In recent years, financial institutions have seen a dramatic increase in check fraud involving some form of check duplication, often referred to as check "counterfeiting."¹⁸ Banks that experience these losses often express a helpless feeling to their insurer -- they simply do not know what to do to combat the problem. From a Bond claim attorney's perspective, these losses are of great concern.

The duplication scheme simply requires the right equipment and an original check. The right equipment usually includes a scanner, computer, color printer and appropriate software, all of which can be purchased easily enough at any computer store. An original check can then be easily obtained from several sources. In its 1996 report, the OCC identified several sources from which the information necessary to perpetrate a check duplication fraud can be obtained, including:

1. obtaining customer information from bank employees or other insiders;
2. stealing customer bank statements and checks;

¹⁷ *Id.* at 239.

¹⁸ As discussed in more detail below in Section IV, the term "counterfeiting" is a misnomer and somewhat misleading in the context of coverage under the FIB.

3. working with dishonest employees of merchants who accept payments by check; or
4. rifling through trash for information about bank relationships.¹⁹

The genuine, original check can then be scanned into the computer. The payee's name and amount are then digitally "cut" out with an editing program. Background sections on the check (usually with no printing or other marks present) are then "pasted" to the cut section. A different payee's name and/or amount are inserted in the digital image and a new check is printed on a color printer. Some schemes have been sophisticated enough to use high-quality check paper, and to imprint the magnetic ink used at the check bottom to print the bank's identification and ABA routing code and the account number.

III. THE UNIFORM COMMERCIAL CODE

Before addressing whether a particular check fraud loss is covered under the FIB, it is important to understand the bank's liability under the Uniform Commercial Code.²⁰ Among other things, the U.C.C. is the model code for most state laws governing Negotiable Instruments (Article 3) and Bank Deposits and Collections (Article 4). Articles 3 and 4 work in tandem, to the extent that Article 4 controls Bank Deposits and Collections of Negotiable Instruments. In short, these articles control whether a bank can debit a customer's account for a check or other instrument on which the bank has made or must make payment. If a bank cannot legally debit the customer account under the U.C.C., and must nonetheless pay on the check, it could suffer a loss that the Bond may cover.

All fifty states have adopted the U.C.C., in some form or another.²¹ Articles 3 and 4 under the 1977 Code were significantly revised in 1990. These revisions were undertaken to accommodate "modern technologies and practices in payment systems and with respect to negotiable instruments."²² Notable differences exist between the 1990 revision and the 1977 Code under Articles 3 and 4. But because only three states -- New York, South Carolina and Rhode Island²³ -- have not adopted the 1990 revisions, this paper will only address the 1990 revised version of the U.C.C.

¹⁹ CHECK FRAUD, *supra* note 5, at 3.

²⁰ Uniform Commercial Code (West 1995) (hereinafter U.C.C.).

²¹ See Robert Briganti, *Forgery or Alteration*, in FINANCIAL INSTITUTION BONDS 207, 237-44 (Duncan L. Clore ed. 1998).

²² U.C.C. art. 3 (Prefatory Note).

²³ See N.Y. U.C.C. Laws §§ 3-101 & 4-101 (McKinney 1999); S.C. Code Ann. §§ 3-101 & 4-101 (Law Co-op. 1999); and R.I. Gen. Laws §§ 3-101 & 4-101 (1999). Before relying on the 1990 revisions, care should be taken to be sure that the jurisdiction in question has adopted the revised version.

It is sometimes amazing to learn how many bank officers and other personnel do not fully understand bank liability under the U.C.C. or its local jurisdictional equivalent. It is very important for claim handlers to know and understand relevant U.C.C. provisions, so they can help ensure that the bank does not automatically pay on every fraudulent check. Otherwise, the bank may be creating losses for itself on checks for which it is not legally liable.

The following discussion will focus on the basic U.C.C. provisions applicable to bank liability for fraudulent checks. This discussion is intended only as a general introduction to Articles 3 and 4. Because the U.C.C. contains numerous exceptions and case-specific provisions that need to be understood when addressing bank liability, each individual case must be carefully reviewed in light of all relevant provisions.

A. General Terms and Definitions

Article 3 of the U.C.C. addresses negotiable instruments. Under Article 3, a check is a negotiable instrument. Article 3 defines a “Negotiable Instrument” as an unconditional promise or order to pay a fixed amount of money on demand.²⁴ A “check” is a Negotiable Instrument if it is a draft (i.e., order) that is payable on demand and drawn on a bank.²⁵ This definition is nearly identical to the Bond “negotiable instrument” definition, as discussed below.

Banks can play different roles in the check negotiation process. The bank’s defined role significantly affects its liability for a fraudulent check. First, a bank can be a payor bank, which the U.C.C. defines as the bank that is the drawee of a draft.²⁶ The drawee is the bank ordered in a draft to make payment.²⁷ Second, a bank can be a depository bank, which the U.C.C. defines as the first bank to take an item of deposit, regardless of whether it is also the payor bank (unless the check is presented for immediate payment, in which case it is not a depository bank).²⁸ Accordingly, a bank can be either a payor bank, a depository bank or both.

Article 4 specifically addresses the rights and duties as between payor banks and their customers and as between payor and depository banks. Under Article 4, a bank may charge against a customer’s account an item that is

²⁴ U.C.C. § 3-104(a). Note that an “order” is a written instruction to pay money signed by the person giving the instruction. *Id.* § 3-103(6). This applies to “drafts,” which includes checks. A “promise” simply means a written undertaking to pay money signed by the person undertaking to pay. *Id.* § 3-103(9). A promise applies to a “note.” A negotiable instrument can be both a “draft” and a “note.” *Id.* § 3-103(e).

²⁵ U.C.C. § 3-104(f).

²⁶ *Id.* § 4-105(3).

²⁷ *Id.* § 3-103(2).

²⁸ *Id.* § 4-105(2).

properly payable from the account, even if the charge creates an overdraft.²⁹ An item is considered properly payable if it is “authorized” by the customer and in accordance with any agreement between the bank and its customer.³⁰ Where a check contains an “unauthorized signature”³¹ or an “alteration,” the customer will not be liable to the bank for a check drawn and paid on the customer’s account.³²

Under the U.C.C., an item may be properly signed: (i) manually; (ii) by means of “a device or machine”; or (iii) by the use of any name executed or adopted by a person with the intent to authenticate a writing (such as a corporate name endorsement).³³ Accordingly, unless the customer or its authorized agent properly signed the check, the customer is not liable for any fraudulent check on which the bank may make payment.³⁴

In addition, unless otherwise provided in the U.C.C., an unauthorized signature is ineffective, except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value.³⁵ Under the U.C.C., an unauthorized signature means one made without actual, implied, or apparent authority, and includes a forgery.³⁶

A customer is also not liable on a check that contains a fraudulent alteration.³⁷ Under the U.C.C., an alteration means either an unauthorized change in an instrument that purports to modify a party’s obligation under the instrument or an unauthorized addition of words or numbers or other changes to an incomplete instrument.³⁸ The customer is generally discharged from any obligation under a fraudulently altered check or other instrument.³⁹

The U.C.C. sets forth at least six exceptions to the general rule that a customer is not liable for an Instrument with either an unauthorized signature or an alteration⁴⁰:

1. a principal can be bound to the signature of a proper agent or representative (as noted above);⁴¹

²⁹ *Id.* § 4-401(a).

³⁰ *Id.*

³¹ *Id.* §§ 3-401 & 3-403.

³² *Id.* § 3-407.

³³ *Id.* § 3-401 (a). Section 3-402 addresses when a customer is liable for the signature of an agent or representative. Under § 3-402, if a person acting or purporting to act as a representative signs an instrument, with either the name of the represented person or the representative’s own signature, the represented person is bound by the signature as provided therein.

³⁴ U.C.C. § 3-401(b).

³⁵ *Id.* § 3-403(a).

³⁶ *Id.* § 1-201(43), and Official Comment 1 to § 3-403.

³⁷ *Id.* § 3-407.

³⁸ *Id.* § 3-407(a).

³⁹ *Id.* § 3-407.

⁴⁰ *See Impact of Revised UCC, supra* note 16, at 232-33 & n.4-9.

⁴¹ U.C.C. §§ 3-401 (a) & 3-402.

2. a person may ratify or adopt another person's signature as his or her own;⁴²
3. an employer may be responsible for a fraudulent endorsement by an employee;⁴³
4. a person whose own negligence facilitated a forgery or alteration may be barred from asserting that forgery or alteration against an innocent party;⁴⁴
5. a bank customer that fails to promptly examine its monthly statement and inform the bank of any forgeries or alterations may be barred from asserting such alterations or forgeries against the bank;⁴⁵ and
6. A person who issues an instrument to an impostor or fictitious payee may be barred from asserting a fraudulent endorsement as against an innocent holder of the instrument.⁴⁶

These are all important exceptions about which bank personnel and claim handlers need to be aware. Two will be discussed in detail.

First, the customer's obligation to check its monthly statement in a reasonably prompt manner for unauthorized signatures or altered checks is important.⁴⁷ If the bank can show that the customer did not exercise such reasonable promptness, and that the bank suffered a loss, the customer cannot assert against the bank an unauthorized signature or alteration on a check or other item.⁴⁸ Additionally, a customer cannot assert an unauthorized signature or alteration on an item more than one year after the statement, notwithstanding the care or lack thereof by either the bank or the customer.⁴⁹

The second important exception is a party's own negligence contributing to a forged signature or altered instrument. The U.C.C. provides

⁴² *Id.* §§ 3-401(b) & 3-403(a).

⁴³ *Id.* § 3-406(b).

⁴⁴ *Id.* § 3-406.

⁴⁵ *Id.* § 4-406.

⁴⁶ *Id.* § 3-404.

⁴⁷ *Id.* § 4-406(c).

⁴⁸ *Id.* § 4-406(d).

⁴⁹ *Id.* § 4-406(f).

that if a person's failure to exercise "ordinary care"⁵⁰ substantially contributes to an alteration or a forged signature, he cannot assert such an alteration or forgery against a party who pays on the instrument in good faith.⁵¹ If, however, the party paying on the instrument also failed to exercise "ordinary care" in paying on the instrument, and such failure contributed to the loss, the loss shall be allocated between the parties.⁵² This comparative fault standard ensures that the bank is not stuck paying on forged or altered checks where its customer bears some fault.

In addition to specific defenses the bank may have as to a forged or altered instrument, Articles 3 and 4 contain general warranties related to check payments. Under Article 3, any party who presents a check or other instrument to a bank (as a drawee) for payment warrants that: the party has good title to the instrument; that there are no alterations in the instrument; and that the presenter has no knowledge of an unauthorized signature.⁵³ If the bank pays on the item presented, and a warranty is breached, the payor bank can recover from the warrantor damages for breach of warranty, which can include the amount paid, expenses and lost interest.⁵⁴ Article 4 provides identical language for Bank Deposits and Collections.⁵⁵

IV. BOND COVERAGE FOR CHECK FRAUD

Insuring Agreement (D) of the Bond is an optional coverage banks can purchase to protect against loss directly caused by check alteration or forgery. Almost all banks purchase this coverage.⁵⁶ Like the banking industry, insurance companies are facing new challenges in addressing advancing technology. As will be discussed in more detail below, it can be argued that the 1986 revisions to the

⁵⁰ The U.C.C. defines "ordinary care" as meaning: "in the case of a person engaged in business an observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4." U.C.C. § 3-103. This standard is not as easy to apply as it sounds. For a discussion of the issues this standard raises with respect to fraudulent checks, see Mark E. Wilson, *Banking Industry Standards Relevant to Coverage and Recoveries Under the Revised Uniform Commercial Code*, V FID. L.J. 79, 92-99 (Oct. 1999).

⁵¹ U.C.C. § 3-406(a)

⁵² *Id.* § 3-406(b).

⁵³ *Id.* § 3-417(3)(a).

⁵⁴ *Id.* § 3-417(3)(b).

⁵⁵ *Id.* § 4-208.

⁵⁶ According to the American Bankers Association, in 1998 100% of surveyed banks with assets exceeding \$300M carried some form of Insuring Agreement (D) coverage. AMERICAN BANKERS ASSOCIATION'S 1998 BANK INSURANCE SURVEY REPORT 25 (1998). For smaller banks, the percentages ranged from 96.6% to 98.6%. In the surveyed banks, average policy limits for Clause (D) ranged from \$900,000 to \$3,900,000 per loss. *Id.*

Bond do not address some of the newer check losses banks are experiencing. Computer-generated check copy loss is the best example.

Insuring Agreement (D) provides that the Underwriter shall indemnify the insured for:

FORGERY OR ALTERATION

- (D) Loss resulting directly from
- (1) Forgery or alteration of, on or in any Negotiable Instrument (except an Evidence of Debt), Acceptance, Withdrawal Order, receipt for the withdrawal of Property, Certificate of Deposit or Letter of Credit,
 - (2) transferring, paying or delivering any funds or Property or establishing any credit or giving any value on the faith of any written instructions or advices directed to the Insured and authorizing or acknowledging the transfer, payment, delivery or receipt of funds or Property, which instructions or advices purport to have been signed or endorsed by any customer of the Insured or by any banking institution but which instructions or advices either bear a signature which is a Forgery or have been altered without the knowledge and consent of such customer or banking institution. Telegraphic, cable or teletype instructions or advices, as aforesaid, exclusive of transmissions of electronic funds transfer systems, sent by a person other than the said customer or banking institution purporting to send such instructions or advices shall be deemed to bear a signature which is a Forgery.

A mechanically reproduced facsimile signature is treated the same as a handwritten signature.

This article will focus on coverage under Agreement (D)(1), for loss resulting directly from Forgery or alteration of a Negotiable Instrument.⁵⁷ This coverage can be broken down into a few important elements.

First, the Bond does not define what constitutes a loss. It is important to understand that the Bond is not a liability policy. Rather, it is a named-peril indemnity policy, which reimburses the insured for certain first-party losses. The policy contains no duty to defend.⁵⁸ And it does not indemnify the insured for damages for which the insured is liable, other than liability for compensatory damages for any loss, claim or damage that, if established, would constitute a collectible loss under the Bond. For example, if an insured is liable for a forged check drawn on a customer's account, the loss fits the Bond's Forgery definition, and it is not otherwise excluded, it would be covered.

A second important point is that Forgery is now a defined term in the Bond:

Forgery means the signing of the name of another person or organization with intent to deceive; it does not mean a signature which consists in whole or in part of one's own name signed with or without authority, in any capacity, for any purpose.

Note that this definition provides that a Forgery does not include signing one's own name, with or without authority. Accordingly, the Bond does not provide coverage for all "unauthorized signatures," as that term is broadly used under the U.C.C.

Finally, there are two Bond exclusions worth noting with respect to Forgery coverage under Agreement (D). First, Exclusion (p) to the Bond provides that the Bond does not cover "loss resulting directly or indirectly from counterfeiting, except when covered under Insuring Agreements (A) [Fidelity], (E) [Securities] or (F) [Counterfeit Currency]." This exclusion is discussed in more detail below.

Secondly, Exclusion (o) provides that the Bond does not cover:

Loss resulting directly or indirectly from payments made or withdrawals from a depositor's account involving items of deposit which are not finally paid for any reason, including but

⁵⁷ The Bond defines a Negotiable Instrument as any writing: (i) signed by the maker or drawer; (ii) containing any unconditional promise or order to pay a sum certain in money; (iii) is payable on demand or at a definite time; and (iv) is payable to order or bearer.

⁵⁸ Although under General Agreement F., entitled "Notice of Legal Proceedings Against the Insured - Election to Defend," the Underwriter may elect to defend any legal proceeding that could result in liability for any loss, claim or damage that, if established, would constitute a collectible loss under the Bond.

not limited to Forgery or any other fraud except when covered under Insuring Agreement (A) [Fidelity].

Exclusion (p) is important today for one simple reason -- banks are under more pressure to allow customers to have access to deposits as soon as possible. Under the Expedited Funds Availability Act,⁵⁹ a depository bank is generally required to make funds available on a deposit for withdrawal by the second business day after the banking day on which a local check is deposited, or by the fifth business day after the banking day on which a non-local check is deposited. If the check is a Forgery and it is dishonored by the payor bank, the depository bank will suffer a loss not covered under the Bond. This pressure on banks to make funds available arguably makes check fraud easier to perpetrate.⁶⁰

A. Coverage for Computer-Generated Check Copies

Having discussed both bank liability under the U.C.C. and the coverage that Insuring Agreement (D) provides, the next issue to address is whether the Bond provides coverage for a loss resulting directly from a fraudulent computer-generated check copy, with the payee and/or amount changed. A recent claim an insured submitted for coverage under Insuring Agreement (D) of the Bond will be reviewed (the names and facts have been changed).

Banks lose money from fraudulent computer-generated checks every day. Here is an example:

1. June 30: Corporation A, a large transportation company, issues check #009999 to Corporation B, a valued vendor, to pay for services rendered. The check is for \$86,324.17 and is printed on site. The check is sent by regular U.S. Mail to Corporation B's out-of-state headquarters.
2. July 28: Corporation B calls Corporation A to let it know it has not yet received payment. Corporation B wants its money. Corporation A is confused. It then verifies internally that it sent payment to Corporation B on June 30.
3. July 29, 9:30 a.m.: Corporation A calls its Bank, Bank A, to see if the check has cleared. Bank A tells Corporation A that in fact the check cleared on July 17, 2000. Corporation A is now concerned, as it does not believe that Corporation B

⁵⁹ 12 C.F.R. § 229.12 (1998).

⁶⁰ See *Deterring Check Fraud*, supra note 7, at 638 n.5.

would lie or be mistaken about not receiving payment. At Corporation A's request, Bank A orders a copy of the check from its off-site processing center for inspection.

4. July 29, 11:30 a.m.: Bank A obtains a faxed copy of the check from its processing center. The check is made payable to Corporation C -- not Corporation B. The check number and amount match Corporation A's records for the check originally issued to Corporation B -- on first glance, only the payee name appears to be different. The check was deposited in Bank B, which is out-of-state, on July 13, 2000. The endorsement was handwritten and stated: "For deposit only Corporation C acc # 0000001." The check was presented to Bank A on July 17, 2000 and paid.
5. July 31, 11:00 a.m.: Bank A receives the original, negotiated check from its processing center by mail.
6. July 31, 12:00 p.m.: Corporation A's Office Manager comes into Bank A's office to inspect the check. Office Manager indicates that the check is a copy, not the original. The stock paper does not match Corporation's A stock paper. No "void" mark appears when the check is photocopied -- all of Corporation A's checks should show this mark when photocopied. Moreover, the vendor number on the check is not in Corporation A's database. Office Manager does indicate, however, that it is an excellent copy.
7. July 31, 12:30 p.m.: Corporation A's Office Manager signs an affidavit of forgery.
8. July 31, 1:00 p.m.: The check and affidavit of forgery are sent back to the processing center to be returned the next day.
9. August 1: The check is returned as a qualified return item to the Federal Reserve.
10. August 17: The Federal Reserve notifies Bank A that the check is coming back to the Bank as a late return.
11. August 18: The Federal Reserve charges Bank A for the item.
12. August 21, 9:00 a.m.: Bank A receives the original fraudulent check back from the Federal Reserve along with supporting documentation.

13. August 21, 11:30 a.m.: Bank A calls its insurance agent and asks her to put Bank A's insurance company on notice of a forgery loss under Bank A's Bond.

This real-life claim poses two interesting questions -- (i) is the bank liable to its customer under the U.C.C. for paying the check, and (ii) is such a fraudulent check copy covered under the Bond?

1. The Bank's Liability for a Fraudulent Check Copy

The first question that must be asked is whether a bank can be liable for a loss caused by a fraudulent computer-generated check. If the bank is not liable, there is no loss under the Bond. As noted, the U.C.C. broadly provides that a customer is not liable on any negotiable instrument that the customer did not sign or which has been altered.⁶¹ Additionally, the U.C.C. does not distinguish between forgeries and counterfeits -- rather it simply speaks to "unauthorized signatures" on instruments. In fact, nowhere in Article 3 or 4 is there a requirement that a Negotiable Instrument -- check or otherwise -- be a genuine original.

A review of relevant case law does not indicate that any court has found that a fraudulent duplicate of an original is not a negotiable instrument. In fact, there have been several cases where courts have found that a bank is liable under the U.C.C. for a duplicate or counterfeit check.

For example, in *Zambia National Commercial Bank Ltd. v. Fidelity International Bank*,⁶² the court held that a foreign bank was liable under the U.C.C. (1977 Revision under New York law) for a duplicate check, which the court called a "counterfeit." Likewise, in *Citizens Fidelity Bank & Trust Co. v. Southwest Bank & Trust Co.*,⁶³ the Nebraska Supreme Court found that a payor bank was liable to a depository bank under the U.C.C. for failing to dishonor duplicate checks in a timely manner. It should be noted, however, that although these banks were found liable under the U.C.C. for computer-generated check copies, neither court specifically addressed whether they were negotiable instruments under the U.C.C.

Given the language of U.C.C. Articles 3 and 4 and the above-referenced cases, it would therefore appear that Bank A in the above example is liable on the check.

⁶¹ U.C.C. §§ 3-401 & 3-407.

⁶² 855 F. Supp. 1377 (S.D.N.Y. 1994), *amended in part*, 1994 WL 440717 (S.D.N.Y. Aug. 12, 1994), *further amended*, 1994 WL 557050 (S.D.N.Y. Oct. 7, 1994).

⁶³ 472 N.W.2d 198 (Neb. 1991).

First, the check did not contain an authorized signature. Although it did contain a copy of an authorized signature, the signature was not affixed to the check with authority. Second, Bank A paid Bank B on the check and Bank B, as the depository bank, did not appear to breach any presentment warranty to Bank A, the payor bank. Third, Company A, the customer, promptly contacted Bank A about the check and completed an affidavit of forgery within days of the check being cashed. Fourth, it does not appear that Company A was negligent -- the check was apparently intercepted in the mail before reaching Company B, and there was no evidence that an employee of Company A was involved in the scheme. Finally, Bank A did not discover that the check was fraudulent and return it to the Federal Reserve within 24 hours.

Bank A is now \$86,000 in the hole. It completes a proof of loss and returns it to its insurance company in a timely manner. What does the insurance company do? The answer is not as simple as it may appear at first glance.

2. Coverage under the Bond for Duplicate Checks

Assuming, therefore, that a bank is found to be liable under the U.C.C. for the fraudulent check drawn on Company A's account, the next question is whether such a loss is covered under the Bond. It is important to note that fraudulent check copies are often called counterfeit checks.⁶⁴ For example, in the two cases cited immediately above with respect to U.C.C. liability, both courts referred to the copied checks as counterfeits. But the term "counterfeit" is a misnomer and somewhat misleading in the context of coverage under the Bond.

The word counterfeit commonly refers to an exact copy of an original. The Bond contains a similar counterfeit definition: "Counterfeit means an imitation which is intended to deceive and to be taken as an original." But a real question exists as to whether a computer-generated check copy truly is a counterfeit. This is important, as noted above, because the Bond excludes coverage for: "loss resulting directly or indirectly from counterfeiting, except when covered under Insuring Agreements (A) [Fidelity], (E) [Securities] or (F) [Counterfeit Currency]." Note that the term counterfeiting, as used in this exclusion, is not a defined term in the Bond (only "Counterfeit" is).

Although a fraudulently copied check is a copy of an original check (with an obvious intent to deceive), the end result (*i.e.*, the printed fraudulent check) is only a copy of part of the instrument. The resulting fraudulent copy will almost always be materially different -- either as to the payee or the amount. So a real question exists as to whether it truly is a copy of an original (as the term counterfeit is commonly used). There does not appear to be any published decision that has addressed whether such a check copy is in fact a counterfeit

⁶⁴ For example, the OCC refers to duplicate checks as "counterfeits." *See, e.g.*, CHECK FRAUD, *supra* note 5.

under the Bond, and therefore excluded from coverage under Insuring Agreement (D) on the basis of exclusion (p).⁶⁵

In reviewing the Bond, it is important to note that neither Insuring Agreement (D) nor the forgery definition contain the word “counterfeit.” Notably, however, Insuring Agreement (E) does refer to both a forgery and a counterfeit. Specifically, it provides that the underwriter agrees to indemnify the insured for:

SECURITIES

- (E) Loss resulting directly from the Insured having, in good faith, for its own account or for the account of others,
 - (1) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of, any original
 - (a) Security,
 - (b) Document of Title,
 - (c) deed, mortgage or other instrument conveying title to, or creating or discharging a lien on, real property,
 - (d) Certificate of Origin or Title,
 - (e) Evidence of Debt,
 - (f) corporate, partnership or personal Guarantee, or
 - (g) Security Agreement,

which:

- (i) bears a signature of any maker, drawer, issuer, endorser, assignor, lessee, transfer agent, registrar, acceptor, surety, guarantor, or of any person signing in any other capacity which is a Forgery, or
- (ii) is altered, or

⁶⁵ It should be noted that in at least one case under a credit union bond, the court held that false checks were counterfeit checks and that counterfeit and “forged” had the same meaning in the context of the case. *See* MBTA Employees Credit Union v. Employers Mut. Lab. Ins. Co. of Wisc., 374 F. Supp. 1299 (D. Mass. 1974). In *MBTA Employees Credit Union*, a wrongdoer had checks printed that were nearly identical in design to those of MBTA Employees Credit Union. The defendant insurer denied coverage on the grounds that the bond covered forged checks, not counterfeit checks. The court, however, rejected this argument. It held that at common law the words “forged” and “counterfeit” were virtually synonymous and that there was coverage under insuring clause (D) of the bond in question. *Id.* It is very important to note, however, that it does not appear that the credit bond in question had an equivalent to exclusion (p) under the Bond, for loss caused by counterfeiting. Moreover, this case predated the Forgery definition in the Bond.

- (iii) is lost or stolen;
- (2) guaranteed in writing or witnessed any signature upon any transfer, assignment, bill of sale, power of attorney, Guarantee, endorsement or any items listed in (a) through (g) above;
- (3) acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any item listed in (a) through (d) above which is a Counterfeit.

Insuring Agreement (E) clearly provides coverage for loss resulting directly from an insured having acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of any item of security that is a Counterfeit. As noted, the Bond provides that a Counterfeit is an imitation that is intended to deceive and to be taken as an original. But because Insuring Agreement (E) does not apply to checks, that coverage does not apply here. Nevertheless, Agreement (E) can be used as a basis to address the issue of whether a check copy is in fact a “Counterfeit.”

In fact, one of the only cases on point involves Insuring Agreement (E). In *Reliance Insurance Co. v. Capital Bankshares, Inc./Capital Bank*,⁶⁶ the insured, a bank, accepted fraudulent common stock certificates under a version of the Bond containing both Insuring Agreements (D) and (E). The insurer denied coverage on the grounds that the stock certificates were neither forgeries nor Counterfeits with the meaning of the Bond. The stock certificates bore fraudulently made, unauthorized signatures of the issuer’s president and secretary.⁶⁷ They also contained a fraudulently made marker for the stock transfer agent and register.

The district court held that, to be covered, “the allegedly counterfeit instrument must be an imitation of an actual existing (or previously existing) original genuine instrument.”⁶⁸ The fraudulent stock certificates in question, however, were not copies of original instruments. Instead, they were fraudulently created copies with material changes. The certificates were therefore not Counterfeits, as defined in the Bond.⁶⁹ On appeal, the Fifth Circuit affirmed. It held that the bank insured’s losses were not covered:

because there never existed any one or more particular genuine AIG stock certificates which the bogus certificates could be said to purport to be or represent or imitate, and because the bogus certificates, by virtue of their facially apparent physical characteristics and the objective facts relating to their creation, as well as the subjective intent of their creator, do not

⁶⁶ 912 F.2d 756 (5th Cir. 1990).

⁶⁷ *Id.* at 757.

⁶⁸ *Id.* at 758.

⁶⁹ *Id.*

constitute attempted or intended physical imitations or duplications of either the general form of genuine AIG stock certificates or any particular genuine AIG stock certificate.⁷⁰

Thus, a duplicate stock certificate containing unauthorized signatures and other changes was not a Counterfeit under Insuring Agreement (E). If such copies are not Counterfeit for purposes of Insuring Agreement (E), why should a check copy with different payee and amount information be a loss as a result of counterfeiting under Agreement (D)? It is a difficult distinction to make. Accordingly, it does not appear to be correct to call a fraudulent check copy with material changes a counterfeit -- notwithstanding that this term is commonly employed to describe such checks in other contexts.

Assuming, then, that a copied check is not a loss resulting from counterfeiting within the meaning of exclusion (p) to the Bond, the next issue to consider is whether such a check meets the Bond's Forgery definition: the signing of the name of another person or organization with the intent to deceive. Forgery does not mean a signature that consists in whole or in part of one's own name, signed with or without authority, in any capacity for any purpose. This definition was first added in the 1980 revision to Form 24 and was later modified to its current form in the 1986 revision. Prior to that, the term Forgery was not defined.

Without a forgery definition, courts had construed pre-1980 forgery coverage to include signing one's own name to a check. For example, in *Filor, Bullard & Symth v. Insurance Co. of North America*, the Second Circuit Court of Appeals held that, absent an exclusion to the contrary, coverage for "forgery," an undefined term under a brokers blanket bond, included loss from unauthorized signatures.⁷¹ The 1980 revision basically made the *Filor* holding moot.

The Bond's Forgery definition is important because it is more restrictive than other uses of the word under relevant ancillary legal contexts, including the criminal law and the U.C.C. Under the criminal law, for example, courts often equate "counterfeiting" (i.e., check copying) with "forgery." For example, in *United States v. Schulman*, where the defendant was accused of check forgery and counterfeiting checks, the district court stated that "[i]t is well settled in the Fourth Circuit that the terms falsely made, forged, altered and counterfeit are 'substantially synonymous and refer to the crime of forgery.'"⁷²

But to some, this conclusion simply begs the question as to whether a signature duplicated on a computer is a Forgery under the Bond. Has an

⁷⁰ *Id.*

⁷¹ 605 F.2d 598 (2nd Cir. 1978), *cert. denied*, 440 U.S. 962 (1979).

⁷² 885 F. Supp. 811, 814 (D. Md. 1995).

authorized person signed the check? The original check's signature has been copied with the scanner. So the answer seems to be "no." The fraud perpetrator does not have authority to affix the customer's signature on the duplicate check. Therefore, a duplicate check probably does not constitute signing one's own name, with or without authority. If it were, coverage would not be available, given the definition of forgery in the Bond.

Insuring Agreement (D) also provides, in part, that, "a mechanically reproduced facsimile signature is treated the same as a hand written signature." Is the image of the original signature a "mechanically reproduced facsimile signature"? This particular language can be found as early as the 1951 revision to the Bond. Traditionally, company executives at large companies do not personally sign all checks that their companies issue. Rather, their signatures are affixed by a machine. And the Bond provides that a signature by such a machine is treated the same as a handwritten signature. Accordingly, if the signature was affixed, without authority and with intent to deceive, it is likely within the Bond's Forgery definition. But the inquiry should not end there.

A computer is arguably a mechanical device, as are scanners and printers. It seems unlikely, however, that the Bond drafters, back in 1951, meant that "mechanically reproduced facsimile signature" would apply to the computers we see being used today to perpetrate check fraud. It is therefore appropriate to review subsequent endorsements to the Bond that may clarify whether the signature on a duplicate check produced with the aid of a computer is a "mechanically reproduced facsimile signature."

Some companies offer a Bond endorsement that modifies Insuring Agreement (D). This endorsement basically provides that a "telefacsimile" signature shall be construed to be a mechanically reproduced facsimile signature and treated the same as a handwritten signature.⁷³ The endorsement further provides that the Forgery definition is extended to include copying an authorized person's signature within a telefacsimile transmission directed to the insured, without authority. The word telefacsimile is commonly defined as a technique for transmitting letters, photographs and other graphic material over telephone lines -- *i.e.*, a facsimile transmission.⁷⁴

The endorsement raises two questions. First, why was it necessary? Presumably, questions arose over whether a telefacsimile signature was a "mechanically reproduced facsimile signature" that would be treated the same as a handwritten signature under the Bond (which, if affixed without authority and with intent to deceive, would be within the definition of Forgery). Second, if an endorsement was prepared to deal with the technological advance of telefacsimile transmissions, is it necessary to prepare a similar endorsement to

⁷³ Such an endorsement is attached.

⁷⁴ See THE NEW WEBSTER'S DICTIONARY AND THESAURUS OF THE ENGLISH LANGUAGE (1992 Lexicon Publications, Inc.).

address technological advances in scanners and computers? The answer to the second question depends on how the insurance company - and the courts - interpret and apply the language in question.

In short, an argument can be made that a signature on a computer-generated check copy is a mechanically reproduced facsimile signature, which should be treated the same as a handwritten signature. If affixed without authority, and with intent to deceive, such a signature would be a Forgery and covered under Insuring Agreement (D) to the Bond.

V. CONCLUSION

Check fraud is continuing, even in the new electronic economy of the twenty-first century. Computers have created a new breed of check-fraud perpetrators and banks are looking for ways to combat such fraud. Advances such as positive pay agreements and increased check security features can help. Because it appears that banks have coverage under their financial institution bond for such losses, insurance companies have a vested interest in working with banks to stem these losses.