

ATMs And Check Fraud: Who's Watching The Store?

Michael J. Weber
Cynthia A. Mellon

I. Introduction

It seems not too long ago that the biggest concern in using automated teller machines¹ was whether the user was being watched, with the risk of being robbed of cash withdrawn from the machine. ATMs are everywhere, many in unattended locations. Watching over shoulders and protecting the visibility of personal identification numbers² were, and remain, common practices.

An ATM is an electronic device by which a natural person may transact business, including deposits, withdrawals, and other transactions, with a bank.³ A proprietary ATM is an ATM that meets one of the three following criteria:

- (1) Owned or operated by, or operated exclusively for, the depository bank;
- (2) Located on the premises, including the outside wall, of the depository bank; or
- (3) Located within fifty feet of the premises of the depository bank, and not identified as being owned or operated by another entity.⁴

Regulation CC provides that, if two banks meet the “owned or operated” test under subsection (1), the ATM will be proprietary to the bank that operates the ATM.⁵ A non-proprietary ATM is defined as an ATM that is not a proprietary ATM.⁶

There are approximately 360,000 ATMs located throughout the United States, and roughly one-half belong to banks.⁷ The rest are “nonbank” machines located in various places, such as restaurants, malls, or hotels. According to a 1998 American Bankers

¹ Hereinafter ATMs.

² Hereinafter PINs.

³ Availability of Funds and Collection of Checks (Regulation CC), 12 C.F.R. § 229.2(c) (2003) [hereinafter Regulation CC].

⁴ *Id.* at 229.2(aa).

⁵ *Id.*

⁶ *Id.* at 229.2(x).

⁷ See Laura Bruce, *ATM Skimming, Skimming the Cash Out of Your Account*, at <http://aol1.bankrate.com/aol/news/atm/2002/004a.asp> (last visited Mar. 12, 2003).

Michael J. Weber is a partner with Leo & Weber, P.C. in Chicago, Illinois. Cynthia A. Mellon is a Senior Attorney in the Bond Claim Department for Liberty Bond Services in Plymouth Meeting, Pennsylvania. The authors gratefully acknowledge Joel R. Page, Jr., of counsel at Leo & Weber, P.C., for his assistance in the preparation of this article.

Association Check Fraud Survey Report, there were in excess of 288,000 cases of check fraud in 1997, averaging \$1,775 per case.⁸ Attempted deposit fraud at banks nationwide totaled \$4.3 billion in 2001, almost double the \$2.2 billion recorded in 1999. Notably, the actual amounts lost to deposit fraud in 2001 are estimated at \$700 million, only a slight increase from \$679 million in 1999.⁹

What does this all mean? While banks may be directing increased levels of energy toward policing bank deposit frauds, attempts to defraud the banks are not slowing down. One obvious way to avoid teller interaction is to use an ATM. The convenience and proliferation of ATMs everywhere add an ever-expanding dimension to detecting bank fraud. After all, why worry about overcoming the extra step of passing a teller's "smell test" if those interested in committing a fraud can avoid human interaction by pushing a few buttons at an automatic machine?

II. The Application of UCC Articles 3 and 4 to ATM Check Fraud

What happens if a dishonest employee grabs a corporate check and deposits the check, through an ATM, into his or her own personal account? In furtherance of the scheme, what is the effect if the employee "properly" endorses the check in the name of the corporate payee before depositing the check through an ATM into his or her personal account, using his or her own PIN? Moreover, what are the rights of the fidelity bond carrier, having paid a claim under its commercial crime policy for the insured's employee's ATM check fraud, against the various banks in the transaction chain?

Articles 3 and 4 of the Uniform Commercial Code¹⁰ govern check fraud cases. The rationale under the UCC is to place the loss on the party that could most easily have prevented that loss.¹¹ However, it is no easy task to determine how ATM check fraud cases will be resolved under the UCC. To say the least, although the revised UCC helps clarify the issues of check fraud liability generally, it remains open to interpretation on a case-by-case basis how the courts will apportion liability to the different parties involved.

The law imposes a duty on a drawee/payor bank to know its customer, the drawer,¹² and on the depositary bank to know its customer, the

⁸ See AMERICAN BANKERS ASSOCIATION, ABA 1998 CHECK FRAUD SURVEY REPORT 8, 3d ed. [hereinafter ABA 1998 Check Fraud Survey].

⁹ See Laura Bruce, *Deposit Fraud, The Rising Tide of Bank Fraud*, at <http://aol1.bankrate.com/aol/news/chk/2002/203a.asp?prodtype=bank> (last visited Mar. 12, 2003).

¹⁰ Hereinafter UCC.

¹¹ See *Underpinning & Found. Constructors, Inc. v. Chase Manhattan Bank, N.A.*, 386 N.E.2d 1319, 1323 (N.Y. 1979).

¹² UCC § 3-401 (2003) provides that "a person is not liable on an instrument unless the person signed the instrument." Section 3-403 provides that "*unless otherwise provided in this Article or Article 4*, 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." (Emphasis added). Section 4-401(a) provides that "[a] bank may charge against the account of a customer an item that is properly payable from that account [A]n item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank." It is the underscored exceptions to the general rule, rather than the rule itself, with which we concern ourselves in this article.

payee/endorser/depositor,¹³ who is likely to have been the perpetrator of check fraud or, at a minimum, the person attempting to deposit an unauthorized instrument into his or her bank account. With the proliferation of ATMs, the check deposit and collection process has become ever faster and less personal. The revised UCC is thought to have embraced this new banking reality by imposing a web of comparative negligence standards throughout the check processing system; in some instances, by shifting to drawers and payees the responsibility for check fraud perpetrated against them and by diluting the definition of “ordinary care” in some instances to embrace check processing by “automated means.” In an automated world, what is left of a bank’s duty to be the gatekeeper against an unauthorized drawer signature in the case of a drawee/payor bank or against an unauthorized payee signature/endorsement in the case of a depository bank? The purpose of this article, relative to the fidelity carrier’s decision to pursue recovery of losses paid due to ATM check fraud, is to examine that question.

III. The Potential Parties to an ATM Check Fraud

Who are the players in an ATM check fraud scenario? Preliminarily, for all but the most devout aficionado of negotiable instruments law, it is appropriate to conduct a brief review of the parties to a typical negotiable instrument transaction. The transaction starts with the drawer,¹⁴ otherwise referred to as the maker or issuer of the instrument.¹⁵ The drawer is the person who writes and signs a check against his or her account and gives the check to his or her creditor as a form of payment.¹⁶ The bank where the drawer maintains the account against which the check is written is the drawee or payor bank.¹⁷ The drawer’s creditor, to whom the check is made out by the drawer and given by the drawer as payment, is the payee.¹⁸ The payee, upon receiving the check, takes the check

¹³ With respect to stolen checks, unauthorized signatures, and alteration of instruments, the depository bank is liable to the drawee/payor bank, which is liable to the drawer, for breach of transfer warranties under §§ 3-416 and 4-207 and possibly presentment warranties under §§ 3-417 and 4-208. The depository bank also is liable for conversion with respect to the payment of stolen instruments and over unauthorized signatures under § 3-420.

¹⁴ Drawer is defined in UCC § 3-103(a)(3) (2003) as “a person who signs or is identified in a draft as a person ordering payment.”

¹⁵ UCC § 3-105 (2003) defines “issue” as “the first delivery of an instrument by the maker or drawer” and defines “issuer” as “a maker or drawer of an instrument.”

¹⁶ “Check” is defined in UCC § 3-104(f) (2003) as “a draft other than a documentary draft, payable on demand and drawn on a bank.” Section 3-104(e) defines a “draft” as an order as distinguished from a promise to pay. Section 3-104(a)(6) defines “order” as “a written instruction to pay money signed by the person giving the instruction.” Section 3-104(a) defines “negotiable instrument” as “an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it: (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder; (2) is payable on demand or at a definite time; and (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money.”

¹⁷ Drawee is defined in §§ 3-103(a)(2) and 4-104 (a)(8) as “a person ordered in a draft to make payment.” Payor bank is defined as “a bank that is the drawee of a draft.”

¹⁸ Payee is not a defined term but is functionally defined in § 3-110 as “the person to whom an instrument is initially payable.”

to his or her bank, the depository bank,¹⁹ endorses the check and deposits it into his or her account. The depository bank is the first bank in the collection chain.²⁰ The depository bank endorses the check and sends the check for value to the next bank in the chain of banks back to the drawee/payor bank. Any banks in between the depository bank and the drawee/payor bank typically take the check for value, endorse it, and give it for value to the next bank in the chain and are referred to as collecting²¹ or intermediary banks.²² Technically, the depository bank also is a collecting bank.²³ The check ultimately is presented²⁴ to the drawee/payor bank for payment from the drawer's funds on account.²⁵

Check fraud can take an infinite number of forms but typically will occur at one of two points in the transaction and against one of two types of a victim. In the first instance, the drawer can be defrauded, for example, by the perpetrator's forging his or her signature or by altering his or her previously valid instrument, thereby making a claim against the account inconsistent with the drawer's intention. In the second instance, the payee can be defrauded by the perpetrator's forging his or her endorsement and receiving value for the instrument inconsistent with the payee's intention—the drawer having intended to transfer value, but to the payee, and the payee not having intended to transfer value at all. The perpetrator of the fraud always is ultimately liable for his or her misdeeds under UCC § 3-420 and common law. However, in the vast majority of cases, the converter cannot be found or does not have the money to reimburse the loss, which places continuing importance on whom else might have ultimate responsibility for the loss.²⁶

ATMs can play a role in the life cycle of a fraudulent check from drawer to a drawee/payor bank in a variety of ways. Having stolen the check and devised his or her claim to entitlement, the thief must cash the check or, more innocuously, deposit the check into his or her account at the depository bank. In doing so, the thief can confront a teller or, more comfortably, an ATM. The ATM can be an onsite or a remote ATM of the depository bank, or it can be an onsite or a remote ATM of a third-party bank.²⁷ If the depository bank's ATM is used, the check will be processed much the same way as if a teller had been used, except that the scrutiny of a teller at the critical time of the deposit is bypassed. If a third-party bank is used, that bank may wire the amount of the check to

¹⁹ Depository bank is defined in § 4-105(2) as “the first bank to take an item even though it is also the payor bank, unless the item is presented for immediate payment over the counter.”

²⁰ UCC § 4-105 (2003).

²¹ Section 4-105(5) defines “collecting bank” as “a bank handling an item for collection except the payor bank.”

²² Section 4-105(4) defines “intermediary bank” as “a bank to which an item is transferred in course of collection except the depository or payor bank.”

²³ UCC § 4-105(5) (2003).

²⁴ UCC § 3-501 (2003) defines “presentment” as “a demand made by or on behalf of a person entitled to enforce an instrument (i) to pay the instrument made to the drawee or a party obliged to pay the instrument made to the drawee” Section 4-105(6) defines “presenting bank” as “a bank presenting an item for collection except the payor bank.”

²⁵ For an excellent discussion of the bank collection process in general, see *Roy Supply, Inc. v. Wells Fargo Bank, N.A.*, 46 Cal. Rptr. 2d 309 (Ct. App. 1995).

²⁶ See *Perez v. Charter One FSB*, 748 N.Y.S.2d 392 (App. Div. 2002).

²⁷ Regulation CC, 12 C.F.R. § 229 n.3.

the depositary bank for deposit, endorse the check, and send the check to yet another bank in the chain of banks back to the drawee/payor bank. Under those circumstances, the depositary bank may never directly possess the instrument.²⁸

But what if the fraud is committed using a non-proprietary ATM—an offsite ATM that is not owned or operated on site by the bank at which the perpetrator has an account? Is the ATM bank, the first bank in the process of deposit and collection, the depositary bank? Or, is it simply the conduit for the transfer of the funds in the ordinary course for deposit into the perpetrator’s account at another bank?

Not surprisingly, whether it is the depositary bank or the ATM bank, either bank will attempt to shift the focus of responsibility to the corporate employer for not “watching over the store” and overseeing the actions of its employees.²⁹ The corporate employer will claim that either or both banks were negligent by failing to exercise ordinary care in the handling of the ATM transaction.³⁰ The banks will claim that they never see the endorsement in an ATM transaction, and the depositary bank (in this example, the bank at which the individual account is maintained) will deny any negligence for not inspecting the endorsement because the funds are wire transferred from the ATM bank into the account. Typically, a drawee bank is liable for claims involving the drawer’s signature on the face of the check (because the drawee bank maintains its customer’s signature card),³¹ and the depositary bank is liable for claims involving the payee’s endorsement on the back of the check because the depositary bank is in the best position to verify the endorsement and has direct contact with the perpetrator presenting the check.³²

Keeping in mind it is simply a matter of time before the fraud is discovered, it seems all too easy to walk up to an ATM, pull out a deposit envelope, fill out the required information, and proceed to deposit a check into one’s personal account simply by pushing a few buttons, using his or her PIN, without any additional safeguards in place to

²⁸ The event of a deposit through a remote ATM at a third-party bank in effect splits the classic function of a depositary bank. The third-party bank in such transactions has the opportunity to inspect the instrument and indorse it before sending it into a chain of collecting banks back to the drawee/payor bank, which chain cannot be expected to include the bank with which the defrauder has an account. On the other hand, the bank with which the defrauder has an account actually is in privity of contract with the defrauder, has an opportunity to know its customer and his account activity, and is the bank that received the unauthorized deposit. Due to this functional split, this configuration is attractive for many types of check fraud. Not surprisingly, the remote, third-party ATM and the bank where the defrauder maintains an account often disagree about which of them is the depositary bank, with the responsibilities and liabilities thereto appertaining.

²⁹ See *Globe Motor Car Co. v. First Fid. Bank, N.A.*, 641 A.2d 1136 (N.J. 1993), *aff’d*, 677 A.2d 794 (N.J. Super. Ct. App. Div. 1996)(employer that hires thief must suffer the consequences of misjudgment); *Brighton, Inc. v. Colonial First Nat’l Bank*, 422 A.2d 433 (N.J. Super. Ct. App. Div. 1980), *aff’d*, 430 A.2d 902 (N.J. 1981)(bank loss should fall on employer because employer is in position to prevent forgery by selection or supervision of its employees and is in better position to cover loss by fidelity insurance).

³⁰ See UCC § 3-103(a)(7) (2003).

³¹ See UCC § 4-401 (2003)(under which drawee bank is responsible for paying on an instrument that was not “properly payable”).

³² See Donn A. Randall, *Massachusetts Check Fraud Law*, 83 MASS. L. REV. 114, 115 (1998).

ensure that the endorsement is proper and that the funds are being credited to the proper payee. Had there been human interaction, say, by a teller, would the bank's obligation to inspect the transactions be any more or less stringent? While a bank teller would presumably question efforts to deposit a check with a corporate payee into an individual account without proper endorsement, should the lack of human interaction be used as a means to, in essence, facilitate the fraud? The same holds true if the ATM bank and depositary bank is one and the same.

IV. The Liability of the Corporate Employer v. The Depositary Bank

The payee has standing to sue after a check it received is stolen. Generally, the payee will bring a conversion action under section 3-420 and can sue either the drawee or depositary bank, which paid on a check bearing an unauthorized endorsement in the payee's name.³³ However, the corporate payee must first receive the instruments, either directly or through delivery to an agent or co-payee, before they were stolen in order to be deemed the owner of the stolen instruments and to be entitled to the rights derived from that ownership.³⁴ Under section 3-420, a depositary bank is strictly liable for conversion on a forged or stolen instrument.³⁵ The ownership provides different alternatives for the payee: sue its drawer/customers to enforce the drawer's liability;³⁶ sue each payor bank paying on a forged endorsement; or sue the depositary bank that enabled the dishonest employee to carry out the fraud for conversion.³⁷ Liability ultimately leads to the depositary bank, whether it is sued by the payee for conversion under section 3-420 or by the collecting bank under section 4-207 for breach of a transfer warranty.

The depositary bank will bear the loss unless it is able to shift part or all of its responsibility to the corporate payee on the grounds that the payee's negligence contributed to the loss.³⁸ The revisions to the UCC instituted a comparative negligence standard for the allocation of certain losses due to check fraud. Specifically, the courts are to employ a comparative test under certain exceptions found under Articles 3 and 4 in which the party using the forgery as a defense was itself negligent or somehow contributed to the loss. For example, under section 3-405, Employer's Responsibility for Fraudulent Indorsement by Employee, comparative negligence would be a factor if the corporate employer entrusted its employee with responsibility with respect to the instrument which the employee fraudulently endorsed, but the depositary bank

³³ See Timothy S. Fisher, *Check Fraud Litigation in Connecticut After the 1990 Revisions to the U.C.C.*, 68 CONN. B.J. 393, 398 (Dec. 1994); see also *Guardian Life Ins. Co. v. Weisman*, 223 F.3d 229 238 (3d Cir. 2000)(1990 revision to UCC expressly disavows that a conversion action is available to drawers against depositary bank).

³⁴ UCC § 3-420(a) (2003).

³⁵ See *Leeds v. Chase Manhattan Bank, N.A.*, 752 A.2d 332, 336 (N.J. Super. Ct. App. Div. 2000).

³⁶ Certainly, a payee suing its own customers, the drawers, due to the fraudulent scheme perpetrated by one of the payee's employees for which the customers were not involved, is generally not the preferred option.

³⁷ 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).

³⁸ *Id.* at 238.

substantially contributed to the loss by failing to exercise ordinary care. Liability would then be apportioned between the corporate payee and the depository bank to the extent each contributed to the loss through its negligence.³⁹

Revised section 3-405 places the loss on the employer if it entrusted an employee with responsibility with respect to the instrument and the bank acted in “good faith” and exercised “ordinary care in paying or taking the instrument.”⁴⁰ Under revised section 3-405, where the bank failed to exercise “ordinary care in paying or taking the instrument and that failure substantially contributes to the loss resulting from the fraud,” the preclusion defense is not absolute. The employer can shift the loss to the depository bank to the extent the bank’s failure to exercise ordinary care contributed to the loss. This likely would result in an allocation of the loss and rejects an absolute shield for the bank regardless of whether the bank was negligent.⁴¹

V. The Tangled Web of “Ordinary Care” Under the UCC

Perhaps one change in the revised UCC that has significant potential for debate in the context of ATM transactions is the definition of “ordinary care” in section 3-103(a)(7). The definition of “ordinary care” is stated as follows, with the new language in italics:

“Ordinary care” in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located. *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.*⁴²

The pre-existing language establishes a community standard of negligence for the business actor to which it applies. Where it applies, the new language could arguably authorize a bank to take and process an instrument without examination, legislatively overruling a line of cases which found banks negligent as a matter of law for blindly processing instruments.⁴³ The new language requires that the bank’s procedures “not vary unreasonably from general banking usage” Where it applies, the new language, therefore, arguably relaxes the negligence standard applicable to banks, first by establishing that it is not negligent to refrain from inspecting an instrument so long as the bank’s own procedures, whatever they may be, are followed, and second, by establishing

³⁹ UCC § 3-405(b) (2003).

⁴⁰ *Id.*

⁴¹ See Donald J. Rapson, *Loss Allocation in Forgery and Fraud Cases: Significant Changes Under Revised Articles 3 and 4*, 42 ALA. L. REV. 435, 458 (1991).

⁴² UCC § 3-103(a)(7) (2003) (emphasis added).

⁴³ See *Wilder Binding Co. v. Oak Park Trust and Sav. Bank*, 527 N.E.2d 354, 358 (Ill. App. Ct. 1988), *rev’d*, 552 N.E.2d 783 (Ill. 1990); *Govoni & Sons Constr. Co., Inc. v. Mechanics Bank*, 742 N.E.2d 1094, 1104 (Mass. App. Ct. 2001).

that those procedures do not have to be the same or, arguably, even as good as the community standard as long as the procedures do not vary unreasonably from that standard. With what could be perceived as a potential reduction of the bank's duty, critical questions remain as to what is the scope of the new language and to what transactions does it apply.

Under section 4-103(c), action or inaction by a bank that is consistent with general banking usage can provide the bank with prima facie evidence of ordinary care.⁴⁴ However, even if the bank "established conformity with local standards," it is not automatically exonerated.⁴⁵ The industry standard may be considered as evidence of compliance with ordinary care, but such evidence is not conclusive.⁴⁶

These questions were framed in a well-known treatise on bank deposits.⁴⁷ Clark presented a hypothetical of an employee taking checks made out to her employer as payee, endorsing the checks "for deposit only" in the name of the employer, and then depositing the checks, without teller inspection, through an ATM to her personal account at the depository bank.

In such a case, the employer will argue that an ATM deposit is not an instrument taken "for processing . . . by automated means" as contemplated by the new language in section 3-103(a)(7).⁴⁸ This argument⁴⁹ focuses on the fact that the new language was adopted in response to cases in which drawee/payor banks had argued, with mixed results, that they were not negligent for failing to compare the drawer's signature on the instrument with that on file and to detect other irregularities apparent on the face of the instrument. Official Comment 5 to the revised section 3-103 applies expressly to the new language in section 3-103(a)(7) and provides that the language "applies primarily to Section 4-406 and it is discussed in Comment 4 to that section."⁵⁰ Section 4-406 imposes a duty on drawers to read their monthly statements from the drawee/payor bank and

⁴⁴ UCC § 4-103(c) (2003).

⁴⁵ *Hanover Ins. Co. v. Brotherhood State Bank*, 482 F. Supp. 501, 506 (D. Kan. 1979)(even an entire industry, by adopting such careless methods to save time, effort, or money, cannot be permitted to set its own uncontrolled standard (quoting WILLIAM PROSSER, LAW OF TORTS 167 (4th ed. 1971))).

⁴⁶ *Id.*

⁴⁷ BARKLEY CLARK & BARBARA CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 12.05[7], at 12-160 (rev. ed. 2002) [hereinafter CLARK].

⁴⁸ The debate is framed in terms of whether "automated means" include ATM transactions as well as the type of magnetic ink character recognition [hereinafter MICR] reading engaged in by drawee banks. The debate just as easily could have been framed in terms of whether "a bank that takes an instrument for processing for collection or payment" was intended to include a depository bank as well as a drawee/payor bank. If the drafters of the Revised UCC had drawee/payor banks in mind in the first instance, they had the same banks in mind in the later instance. A drawee/payor bank can complete its processing solely by resort to the MICR and arguably can rely on the upstream involvement of the depository bank, where a depository bank will always need additional instruction from the party cashing or depositing the instrument, its customer. Moreover, a drawee/payor, which sends monthly statements to its customer, the drawer, will have a temporal limitation to its exposure to liability in that the drawer is required under section 4-406 to alert the drawee/payor bank to any improprieties.

⁴⁹ The employer's argument set forth here is essentially paraphrased from CLARK, *supra* note 47, ¶ 12.05[7], at 12-160.

⁵⁰ UCC § 3-103(a)(7) cmt. 5 (2003).

promptly report any improprieties and sets up a comparative negligence standard in those cases where the instrument fraud would have been prevented by such an inspection. Official Comment 4 to section 4-406 provides that the “term ‘ordinary care’ . . . is defined in Section 3-103(a)(7), made applicable to Article 4 by Section 4-104(c), to provide that sight examination by a payor bank is not required if its procedure is reasonable and is commonly followed by other comparable banks in the area.”⁵¹ Thus, the conclusion urged by employers is that the “automated means” contemplated by the revised definition of “ordinary care” are solely the means of electronically reading and applying instruments against customer accounts by a payor bank.

In such a case, the depository bank undoubtedly will attempt to avail itself of section 3-103(a)(7) for legitimization of its practice of not inspecting instruments.⁵² The bank will focus on the language, “[i]n the case of a bank that takes an instrument for processing for collection or payment by automated means” The depository bank will argue that the language is broad enough to include a depository bank taking an instrument for collection, by way of ATM deposit, as well as a payor bank taking for payment.⁵³ Does the same argument hold true if the funds were first deposited in a non-proprietary ATM, acting as a conduit for transfer of the funds to the depository bank?

Clark concludes its discussion of this hypothetical as follows:

It is true that the drafters of the UCC had payor banks *primarily* in mind when they inserted the “automatic-processing” defense. However, the language is broad enough to cover both ends of the bank collection chain. If the bank in a particular case has a policy of ignoring indorsement verification for ATM deposits in order to reduce costs and if that policy is consistent with what other comparable banks do, it should be protected by the “automated-processing” defense and should not have to share the check-fraud loss with the company who hired the embezzler.

The bank has the better argument. Application of the “automated-processing” defense of UCC § 3-103(a)(7) to ATM deposits has not yet been considered by any appellate court, but it should apply. Given the huge number of checks deposited into ATMs, the issue has great significance nationwide.⁵⁴

Notwithstanding the prior comments made by Clark, recently the Illinois Appellate Court, in *Continental Casualty Co., Inc. v. American National Bank and Trust*

⁵¹ UCC § 4-406 cmt. 4 (2003).

⁵² The bank’s argument set forth here is essentially paraphrased from CLARK, *supra* note 47, ¶ 12.05[7], at 12-160.

⁵³ “Processing for collection” is not a defined term in the UCC, but “collection bank” is defined in § 4-105(5) as “a bank handling an item for collection except the payor bank.” While the definition of “collecting bank” would appear broad enough to include a depository bank, a depository bank is defined more by its role as a depository bank than by its role as a collecting bank; and the question remains concerning what the UCC drafters had in mind for the new language of § 3-103(7).

⁵⁴ CLARK, *supra* note 47, ¶ 12.05[7], at 12-160.

Co. of Chicago,⁵⁵ addressed the scope of the revised standard of care for banks processing instruments. In that case, the unfaithful employee caused his employer to sign nine checks over time, each in the range of \$40,000 to \$50,000, made out to the depository bank, as payee. The employer was told by its employee that the checks were for payroll taxes. The employee deposited the checks in separate transactions at an ATM of the depository bank, with deposit slip instructions to deposit the checks to the employee's personal account at the depository bank. The depository bank was not owed any payment from the employer and deposited the checks, pursuant to the employee/depositor's instruction, in the employee's account. When the fraud came to light, the employer sued the depository bank for breach of contract and duty of ordinary care implied thereby. The complaint was dismissed for legal insufficiency and the employer appealed.⁵⁶

The appellate court reversed and remanded the case, concluding that the employer had stated a cause of action for breach of contract against the bank.⁵⁷ The court further concluded that the allegations of the complaint, if proven, constituted bank negligence as a matter of law. The court reasoned that a bank named as payee when it is not owed a debt by the drawer has a duty to determine the appropriate disposition of the funds and that on the face of the transaction the diversion to the employee's account of employer funds payable to the bank puts the bank on notice of potential foul play.⁵⁸

On appeal, in an attempt to reduce its common law duty of ordinary care, the bank argued that its failure to inquire and examine the checks did not amount to negligence because the employee/depositor "did not deposit the checks with a human bank teller who could obtain knowledge in a face-to-face transaction but, rather, deposited the checks at an ATM, where they were processed by automated means."⁵⁹ In support of this argument, the bank expressly relied on the language in section 3-103(a)(7). The court rejected this argument outright, supporting the conclusion that the new language of section 3-103(a)(7) only applied to payor banks, stating:

We cannot agree with ANB's [the bank's] argument. Section 3-103(a)(7) does not provide protection to ANB under the facts in this case, because this provision of the UCC applies specifically to payor banks, which under certain circumstances are excused from visually inspecting the signatures on checks drawn by their customers. Section 3-103(a)(7) was amended to protect payor banks from having to visually inspect

⁵⁵ 768 N.E.2d 352 (Ill. App. Ct. 2002).

⁵⁶ *Id.* at 356-67. The case could not be brought as a conversion case under § 3-420 because there was no unauthorized signature on the face of the instrument. There was some suggestion in the appellate opinion that the case could have been brought as an improper payment claim under § 4-401(a); nevertheless, the court rejected the bank's argument that the common law contract claim was displaced by the UCC and concluded that the claim was a supplement to the UCC, expressly authorized under § 1-103. The court observed that "there is no provision of the UCC that delineates what a bank's rights and obligations are when an individual presents a corporate check payable to the bank and then instructs the bank to divert the proceeds of the check to his own benefit." *Id.* at 362.

⁵⁷ *Id.* at 359.

⁵⁸ *Id.*

⁵⁹ *Id.* at 3.

drawer signatures, since these banks could fully process checks by electronic information encoded on a MICR [magnetic ink character recognition] line and therefore, no visual inspection was necessary.

....

In the present case, because ANB was the bank of first deposit rather than the payor bank and because the alleged breach of contract claim related to the failure to verify the named payee rather than drawer signatures, section 3-103(a)(7) does not provide ANB with a defense in this case.⁶⁰

In *Guardian Life Insurance Co. of America v. Weisman*,⁶¹ the Third Circuit Court of Appeals considered whether a drawee bank had a duty to review payee endorsements on checks received from depositary banks. The court held that no such duty existed, reasoning that the drawee bank was entitled to rely on presentment warranties from the depositary bank. In *dicta*, the court analyzed the revised UCC's definition of "ordinary care" and implicitly considered the "automated means" language applicable to a depositary bank:

Because the most authoritative view is that depositary banks need only conduct at most random reviews of payee indorsements for most checks, we think it follows that drawee banks need not review each check to verify that the payee indorsement is legible and matches the named payee on the front of the check.⁶²

No other appellate courts have directly addressed the question of whether section 3-103(a)(7)'s standard of care is limited to payor banks or applies as well to depositary banks. For that matter, very few appellate courts have addressed ATMs or automated transactions as a basis of distinguishing a bank's duty of care. In *Stenseth v. Wells Fargo Bank, N.A.*,⁶³ the California Court of Appeals implied that a depositary bank should be held to a stricter standard of care when a living, breathing human teller processes a transaction as opposed to an ATM. In that case, the faithless employee forged her employer's signature to checks made out to the employer as payee. For several years the employee took the checks to her employer's bank where she obtained cash for the checks.⁶⁴

The trial court entered judgment in favor of the employer and against the depositary bank, and the bank appealed. The appellate court reviewed the evidence in the

⁶⁰ *Id.* at 359-60 (relying in part on CLARK, *supra* note 47, ¶ 12.05[7], at 12-160 (rev. ed. 1999) (stating that, presently, the "automated-processing" defense and the industry-wide standard now codified in the revised UCC protect payor banks in drawer signature verification cases, but not depositary banks in ATM deposit cases").

⁶¹ 223 F.3d 229, 233 (3rd Cir. 2000).

⁶² *Id.* at 235.

⁶³ 48 Cal. Rptr. 2d 192 (Ct. App. 1995).

⁶⁴ *Id.* at 193-94.

record to determine that it supported the trial court's finding of no negligent supervision on the part of the employer.⁶⁵ In distinguishing the facts of *Menichini v. Grant*,⁶⁶ which found the employer negligent as a matter of law, the *Stenseth* court characterized the issue as which of two innocent parties should bear the loss, which led to a comparative negligence analysis.⁶⁷ In this context, the *Stenseth* court appeared to weigh heavily the fact that, in *Menichini*, where the employer was made to bear the loss, the transactions had been processed through ATMs, whereas in the case at bar the bank's tellers had repeatedly given cash to the employee in exchange for checks naming the employer as payee. "More importantly, [the faithless employee in *Stenseth*] presented the forged checks to defendant's tellers who never questioned her authority to cash plaintiff's checks. In contrast, the bookkeeper in *Menichini* deposited the checks through remote automated teller machines."⁶⁸

Apart from instances where revised section 3-103(a)(7) applies, this notion that a bank is less culpable where it chooses not to have a teller inspect the instrument is controversial at best. A number of cases under the original UCC and the revised UCC have found depository banks negligent as a matter of law for choosing as a matter of procedure to forego inspection of certain types of instruments or all instruments under certain circumstances.⁶⁹

In *Medford Irrigation District v. Western Bank*,⁷⁰ an Oregon appellate court stated as follows:

We do not hold that a bank must adopt a particular procedure, such as "sight review," in order to comply with the statutory mandate. We do hold that the procedure used must reasonably relate to the detection of unauthorized signatures in order to be considered an exercise of ordinary care or reasonable commercial banking standards.⁷¹

Further, in the case of *Wilder Binding Co. v. Oak Park Trust and Savings Bank*,⁷² the state appellate court observed as follows:

Certain procedures "may well be common among banks, but the defendants failed to show that such conduct is reasonable. An examination of signature cards to determine the genuineness of endorsements may not be entirely practical under modern banking

⁶⁵ *Id.* at 195-96.

⁶⁶ 995 F.2d 1224 (3rd Cir. 1993).

⁶⁷ 48 Cal. Rptr. 2d at 196.

⁶⁸ *Id.*

⁶⁹ See *Mutual Serv. Cas. Ins. Co. v. Elizabeth State Bank*, 265 F.3d 601 (7th Cir. 2001); *Wilder Binding Co. v. Oak Park Trust and Sav. Bank*, 527 N.E.2d 354, 358 (Ill. 1988), *rev'd*, 552 N.E.2d 783, 788 (Ill. 1990); *Govoni & Sons Constr. Co., Inc., v. Mechanics Bank*, 742 N.E.2d 1094, 1104 (Mass. App. Ct. 2001); *Medford Irrigation Dist. v. Western Bank*, 676 P.2d 329 (Or. Ct. App. 1984).

⁷⁰ 676 P.2d 329 (Or. Ct. App. 1984).

⁷¹ *Id.* at 332.

⁷² 527 N.E.2d 354 (Ill. App. Ct. 1988), *rev'd on other grounds*, 552 N.E.2d 783 (Ill. 1990).

methods, but we do not feel that that necessarily relieves banks of the risk of loss from payment on forged checks.”⁷³

Although the appellate court in *Wilder Binding* was reversed and remanded, the Illinois Supreme Court did not address whether the bank did in fact exercise ordinary care in its payment of checks but rather held that the question of ordinary care is one of fact, which should be answered by the trier of fact and is not proper at summary judgment.⁷⁴

The language in section 3-103(7) provides essentially a two-part test of ordinary care. The conduct in question must be measured against “commercial standards prevailing in the area in which the person is engaged,” and those standards themselves must not be unreasonable relative to general banking usage. For example, is it reasonable for a non-proprietary ATM bank, where the fraudulent check was first processed, to argue that it has no obligation to examine the contents of an ATM deposit envelope or that its obligation is limited to sending the funds up the chain to the depositor’s bank? Is it logical for a depository bank, if the court determines that the non-proprietary bank is not the depository bank, to argue that it has no obligation to inspect deposits received through a non-proprietary ATM? If neither the non-proprietary ATM—either in an intermediary or depository bank capacity—or the depositor’s bank—in a depository capacity—has any obligation to meet even a minimal level of examination relative to ATM deposits, does it not act to relieve the banks of their own duty of care? Where the bank’s conduct conforms to that of other banks in the locale but offends the court, the court, as a trier of fact, is likely to determine whether the bank’s procedures, or lack thereof, as well as the local standards, are unreasonable.

A. A COST-BENEFIT ANALYSIS

Some courts and commentators have attempted to employ economics and a cost-benefit analysis to determine the appropriate standard of care to impose on banks in check-processing transactions. One school of thought is that it is unreasonable to require a bank to do anything that is uneconomic, that is, where the benefits do not justify the costs.

Increasingly banks are little more than high-speed mechanical sorters of checks, and drawers or other parties are in much better positions to prevent losses. In such circumstances we should resist the temptation to put the loss on the more wealthy but less culpable and less capable risk avoider. To allocate the loss to the bank in such a case may make the court feel magnanimous, but one should not be misled. Ultimately such allocation diminishes the efficiency of the system either by permitting

⁷³ 527 N.E.2d at 358 (Ill. 1988) (quoting *Perely v. Glastonbury Bank & Trust Co.*, 368 A.2d 149, 155 (Conn. 1976)).

⁷⁴ *Wilder Binding Co. v. Oak Park Trust and Sav. Bank*, 552 N.E.2d 783 (Ill. 1990).

greater losses than would otherwise occur or by causing banks to spend excess resources to avoid their recurrence.⁷⁵

This school seems to presuppose that the benefits of speed and low cost and the burdens of delay and high cost are borne by the banking system as a whole and only by coincidence align with the bank's profit motive. Procedures that are uneconomic will not be imposed on banks under a standard of reasonableness or ordinary care, and, as a consequence, in any comparative fault analysis, the loss resulting from such procedures will be borne by the negligently supervising employer or other drawer or payor.

Another school of thought uses the same tools to reach the opposite conclusion.⁷⁶ This school tends to view banks as conducting a cost-benefit analysis from their own parochial perspective and not for the good of society as a whole. A Massachusetts appellate court recently stated as follows:

The bank argues that the vast number of checks a modern bank must rapidly process makes it practically impossible for it to examine all presented checks for such information as the identity of the named payee. While forcefully made, the substance of this argument is called into question by a recent report of the Federal government's Check Fraud Working Group. The report instructs banks to confirm the identity of customers presenting checks, to record identification information on the back of each check, and to train tellers to look for telltale signs of check fraud, including attempts to deposit checks payable to corporations into the accounts of individuals. If for the sake of efficiency banks feel that they must forego these prudent safeguards, they should also appreciate that they must bear the losses that result as a cost of doing business.⁷⁷

From this perspective, if an individual bank or a community of banks chooses to forego tellers for certain types of transactions, it is implicitly assuming the risk of reduced scrutiny, while it should not be permitted to deflect liability to other parties, such as employers. Indeed, if it is within the industry's best interests to train tellers to look for telltale signs of check fraud, including attempts to deposit checks payable to corporations into the accounts of individuals, isn't it all the more relevant to close all potential gaps and to impose a system of checks and balances where tellers are not part of the

⁷⁵ 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 805 (3rd ed. 1988) [hereinafter WHITE & SUMMERS]. See also *Guardian Life Ins. Co. of America v. Weisman*, 223 F.2d 229, 234 (3rd Cir. 2000) ("Reasonable care . . . has long been evaluated in terms of a very conventional piece of economics: the cost of a risk-averting procedure should not exceed its expected benefit, where the measure's expected benefit in this context is calculated by multiplying the harm sought to be averted by the amount the measure reduces the likelihood of the harm occurring" (citing *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 295 (1st Cir. 1988)(although the bank did not review every check, its system subjected virtually every check to varying degrees of sight review or random sampling prior to payment, depending on the amount of the check)).

⁷⁶ See *Govoni & Sons Constr. Co., Inc. v. Mechanics Bank*, 742 N.E.2d 1094 (Mass. App. Ct. 2001).

⁷⁷ *Id.* at 1103-04.

transaction? From this point of view, the bank is playing with its own money and is free to strike the balance between paying to prevent fraud and paying fraud losses.⁷⁸

1. The Standards of Ordinary Care v. Good Faith

We now know that the revised UCC's definition of "ordinary care" applies narrowly to drawee/payor banks processing MICR lines on checks . . . or broadly to include depository banks doing all sorts of things through the blind eye of ATMs.⁷⁹ Regardless of how this debate is resolved, it is important to realize that the ordinary care standard of section 3-103(a)(7) is not universally available to all banks of a given class or in all of the various roles they play in all manner of transactions. "Ordinary care" is a defined term for the purposes of the other sections of the revised UCC. Sections of the UCC that do not incorporate the term "ordinary care" expressly or implicitly incorporate the statutory definition of "good faith,"⁸⁰ which do not necessarily encompass the standards contained in section 3-103(a)(7)'s definition of "ordinary care."⁸¹

"Good faith," for purposes of Articles 3 and 4 of the revised UCC, "means honesty in fact and the observance of reasonable commercial standards of fair dealing."⁸² The definition of "good faith" in section 3-103(4) was modified in 1990 as part of the 1990 revision to Articles 3 and 4 of the UCC and supplants the general definition found in section 1-201.⁸³ The revised definition is a departure from the general subjective definition that was found in the 1962 version of the UCC.⁸⁴ Under the 1962 definition, only the subjective "honesty in fact" requirement need be met.⁸⁵

"Ordinary care," as we have discussed, also is defined in terms of reasonable commercial standards, but standards of what? With respect to "good faith" the standards at issue are standards of "fair dealing."⁸⁶ Whether a bank acted in good faith is a question of fact.⁸⁷ In determining whether a bank acted with bad faith, courts have asked "whether it was 'commercially' unjustifiable for the payee to disregard and refuse to learn facts

⁷⁸ Depository banks must strike a balance between the costs and benefits of loss prevention for purposes of the base case where depository banks are strictly liable. *See* note 12, *supra*. Therefore, it is doubtful that their safeguards against check fraud in general will be influenced greatly by the fact that in some cases of payee or drawer negligence the bank will be able to assert a partial or total defense. On the other hand, the revised UCC gives drawers and payees strong incentives to implement safeguards on their side of check processing transaction, to complement whatever safeguards are taken by the depository bank.

⁷⁹ Obviously, an ATM transaction does not have to be blind. While there is no opportunity for a human teller to observe and interrogate the depositor, the ATM bank is free to have banking personnel inspect the instruments before endorsing them and sending them into the collection stream.

⁸⁰ UCC § 3-103(a)(4) (2003).

⁸¹ UCC § 3-103(a)(7) (2003).

⁸² *Id.*

⁸³ UCC § 3-103 cmt. 4 (1990).

⁸⁴ The 1962 definition remains unchanged in UCC § 1-201 (2003) in the general definitions but is applicable to this part of the Code where a separate definition is not provided.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Lichtenstein v. Kidder, Peabody & Co., Inc.*, 777 F. Supp. 423 (W.D. Pa. 1991)(genuine issue of material fact existed as to whether bank acted in bad faith in accepting forged checks so as to bar one year-statute of limitations for reporting; therefore, summary judgment for bank precluded).

readily available . . . at some point obvious circumstances become so cogent that it is ‘bad faith’ to remain passive.”⁸⁸ With respect to “ordinary care” the standards at issue are all standards “prevailing in the area in which the person is located, with respect to the business in which the person is engaged.”⁸⁹ Where the revised UCC uses the term “good faith,” it means fairness; when it uses the term “ordinary care,” it means reasonableness in a common law negligence sense.⁹⁰ Official Comment 4 to section 3-103 provides as follows:

Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction. Both fair dealing and ordinary care, are to be judged in the light of reasonable commercial standards, but those standards in each case are directed to different aspects of commercial conduct.⁹¹

This distinction is critically important in the context of ATM transactions and a bank’s desire to avoid liability for processing fraudulent instruments without examination, in transactions to which the revised UCC’s definition of “ordinary care” otherwise applies. While “good faith” and “ordinary care” are similar in their focus on reasonable commercial standards, the terms are distinctly different and not interchangeable. The bottom line is that a revised UCC section using the term “good faith” should not be permitted to import the license to process instruments with the arguable impunity found in section 3-103(a)(7).

2. Exceptions to Liability Relative to a Finding of Comparative Fault

We now can turn our attention to the exceptions to the general rules that hold drawee/payor banks liable for paying stolen and unauthorized instruments and hold depository banks ultimately liable for doing the same thing. These exceptions arise under section 3-404 involving impostors and fictitious payees, section 3-405 involving an employer’s responsibility for fraudulent endorsement by an employee, and section 3-406 involving negligence contributing to a forged signature or alteration. Under the revised UCC, all three of these exceptions incorporate the new definition of “ordinary care” and, therefore, the debate about the proper scope of the “automated means” relaxation of the ordinary care standard. All three exceptions also incorporate the concept of comparative fault, which makes the standard for determining fault of vital importance.

Section 3-404 addresses the problem of a drawer being induced to issue an instrument to an impostor of the payee, to a fictitious or nonexistent payee, or to an authentic payee, where the person whose intent determines to whom an instrument is

⁸⁸ *Appley v. West*, 832 F.2d 1021, 1031 (7th Cir. 1987) (quoting *Md. Cas. v. Bank of Charlotte*, 340 F.2d 550 (4th Cir. 1965)).

⁸⁹ UCC § 3-103(a)(7) (2003).

⁹⁰ UCC § 3-103(a)(4)&(7) (2003).

⁹¹ UCC § 3-103 cmt. 4 (2003).

payable does not intend the authentic payee to have any interest in the instrument. These are all types of frauds in which the depository and drawee/payor bank is thought to have less chance to detect the fraud and less culpability with respect to it than the drawer in the first instance.⁹² Accordingly, in these cases, section 3-404 provides that the endorsement by any person in the name of the payee is effective “in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.”

This section protects banks and other parties ignorant of the fraud, by removing the requirement for proper payment of the instrument and shifting liability back to the drawer. Nevertheless, the section imposes an ordinary care standard on banks and others handling the instrument and indirectly invites a comparative negligence analysis, where the ordinary care standard has been breached by the depository bank. Section 3-404(d) provides as follows:

With respect to an instrument to which subsection (a) or (b) applies, if a person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.⁹³

With respect to the types of fraud schemes reflected in section 3-404, the revised UCC places responsibility on the drawer in the first instance but allows that party to shift responsibility partially or totally to a depository or drawee/payor bank to the extent their failure to exercise ordinary care contributed to the loss. When an ATM is involved, if a depository bank can avail itself of section 3-103(a)(7)'s relaxed standard for processing by automated means, it will rarely, if ever, have any share of the liability in these types of transactions. If the relaxed standard is not available or the bank's prescribed procedures vary unreasonably from general banking usage, such depository bank should be held to a quasi-community standard of vigilance, arguably inviting a comparison to transactions involving tellers. Applying the relaxed standard to a depository bank in these circumstances may encourage banks to favor the less expensive and less protective means of processing instruments, through ATMs.

Section 3-405 is another provision in the revised UCC that shifts responsibility initially, in this context to employers in their role as drawer or payee. The crux of section 3-405 is that, if an employer confers responsibility on an employee and that employee makes a fraudulent endorsement of the instrument, that endorsement will be effective as the signature of the payee if it is made in the name of the payee.⁹⁴ This section addresses fraudulent endorsement of the employer's signature as payee and of the employer's payee's signature.⁹⁵ The section runs in favor of a bank or other person who, in good faith, pays an instrument or takes it for value or collection and, similar to section 3-404,

⁹² See UCC § 3-404 cmt. 3 (2003).

⁹³ UCC § 3-404(d) (2003).

⁹⁴ UCC § 3-405(b) (2003).

⁹⁵ *Id.*

takes away traditional drawer and payee challenges to payment of the instrument and shifts responsibility in the first instance to the employer. The policy underlying this section is that a bank or other person should be able to rely on the authority of a duly appointed corporate actor and that as a general proposition the employer is in a better position to prevent the fraud through diligence in hiring and supervising its employees.⁹⁶ Indeed, a separate remedy under the Uniform Fiduciary Obligations Act results in a bank being relieved from liability for negligence, but it allows a cause of action when the bank has actual knowledge of the fiduciary's misappropriation or when the bank has knowledge of sufficient facts that its action in paying the checks amounts to bad faith.⁹⁷

That being said, in language virtually identical to that quoted above from section 3-404, section 3-405 allows the employer to shift back to a depository bank, or to any other person whose failure to exercise ordinary care contributed to the loss, some or all of the responsibility on the basis of a comparative fault analysis. Once again, if a bank in an ATM transaction can avail itself of the lower standard of care in the definition of ordinary care, the bank will argue its lack of negligence, claiming that, in cases to which section 3-405 applies, the employer should absorb the loss irrespective of negligence in a common law sense. If the bank is held to a community standard of care, it may be found negligent for choosing to process instruments without inspection; and the case will tend to focus on the relative negligence of the depository bank and the employer as allocators of liability for the loss.

Additionally, section 4-406 imposes on drawers the duty to review their account statements with reasonable promptness and to notify the drawee/payor bank of any unauthorized payment due to an alteration or unauthorized signature.⁹⁸ This section as well relies on negligence principles requiring that the drawer notify the drawee/payor bank of any unauthorized payment that "the customer should reasonably have discovered."⁹⁹ A drawer who fails to discharge this duty will be precluded from asserting against the drawee/payor bank the unauthorized payment on the instrument in question, as well as on any subsequent forgeries perpetrated by the same wrongdoer, until the drawer puts the drawee/payor bank on notice of the wrongdoing.

⁹⁶ Official Comment 1 to § 3-405 provides as follows: "Section 3-405 adopts the principal that the risk of loss for fraudulent indorsement by employees who are entrusted with responsibility with respect to checks should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. Section 3-405 is based on the belief that 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 indorsement on instruments payable to the employer of fraud in the issuance of instruments in the name of the employer."

⁹⁷ UNIF. FIDUCIARIES ACT, ch. 545, 45 Stat. 509 (1928). The Uniform Fiduciaries Act has been adopted by the following jurisdictions: Alabama, Arizona, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Louisiana, Maryland, Minnesota, Missouri, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Utah, Virgin Islands, Wisconsin, and Wyoming. *See also* In re Lauer, 98 F.3d 378 (8th Cir. 1995)(evil motive is not the gauge; it is whether it is commercially unjustifiable for the bank to disregard or refuse to learn facts readily available); Appley v. West, 832 F.2d 1021 (7th Cir. 1987), *aff'd*, 929 F.2d 1176 (7th Cir. 1991); Master Chem. Corp. v. Inkrott, 563 N.E.2d 26 (Ohio 1990).

⁹⁸ *See* Travelers Indem. Co. v. Good, 737 A.2d 690, 694 (N.J. Super. Ct. App. Div. 1999).

⁹⁹ UCC § 4-406 (2003).

This section, like the others we have considered, leaves the door open for the customer to shift the liability back to the bank, where the bank fails to exercise ordinary care in the transaction. Although section 4-406 provides banks with an affirmative defense to the general rule that they are liable for paying forged checks, if the customer establishes that his bank failed to exercise ordinary care in paying a forged check, the bank's affirmative defense is inapplicable.¹⁰⁰

Section 4-406 is mentioned here because it follows the pattern of shifting responsibility to the drawer based on negligence principals and ultimately invites a comparative negligence analysis between the parties. Also worthy of note, with respect to this section, is that it provides further support for the distinction between drawee/payor and depositary banks for purposes of the application of the standard of ordinary care. A drawee/payor bank can count on monthly feedback from its customer, which limits, at least temporally, the risk of not requiring the drawee bank to inspect instruments.¹⁰¹ A depositary bank gets no such feedback, which explains why check fraud schemes victimizing payees and their endorsees can play out incrementally over a number of years.¹⁰²

Moreover, under section 3-406, if a person's failure to exercise ordinary care contributes to an alteration or forgery of an instrument, that person is precluded from asserting the alteration or forgery against a person who, in good faith, pays the instrument or takes it for collection.¹⁰³ However, section 3-406 also provides as follows:

(b) [I]f the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.¹⁰⁴

The phrase, "substantially contributes to" is read to be a "substantial contribution to the forgery rather than the negligence that must be substantial."¹⁰⁵ The burden is on

¹⁰⁰ *Wilder Binding Co. v. Oak Park Trust and Sav. Bank*, 527 N.E.2d 354, 358 (Ill. App. Ct. 1988), *rev'd on other grounds*, 552 N.E.2d 783, 788 (Ill. 1990).

¹⁰¹ UCC § 4-406 (2003).

¹⁰² The bookkeeper's check fraud scheme in *Stenseth v. Wells Fargo Bank*, 48 Cal. Rptr. 2d 192 (Ct. App. 1995), continued for three years; and the employer was found to have exercised ordinary care. In *Menichini v. Grant*, 995 F.2d 1224 (3rd Cir. 1993), the bookkeeper stole 150 of her employer's checks over approximately twenty months. Further support for the distinction between drawee/payor banks and depositary banks for purposes of the application of the standard of ordinary care can be found in the relative position of the two types of banks in the check collection process and the right of drawee/payor banks to rely on the endorsement warranties emanating from the depositary bank. "It is foolhardy to ask collecting banks who are not depositary banks to do any more than pass on instruments in an utterly mechanical way without consideration of anything other than the MICR line. Depositary banks, on the other hand, are in the best position to prevent certain kinds of fraud, particularly those involving indorsements." WHITE & SUMMERS, *supra* note 75, at 808.

¹⁰³ UCC § 3-406(a)(2003).

¹⁰⁴ UCC § 3-406(b)(2003).

¹⁰⁵ See *Dubin v. Hudson County Probation Dep't*, 630 A.2d 1207 (N.J. Super. Ct. Law Div. 1993).

the victim to prove that the bank failed to exercise ordinary care.¹⁰⁶ A lack of ordinary care by the bank paying items under section 3-406 may be established by proof that the bank's procedures were below standard or that the bank's employees failed to exercise care in processing items.¹⁰⁷ Because section 3-103(a)(7)'s pass on inspection of instruments unquestionably applies to drawee/payor banks processing checks by MICR, only on the most unusual facts will the drawee/payor bank be found to have breached its duty of ordinary care under section 3-406. Because drawee/payor banks are likely to rely on MICR regardless of whether an ATM or a teller was used to make the deposit, the distinction between ATM and teller deposit is insignificant.

Section 3-406 provides another instance of check fraud risk shifting in the revised UCC. This section addresses fraud in altering or signing an instrument. It shifts back to drawers responsibility where their failure to exercise ordinary care substantially contributed to the alteration or forged signature. Thus, a drawer's negligence in ordering, storing, writing, or mailing checks and signature stamps can preclude it from asserting liability against a drawee or depository bank or "a person who, in good faith, pays the instrument or takes it for value or collection."¹⁰⁸

This section follows the now familiar policy objective, in the first instance, of protecting banks and other persons who innocently pay on forged or altered instruments, by shifting to the drawer losses resulting from his or her negligence. Similar to sections 3-404 and 3-405, under section 3-406 a negligent drawer is precluded from imposing liability on a bank or other person who "pays the instrument or takes it for value or for collection," upon that person's assertion of the preclusion. The section further provides that if the bank or other person "asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss."¹⁰⁹ Section 3-406, therefore, provides yet another example of comparative negligence expressly holding both parties to the "ordinary care" standard.

In cases where section 3-406 applies, the drawee/payor bank will be liable to its drawer for paying an instrument which is not properly payable, unless the drawer's

¹⁰⁶ UCC § 3-406(c)(2003).

¹⁰⁷ See *New Jersey Steel Corp. v. Warburton*, 655 A.2d 1382 (N.J. 1995) (quoting *First Nat'l Bank & Trust Co. v. Cutright*, 205 N.W.2d 542, 545 (Neb. 1973)).

¹⁰⁸ UCC § 3-406 (2003). See also *Northwestern Nat'l Ins. Co. of Milwaukee v. Lutz*, 71 F.3d 671 (7th Cir. 1995); *Kaiser Aluminum & Chem. Corp. v. Mellon Bank, N.A.*, No. A 96-399, 1997 WL 361354 (W.D. Pa. Jun. 24, 1997) (at trial, defendant bank failed to establish that plaintiff failed to exercise ordinary care that substantially contributed to the making of forged signatures on checks); *Royal Ins. Co. of America v. Citibank, N.A.*, 2003 N.Y. Slip. Op. 15453, 2003 WL 404593, at *1 (App. Div. Jun. 19, 2003) (granting summary judgment in favor of plaintiff and rejecting defendant bank's allegations that plaintiff's negligence substantially contributed to the forgery, citing that defendant bank failed to show that there was no contributory negligence on its own part and that it exercised "reasonable commercial standards" in verifying signature on checks presented for payment); *Kersner v. First Fed. Sav. and Loan Ass'n of Rochester*, 695 N.Y.S.2d 369, 371 (App. Div. 1999) (rejecting defendant bank's contention that plaintiff by his negligence substantially contributed to the making of an authorized signature and further rejecting the bank's contention that it acted in good faith and in accordance with reasonable commercial standards).

¹⁰⁹ UCC § 3-406(b)(2003).

negligence substantially contributed to the loss, in which case the drawee/payor bank processing checks by reading MICR will get the protection of the relaxed standard of care and the drawer will bear the entire loss. When a drawee bank receives a check from a depositary bank, the drawee bank receives certain presentment warranties from the depositary bank guaranteeing payment.¹¹⁰ In the absence of negligence by the drawer and the depositary bank, the drawee/payor bank is liable to the drawer for paying an instrument that is not properly payable and the depositary bank is liable to the drawee/payor bank on its transfer warranties and for conversion.¹¹¹

3. A Practical Analysis of the Apportionment of Liability

We have considered that the revised UCC deflects responsibility for check fraud from the banks which process the instrument in certain instances, where the banks are presumed not to be in a position to detect the fraud and where another party to the transaction is presumed to be in a better position to do so. Section 3-404 provides this deflection with respect to impostors and fictitious payees; section 3-405 does so with respect to employers who have placed an employee in a position of trust; and section 3-406 does so with respect to drawers whose negligence in handling or writing checks contributed to an unauthorized signature or alteration.

All of these deflection provisions leave the door open to apportion some or all of the losses to a bank or other person on the basis of its own negligence. That is why it is so important to consider the proper scope of section 3-103(a)(7)'s definition of ordinary care and whether depositary banks will get a pass for not inspecting checks deposited through ATMs. It is important to note, however, that there is a realm of transactions, at least in theory, where no party is negligent and where none of the bank liability deflection provisions apply. In this realm, the revised UCC essentially leaves prior law intact by allocating liability to either the depositary bank or the drawee/payor bank depending on the type of check fraud involved.

Absent any negligence in the transaction and absent the availability of any of the claim preclusive/liability shifting provisions addressed above, the drawee/payor bank is responsible to only charge the drawer's account if the item is properly payable, that is, authorized by the drawer and in accordance with any agreement between the drawer and the drawee/payor bank.¹¹² As a general rule, if a drawee/payor bank pays an unauthorized instrument, it is bound to recredit the drawer's account and, with respect to an unauthorized drawer signature, absorb the loss.¹¹³ The liability imposed in this regard is not absolute, as we have seen; but it is strict, in the sense that it exists without regard to

¹¹⁰ See UCC §§ 4-207 and 3-417 (2003).

¹¹¹ See *Guardian Life Ins. Co. v. Wiesman*, 223 F.2d 229, 233 (3rd Cir. 2000).

¹¹² UCC § 4-401(a)(2003) provides: "A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank." UCC § 3-401(a)(2003) provides: "A person is not liable on an instrument unless (i) the person signed the instrument . . ."

¹¹³ *Id.* See also *Guardian Life Ins. Co.*, 223 F.2d at 232.

fault on the part of the drawee/payor bank. But what of the exceptions to the general rule and do they prove or ultimately crowd out the rule?

A drawee/payor bank still has to know its customer's signature unless the customer issued the check to an imposter or fictitious payee. A drawee/payor bank still has to know its customer's signature unless the customer failed to inspect his or her statements and notify the bank of any wrongdoing. A drawee/payor bank has to know its customer's signature unless the customer was negligent in allowing his or her checks and/or signature stamp to be accessed by a wrongdoer. A drawee/payor bank also has to know its customer's signature unless the customer is an employer who has vested a faithless employee with authority to sign or endorse an instrument on behalf of the employer. Under all of these exceptions, the bank's strict liability vanishes, and the bank's duty to exercise ordinary care remains, although in an eviscerated form under the revised UCC. Absent any of these exceptions, the drawee/payor bank is liable.

With the benefit of hindsight following a consummated check fraud, it seems likely that the drawee/payor bank will be able to create a question of fact in the vast majority of cases as to whether the drawer and possibly other persons in the transaction discharged their duties, and complex litigation will ensue. If the drawee/payor bank can prove a breach of duty by the drawer or another party, the drawee/payor bank will escape what is otherwise strict liability. In such cases, the drawee/payor also will tend to escape some allocation of liability on the basis of comparative fault, owing to its reduced duty of ordinary care under section 3-103(7).

And what of the depository bank? The general rule of liability with respect to a depository bank emanates from the law of conversion and section 3-420, which provides: "An instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment."¹¹⁴ Depository banks also are liable for the instruments they take for deposit or cash on the basis of their transfer warranties. This liability is strict in the sense that it depends not on the depository bank's negligence.¹¹⁵

A depository bank will be strictly liable for taking for deposit or cash a fraudulent instrument unless the payee is fictitious or an impostor, unless the payee is an employer who authorized a faithless employee with respect to the instrument and unless any other person's negligence contributed to a forgery or alteration. In these cases, the depository bank avoids strict liability but remains subject to a duty of ordinary care.¹¹⁶

¹¹⁴ UCC § 3-420(c)(2003) provides that "a representative, other than a depository bank, who has in good faith dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion to that person beyond the amount of any proceeds that it has not paid out."

¹¹⁵ UCC § 3-417(2003) sets forth warranties on presentment and transfer. *See also* Perez v. Charter One FSB, 748 N.Y.S.2d 392 (App. Div. 2002); Mouradian v. Astoria Fed. Sav. and Loan, 689 N.E.2d 1385 (N.Y. 1997)

¹¹⁶ *See* Nat'l Accident Ins. Underwriters, Inc. v. Citibank, F.S.B., 243 F. Supp. 2d 769 (N.D. Ill. 2003) (finding that "strict liability" does not eliminate all affirmative defenses); Leeds v. Chase Manhattan

This is where the analysis of a depository bank's liability differs from that of a drawee/payor bank. If the depository bank is not expressly authorized to process ATM transactions without inspection of the instrument under the revised UCC's definition of ordinary care, the depository bank will be held to a reasonable community standard of ordinary care. Courts have tended to take a dim view of depository banks choosing to forego inspection in the processing of instruments, often finding them negligent as a matter of law.¹¹⁷ Even so, under the revised UCC, the depository bank will be permitted to shine the litigation spotlight back on the drawer, the payee and any subsequent endorsee, and the drawee/payor bank, as the facts of a given case permit.¹¹⁸ Again with the benefit of hindsight and the threat of complex litigation, the depository bank will most likely find a reluctant company with which to share the loss.

And how valuable, as a practical matter, are cases holding the depository bank negligent as a matter of law for processing instruments without inspection? Because comparative fault ultimately requires the finder of fact to determine not only the existence of negligence, but the percentage of a loss caused by each party's negligence, a drawer or payee will want to go beyond the question of whether the depository bank was negligent, to questions of how negligent it was and how much it contributed to the losses. This will require a full scope of discovery and presentation of evidence against the depository bank. Similarly, because the standard of negligence is a community standard, determinations of negligence as a matter of law in one case arguably will have limited precedential value in another case. For these reasons, cases holding depository banks negligent as a matter of law are more likely to find traction in jury instructions at trial than in pre-trial motions for summary judgment.

Some misappropriations of instruments may not involve impostors or fictitious payees, fraudulent endorsements, or forged signatures or alterations. In such cases, the statutory exceptions should not apply, and, therefore, the general rules should apply. In these cases the depository bank, which allowed the transaction to occur, should be held ultimately responsible, whether strictly or in negligence, without the opportunity to apportion the responsibility on the basis of the fault of some other party to the transaction.

An example of such a misappropriation is the restrictive endorsement case. Assume a check is made payable to an employer corporation as payee and the check is endorsed by its employee with the restrictive endorsement "for deposit only" and signed "Employer Corporation." The employee's instruction to the depository bank, which is separate from the instrument, is to deposit the check to the employee's account.¹¹⁹ In

Bank, N.A., 752 A.2d 332 (N.J. Super. Ct. App. Div. 2000)(finding depository bank was strictly liable to payee for conversion after customer altered the check to make himself payee as attorney for payees, reasoning the bank made payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment).

¹¹⁷ See cases cited *supra*, note 69.

¹¹⁸ UCC §§ 3-404, 3-405, 3-406, 4-406 (2003).

¹¹⁹ This is the fact pattern presented in CLARK, *supra* note 47, ¶ 12.05[7], at 12-160, except that Clark assumed the employee had no authority to make even a restrictive endorsement. Clark focused on the applicable standard of ordinary care but did not address the basis of any strict liability on the part of the

such a case, a question can always be raised as to the authority of the employee to make the restrictive endorsement on behalf of the employer corporation.¹²⁰ A depository bank would argue that the endorsement is fraudulent and should be covered by the liability-shifting provision of section 3-405. But if the employee had authority to make a restrictive endorsement, as distinguished from an endorsement to himself or a third party, section 3-405 by its terms would not apply. The essence of the problem is not the employee's restrictive endorsement of the instrument that allows the instrument only to be paid to the account of the employer corporation. The essence of the problem is the depository bank's disregard of the restrictive endorsement and allowing the check to be deposited into the employee's account without any endorsement from the employer corporation to the employee. The depository bank should be held strictly liable and liable for negligence.¹²¹

VI. Conclusion

The procedures banks employ to verify signatures have changed dramatically over the years, especially in light of the volume of checks processed through the banking system and the banks' need for automation. As a result, checks may go unverified, or, at a minimum, may be randomly sampled. Without teller interaction, possibly in some instances the last resort for verification of signatures, the use of ATMs can become a breeding ground for check fraud.

In instances where the drawer is not negligent, it seems that any negligence by the depository bank, subject to the caveats discussed above, will fall on that bank either through an action by the payee or by the drawee bank seeking recovery of losses under the presentment warranties.

In the context of performing its own cost-benefit analysis of pursuing its subrogation rights against the banks, it is vitally important for the fidelity carrier to evaluate the underlying facts of the particular ATM check fraud scheme, and the actions or inactions of each of the individuals and entities involved, in conjunction with a thorough analysis of the standards set forth in UCC Articles 3 and 4, playing particular attention to the ordinary care definition in section 3-103(7) and the comparative negligence standards set forth throughout Articles 3 and 4.

depository bank or any particular liability shifting provision of the UCC that would incorporate the § 3-103(7) definition of ordinary care.

¹²⁰ See *Menichini v. Grant*, 995 F.2d 1224, 1233 (1993)(revised Article 3 recognizes principals' ability to minimize agency costs and resolves the agency problem by assigning check fraud losses to the payee-employer).

¹²¹ *Rutherford v. Darwin*, 622 P.2d 245 (N.M. Ct. App. 1980); see also *Underpinning & Found Constructors, Inc. v. Chase Manhattan Bank*, 403 N.Y.S.2d 501 (App. Div. 1978), *aff'd*, 414 N.Y.S.2d 298; UCC § 3-206 (2003).