

Shifting Check Fraud Losses From Banks To Businesses Under Recent Revisions To The Uniform Commercial Code

By John D. North

GREENBAUM, ROWE, SMITH,
RAVIN, DAVIS & HIMMEL

In June, 1995, New Jersey enacted revisions to Articles 3 and 4 of the Uniform Commercial Code, which deal with negotiable instruments and bank deposits and collections. The revisions had already become law in many other states.

This revision of the UCC shifts a significant degree of exposure for check fraud losses from banks to their business customers.

The purpose of this article is to highlight the most significant areas where the risk of loss from check fraud has been shifted from banks to businesses, and the areas where businesses and banks must tighten their procedures in order to protect themselves.

Background

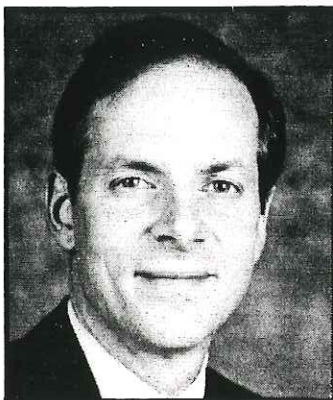
Under the former version of the UCC, check fraud losses were allocated between banks and businesses according to an "all or nothing" system of claims and defenses.

Generally, check frauds perpetrated by a business's employees were allocated to the business, not the banking system. In cases where the business had failed to detect an "inside job" by examining its banking statements, or where dishonest employees had conducted a "padded payroll" or similar scheme involving the issuance of bogus checks, or where the business's negligence otherwise "substantially contributed" to check forgery, the banks were entitled to assert defenses which barred the business's claims and left it with the loss.¹

However, businesses were very often able to overcome bank defenses. The "slightest contributory negligence" on the part of a bank would make most bank defenses unavailable.² As a result, in many cases, even where the business' negligence played the most important role in bringing about the loss, the business could succeed in shifting the entire loss to a bank.

This "all or nothing" system of allocating fraud losses produced unfair results. Almost all large check fraud losses occur, not in a single isolated transaction, but over an extended period of time in schemes by dishonest employees. Such extended schemes cannot occur unless there is a lack of adequate supervision and internal control. In almost all large check fraud losses, negligence on the part of the business plays a significant role.

However, since even "the slightest" negligence on the part of a bank precluded its defenses, a bank whose negligence played but a small role was required to absorb the entire loss, while the customer whose lack of diligence



By John D. North

allowed the fraudulent scheme to continue, escaped the consequences altogether.

The Adoption Of Comparative Fault

In order to bring litigation results more in line with the parties' degree of responsibility for check fraud losses, the revisions to Articles 3 and 4 have replaced the system of "all or nothing" loss allocation with one based upon comparative fault.

Under the revised UCC, check fraud losses are allocated "according to the extent to which the failure of each [party] to exercise ordinary care contributed to the loss."³

The result is a significant shift of loss exposure from banks to businesses. In larger cases, the business's failure to adopt internal controls that would lead to the detection of a check fraud scheme will almost always be a substantial factor in the resulting loss. Therefore, even in a case where the bank has been negligent, the employer will be forced to absorb a substantial portion of the loss.

The Accounts Receivable Embezzlement Scheme

In addition to the adoption of comparative fault as a means of loss allocation, the UCC revision has also shifted the loss exposure from banks to businesses for a specific type of check fraud, which is increasingly common.

The scheme is conducted by the accounts receivable clerk. When checks made payable to the business are received, the accounts receivable clerk posts the payment to the customer's account. The clerk then steals the check. Assuming the clerk was careful not to steal a check that was so large it would be missed, and assuming that the clerk was careful to wait for a day when there was a sufficient volume of incoming checks, the absence of a single non-descript check from the day's bank deposit would not be noticed.

The accounts receivable clerk then deposits the stolen check into an account she has opened in a bank other than her employer's. The account bears the same name or a similar name to that of the business. The "endorsement" on the check is a "for deposit only" rubber stamp the dishonest clerk has had made specifically for the purpose of carrying out the scheme.

As long as the clerk remains careful and calculating, this scheme is almost impossible to detect. Unlike padded payroll schemes or other check frauds involving the issuance of unauthorized checks or forged checks, the theft of incoming checks cannot be discovered by reviewing the business' bank statements and cancelled checks. While the payment of unauthorized or forged checks is reflected on the account statement, and in almost all cases, immediately obvious when the unauthorized or forged check is inspected, the fact that an incoming check was not deposited appears nowhere.

Under the former version of the UCC, the losses resulting from such schemes were allocated to banks. Now, the loss is allocated to the business.

Under new §3-405, a fraudulent endorsement is treated as "effective" if it has been placed on the check by an employee who has been entrusted "with responsibility with respect" to the check. "Responsibility" under §3-405 includes the authority to process incoming checks for bookkeeping, for bank deposits, or "for other disposition," as well as numerous other back office functions.

"Employee" is defined under §3-405 not only to include direct employees, but also independent contractors and employees of independent contractors. Thus, outside accountants who perform internal bookkeeping and accounting functions are considered "employees" under §3-405, and losses caused by their dishonesty are also allocated to the business.

What To Do?

The purpose of the UCC revisions just as the purpose of the original UCC, was not to pit banks and business customers against each other in a fight to determine who will be left holding the bag. The purpose is to encourage both banks and businesses to take steps necessary to prevent check fraud losses.

From the business point of view, the primary areas of loss exposure are (1) the issuance of unauthorized checks or forged checks, which was a significant area of loss exposure under the former version of the Code, and continued under the revision; and (2) the theft of incoming checks made payable to the business, which is an area of loss exposure which has been greatly expanded under the revised Code.

In order to protect against their expanded areas of loss exposure, businesses must verify that all checks received from customers and posted to their accounts are in fact deposited in the bank. In addition, businesses should continue, as before, to perform a timely and effective review of bank account statements for forged and unauthorized items.

These controls can only be carried out effectively through segregation of duties or close supervision. The same individual who issues checks should not also review bank statements for unauthorized checks or forgeries. Delegating both functions to the same

individual places that individual in the position to both perpetrate and conceal check forgeries. The employee who posts checks to customers' accounts should not also be responsible for verifying that all of the checks that have been posted are included in the business's bank deposits.

Small businesses may not be able to segregate bookkeeping functions by assigning them to separate employees. In such businesses, the only solution is to supervise employees closely. Carefully reviewing bank statements and verifying check deposits can accomplish the same level of control as segregation of duties, although it does represent a significant burden to the small business.

From the banking standpoint, the primary area of loss exposure continues to be in the deposit function. Even under the revised Code, banks will retain a significant exposure for losses when they allow accounts to be established in corporate names or in tradenames without the proper documentation, such as certificates of incorporation, corporate resolutions or trade name certificates. The absence of such documentation will almost always lead to a finding that the bank has not complied with reasonable commercial standards.

In addition, banks must be careful to determine that the payee of a check, the endorsement and the account to which the check is deposited are all the same. Otherwise, the acceptance of the deposit by the bank may be considered negligent and render the bank liable for a portion of the business' fraud losses. If a bank's tellers allow a pattern to develop with a customer who turns out to be the dishonest accounts receivable clerk described above, the business will have a strong argument that while its negligence was ongoing, so was the bank's, and, therefore, the bank should share at least an equal portion of the loss.

Conclusion

The inevitable consequence of the shift of exposure for check fraud losses from banks to businesses under the revisions to UCC Articles 3 and 4 is to place an added burden on businesses to tighten their internal controls and employee supervision. This is especially so in the accounts receivable area, where check fraud is easy to perpetuate and hard to detect.

Due to the comparative fault provisions in revised Articles 3 and 4, however, neither banks nor businesses face an "all or nothing" exposure. As a result, just as businesses must tighten their procedures to protect themselves against new areas of loss exposure, banks will have to tighten their own controls, particularly in the deposit function, if they are to benefit from the leveling of the UCC playing field.

John D. North is a Partner in the banking group of Greenbaum, Rowe, Smith, Ravin, Davis & Himmel, Woodbridge, New Jersey. A substantial portion of Mr. North's practice is devoted to litigation involving check frauds.

¹ See former UCC §§ 3-405, 3-406 and 4-406.

² New Jersey Steel Corp. v. Warburton, 139 N.J. 536, 655 A2d 1382 (1995).

³ See revised UCC §§3-406(b) and 4-406(e).

Reminder: Use Our FAX FOLLOW-UP SERVICE, (908) 549-1881 (to author's attention) for questions about this article.