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## Check Fraud and the Common Law: At the Intersection of Negligence and the Uniform Commercial Code

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# CHECK FRAUD AND THE COMMON LAW: AT THE INTERSECTION OF NEGLIGENCE AND THE UNIFORM COMMERCIAL CODE

**Abstract:** Common law negligence claims persist in check fraud cases despite the Uniform Commercial Code's loss allocation provisions in Articles 3 and 4. Absent an explicit preemption provision, courts disagree as to whether, when, and to what extent the Code preempts these common law claims. As a result, the courts' varying analytical approaches to common law negligence claims often create seemingly conflicting results. This Note reviews the current loss allocation rules in check fraud scenarios and examines recent preemption case law. It argues in favor of the comprehensive rights and remedies analysis used by the majority of courts to determine the circumstances under which common law negligence claims should be allowed under the Code. It also makes recommendations for future Code revisions based on the recent case law. Finally, this Note suggests that the loss allocation scheme as presently constituted provides a latent benefit to the payment system by encouraging customers to move toward electronic payment.

## INTRODUCTION

Delighted by the sudden success of his business but unable to keep up with operations himself, a small business owner hires an accountant to manage the company's finances.<sup>1</sup> The owner's trust is misplaced, and the accountant embezzles hundreds of thousands of dollars from the business over the next several years.<sup>2</sup> The owner neither reviews monthly bank statements nor audits the books, but hundreds of checks issued to the business were indorsed over to the accountant and deposited in his personal bank account without a second look from his bank.<sup>3</sup>

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<sup>1</sup> For actual occurrences of this scenario and its potential repercussions, see *Lee Newman, M.D., Inc. v. Wells Fargo Bank*, 87 Cal. App. 4th 73, 75–76 (Ct. App. 2001) (discussing liability for losses where an assistant bookkeeper and office manager forged company indorsements on insurance payments and cashed or signed the checks over to themselves); *Peters Family Farm v. The Sav. Bank*, No. 10CA2, 2011 WL 497476, at \*1 (Ohio Ct. App. Jan. 28, 2011) (discussing liability for losses where an accountant cashed checks signed by a company president for fictitious tax liability).

<sup>2</sup> See *Lee Newman*, 87 Cal. App. 4th at 76; *Peters Family Farm*, 2011 WL 497467, at \*1.

<sup>3</sup> See *Lee Newman*, 87 Cal. App. 4th at 76; *Peters Family Farm*, 2011 WL 497467, at \*1.

A decedent's heirs hire an attorney to administer their loved one's estate.<sup>4</sup> When the heirs call the bank to inquire about missing monthly statements, they are dismayed to learn that the funds are now with the estate administrator somewhere in the South Pacific.<sup>5</sup> Although the administrator was not authorized to initiate transactions on the estate's account without a cosigner, the bank allowed him to do so several times.<sup>6</sup>

An elderly gentleman receives a bank check in the mail along with a letter from an African prince and humanitarian asking for his help.<sup>7</sup> Feeling skeptical, the gentleman asks a bank manager how long he should wait to ensure that the check will be honored.<sup>8</sup> The bank manager informs him that the bank check is "as good as cash" and can be moved at any time without risk.<sup>9</sup> Based on this information, the customer sends a wire transfer out of the country per his agreement with the African prince.<sup>10</sup> Unfortunately, the check deposited to cover the wire is returned the same day by the payor bank because it was fraudulent.<sup>11</sup>

These and other similar scenarios play out each day in our payment system.<sup>12</sup> Not surprisingly, check fraud scenarios create significant litigation involving loss allocation.<sup>13</sup> Parties often disagree as to which

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<sup>4</sup> For an actual occurrence of this scenario and its potential repercussions, see *Brannon v. BankTrust, Inc.*, 50 So. 3d 397, 399–400 (Ala. 2010) (discussing liability for losses where an attorney hired to assist with estate administration initiated several transactions payable to his law firm which were honored by the bank notwithstanding the fact that he was not authorized to make transactions against the estate's account).

<sup>5</sup> *See id.*

<sup>6</sup> *See id.*

<sup>7</sup> For an actual occurrence of this scenario and its potential repercussions, see *Valley Bank of Ronan v. Hughes*, 147 P.3d 185, 188–89 (Mont. 2006) (discussing liability for losses where a customer received solicitation from a purported humanitarian asking for help with the purchase of farming equipment for a needy foreign village). A bank check, also known as a bank draft, is a check "where the payment is guaranteed to be available by [the] issuing bank." *See Bank Draft*, INVESTOPEDIA, [http://www.investopedia.com/terms/b/bank\\_draft.asp](http://www.investopedia.com/terms/b/bank_draft.asp) (last visited Oct. 20, 2013).

<sup>8</sup> *See Valley Bank*, 147 P.3d at 188–89.

<sup>9</sup> *See id.*

<sup>10</sup> *See id.*

<sup>11</sup> *See id.*

<sup>12</sup> *See* BAI PAYMENTS CONNECT, CHECK FRAUD: WHY ARE LOSSES TRENDING DOWN? 3 (2013) (noting that losses from check fraud totaled \$893 million in 2010); *see also* *Adams v. Martinsville DuPont Credit Union*, 573 F. Supp. 2d 103, 113 (D.D.C. 2008) (discussing liability from fraud arising from the theft of a customer's checkbook); *In re World Metals, Inc.*, 313 B.R. 720, 723 (Bankr. D. Ohio 2004) (discussing liability from an employee fraud case involving alleged embezzlement perpetrated by a bankrupt employer's bookkeeper).

<sup>13</sup> *See* *Advance Dental Care, Inc. v. SunTrust Bank*, 816 F. Supp. 2d 268, 270–71 (D. Md. 2011) (discussing liability for fraud losses where an office manager signed check pay-

law controls the parties' rights, duties, and liabilities.<sup>14</sup> On the one hand, Articles 3 and 4 of the Uniform Commercial Code set out a system of rights and liabilities for check fraud in which unavoidable losses are allocated to the banks, whereas avoidable losses are generally allocated to the "best loss avoider."<sup>15</sup> As a practical matter, the best loss avoider is generally the customer.<sup>16</sup> Furthermore, even where other Code provisions do not allocate loss to the customer, the Code also provides a strict statute of limitations for claims that may preclude a customer from recovery.<sup>17</sup>

Thus, customer-plaintiffs may wish to advance common law claims such as negligence to avoid these limitations.<sup>18</sup> But courts disagree about whether and to what extent common law negligence claims are valid under the Code.<sup>19</sup> And to extent that courts allow common law negligence claims, they disagree as to the appropriate analytical preemption test.<sup>20</sup> For example, some courts ask whether the Code provides a comprehensive set of rights and remedies to the parties in the dispute.<sup>21</sup> Other courts ask whether the underlying factual circum-

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ments from insurance companies over to herself and deposited them in her personal checking account); *Chi. Title Ins. Co. v. Allfirst Bank*, 905 A.2d 366, 377 (Md. 2005) (discussing liability for fraud losses where an account holder deposited a bank check—intended to pay off his first mortgage as part of a refinancing—into his personal checking account); see also Sarah Howard Jenkins, *Preemption & Supplementation Under Revised 1-103: The Role of Common Law & Equity in the New U.C.C.*, 54 SMU L. REV. 495, 499 (2001) ("Courts have wrestled with the coordination of supplemental law and U.C.C. provisions in over 600 cases between 1964 and 1999.").

<sup>14</sup> See Jenkins, *supra* note 13, at 499; see also *Allfirst Bank*, 905 A.2d at 377 (illustrating disagreement over whether UCC or common law applies in check fraud scenarios); *C-Wood Lumber Co. v. Wayne Cty. Bank*, 233 S.W.3d 263, 281–82 (Tenn. Ct. App. 2007) (same).

<sup>15</sup> See U.C.C. §§ 3-102, 4-102 (2002) (illustrating the scope of these provisions); Bryan D. Hull, *Common Law Negligence and Loss Allocation: Has the Common Law Supplemented or Supplanted the U.C.C.?*, 51 OHIO ST. L. J. 605, 606 (1990) (discussing "best loss avoider"); A. Brooke Overby, *Check Fraud in the Courts After the Revisions to U.C.C. Articles 3 and 4*, 57 ALA. L. REV. 351, 354–55 (2005).

<sup>16</sup> JAMES STEVEN ROGERS, *THE END OF NEGOTIABLE INSTRUMENTS* 124 (2012).

<sup>17</sup> See, e.g., U.C.C. § 3-118 (providing a three-year statute of limitations for actions regarding the conversion of instruments); Overby, *supra* note 15, at 390.

<sup>18</sup> See Overby, *supra* note 15, at 390.

<sup>19</sup> See Hull, *supra* note 15, at 610–11; Overby, *supra* note 15, at 390–91; *infra* notes 21–24 and accompanying text (illustrating the disparate analyses and outcomes reached by courts).

<sup>20</sup> See Hull, *supra* note 15, at 610–11; Overby, *supra* note 15, at 390–91; *infra* notes 21–24 and accompanying text (illustrating the disparate analyses and outcomes reached by courts).

<sup>21</sup> See, e.g., *AmSouth Bank v. Tice*, 923 So. 2d 1060, 1066 (Ala. 2005); *C-Wood Lumber*, 233 S.W.3d at 281–82.

stances fall within the Code's scope of coverage.<sup>22</sup> And at least one jurisdiction employs a textual analysis of the Code's provisions to determine whether the Code's plain meaning preempts common law claims.<sup>23</sup> Regardless of the chosen inquiry, common law negligence claims are occasionally permitted.<sup>24</sup>

This Note advocates for the “comprehensive rights and remedies approach” to evaluating common law negligence claims in check fraud scenarios, but suggests revisions to the current Articles 3 and 4 scheme to address fairness issues identified by the courts.<sup>25</sup> Part I discusses common forms of check fraud and explains the history and mechanics of the loss allocation scheme under Articles 3 and 4.<sup>26</sup> Part II examines the courts' analyses of common law negligence claims under the Code for check fraud scenarios.<sup>27</sup> Part III argues that common law negligence claims probably should not be allowed based on a strict reading of the Code.<sup>28</sup> Recognizing the limited circumstances in which courts have allowed common law negligence claims—and the minimal impact they have had on predictability—however, Part III recommends revisions to the check fraud allocation scheme based on the results reached by courts, which better reflect the broader goal of consumer protection articulated in payment systems generally.<sup>29</sup> Finally, Part III suggests that the check fraud loss allocation scheme provides a latent benefit to the payment system as a whole by encouraging customers to move toward electronic payments.<sup>30</sup>

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<sup>22</sup> See, e.g., *Notredan, LLC v. Old Republic Exch. Facilitator Co.*, 875 F. Supp. 2d 780, 788 (W.D. Tenn. 2012); *Allfirst Bank*, 905 A.2d at 377.

<sup>23</sup> See *Van Der Werff v. Shawmut Bank Conn.*, No. CV 950554654, 1996 WL 686916, at \*3 (Conn. Super. Ct. Nov. 20, 1996).

<sup>24</sup> *Compare, e.g., Sebastian v. D&S Express, Inc.*, 61 F. Supp. 2d 386, 387 (D.N.J. 1999) (holding that a common law negligence claim was preempted because the Code provided a comprehensive remedy for a company whose president was engaged in a fictitious payee check fraud scheme), *with In re Clear Advantage Title*, 438 B.R. 58, 65 (Bankr. D.N.J. 2010) (carving out an exception for common law negligence claims under the Code where a “special relationship” existed between the parties, such as one created by fiduciary, confidential, contractual, or legal duties).

<sup>25</sup> See *infra* notes 31–288 and accompanying text.

<sup>26</sup> See *infra* notes 31–144 and accompanying text.

<sup>27</sup> See *infra* notes 145–220 and accompanying text.

<sup>28</sup> See *infra* notes 226–246 and accompanying text.

<sup>29</sup> See *infra* notes 247–276 and accompanying text.

<sup>30</sup> See *infra* notes 277–288 and accompanying text.

## I. CHECK FRAUD, THE UCC, AND LOSS ALLOCATION UNDER ARTICLES 3 AND 4

Check fraud has been a widespread and widely known phenomenon since the beginning of negotiable instruments law.<sup>31</sup> In many ways, check fraud is easier to commit today than ever before: automated check processing systems have rendered physical review of checks a thing of the past, and simple desktop publishing software has made it easier than ever to make a convincing forgery at home.<sup>32</sup> Despite the prevalence of check fraud, however, the United States remains tied to the check as a significant payment method for consumers and businesses alike.<sup>33</sup> In 2010, for example, U.S. businesses and consumers used more than 8 billion checks to pay for everything from rent and employee wages to the bus costs for school field trips.<sup>34</sup> Each check cost approximately 43 cents to process, for a total cost of \$3.4 billion.<sup>35</sup> That same year, losses from check fraud totaled \$893 million.<sup>36</sup>

Section A of this Part provides background information on the different types of check fraud and the Code's allocation scheme for losses resulting from such fraud.<sup>37</sup> Section B of this Part discusses the

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<sup>31</sup> See BAI PAYMENTS CONNECT, *supra* note 12, at 3. See also generally *Price v. Neal*, (1762) 97 Eng. Rep. 871 (K.B.) (holding that the bank is liable for paying unauthorized drafts). Check fraud even made its way into popular culture when America's most famous check fraudster, Frank Abagnale, provided the backdrop for the 2002 Hollywood blockbuster *Catch Me If You Can*. See *CATCH ME IF YOU CAN* (DreamWorks 2002). This movie grossed \$352.1 million, making it the eleventh-highest-earning movie in 2002. See *2002 Worldwide Grosses*, BOX OFFICE MOJO, <http://www.boxofficemojo.com/yearly/chart/?view2=worldwide&yr=2002&p=.htm> (last visited Oct. 10, 2013).

<sup>32</sup> See CHECK FRAUD WORKING GROUP, CHECK FRAUD: A GUIDE TO AVOIDING LOSSES I (1999) [hereinafter CHECK FRAUD GUIDE], available at <http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-check-fraud.pdf>. The Check Fraud Working Group is "a subgroup of the interagency Bank Fraud Working Group" and is comprised of "representatives from the Federal Bureau of Investigation, the Department of Justice, Federal Deposit Insurance Corporation, Federal Reserve Board, Internal Revenue Service, Office of the Comptroller of the Currency, Office of Thrift Supervision, U.S. Postal Inspection Service, National Credit Union Administration, and U.S. Secret Service." *Id.*

<sup>33</sup> See 97 BD. OF GOVERNORS OF THE FED. RESERVE SYS. ANN. REP. tbl.12 (2011) [hereinafter 2010 Annual Report], available at <http://www.federalreserve.gov/publications/annual-report/statistical-tables/2010-statistical-table12.htm>.

<sup>34</sup> See *id.*

<sup>35</sup> See Paul W. Bauer & Geoffrey R. Gerdes, *The Check Is Dead! Long Live the Check! A Check 21 Update*, ECON. COMMENT., June 2009, at 1, 3 fig.2, available at <http://www.clevelandfed.org/research/commentary/2009/0609.cfm> (check processing costs); 2010 Annual Report, *supra* note 33 (illustrating that over eight billion checks were processed by the federal government in 2010).

<sup>36</sup> BAI PAYMENTS CONNECT, *supra* note 12, at 3.

<sup>37</sup> See *infra* notes 39–128 and accompanying text.

history of Articles 3 and 4 and the intersection of their provisions with common law negligence claims.<sup>38</sup>

### A. *The UCC and Check Fraud*

This Section explains the check collection process and how it facilitates check fraud.<sup>39</sup> It also discusses how alterations and forgeries are commonly used to commit check fraud.<sup>40</sup>

#### 1. Fraud Based on the Check Collection Process

The check collection process often contributes to check fraud.<sup>41</sup> This process has been historically paper based and has essentially followed the check.<sup>42</sup> The person writing the check, known as the “drawer,” gives the check to the beneficiary, who in turn presents it to his or her bank to begin the collection process.<sup>43</sup> The beneficiary’s bank, known as the “depository bank,” then forwards the check’s information to the drawer’s bank, known as the “payor bank.”<sup>44</sup> The payor bank receives the information and sends funds to the depository bank as indicated on the check.<sup>45</sup> Upon receiving the funds, the depository bank applies them to the beneficiary’s account to complete the payment.<sup>46</sup>

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<sup>38</sup> See *infra* notes 129–144 and accompanying text.

<sup>39</sup> See *infra* notes 41–60 and accompanying text.

<sup>40</sup> See *infra* notes 61–128 and accompanying text.

<sup>41</sup> See, e.g., *Williams v. United States*, 458 U.S. 279, 281 n.1 (1982) (illustrating a typical check fraud scheme); James Steven Rogers, *The Basic Principle of Loss Allocation for Unauthorized Checks*, 39 WAKE FOREST L. REV. 453, 456 (2004) (explaining the check collection process).

<sup>42</sup> See Peter J. Mucklestone, *The Journey of a Check*, PROF. LAWYER, 2006, at 39, 39 (explaining that the check collection process was historically paper based); Rogers, *supra* note 41, at 456 (explaining the check collection process).

<sup>43</sup> See Rogers, *supra* note 41, at 456; see also U.C.C. § 3-103(a)(3) (2002) (“Drawer” means a person who signs or is identified in a draft as a person ordering payment.”).

<sup>44</sup> See Rogers, *supra* note 41, at 456; see also U.C.C. § 4-105(2) (“Depository bank” means 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.”); *id.* § 4-105(3) (“Payor bank” means a bank that is the drawee of a draft.”).

<sup>45</sup> See Rogers, *supra* note 41, at 456–57.

<sup>46</sup> See *id.* at 456. The inefficiency of the system is apparent when it is considered in reference to electronic payment systems. See *id.* With electronic transfers, the originator gives instructions for payment to its own bank, which sends the funds to the beneficiary’s bank, which in turn applies the funds to the beneficiary’s account. See *id.* This process avoids the burdensome and inefficient back-and-forth required by the paper check collection process. See *id.*; *supra* notes 43–45 and accompanying text (describing the paper check collection process).

Nevertheless, the 2003 Check Clearing for the 21st Century Act (Check 21 Act), provided the legislative stamp of approval for electronic presentment.<sup>47</sup> Today, banks often remove a physical check from circulation and electronically transmit either an image of the check or the check's "MICR" information to the payor bank for collection.<sup>48</sup> This image becomes the legal equivalent of the paper check and can be used the same way as the original check.<sup>49</sup> Thus, electronic presentment provides a time- and cost-saving alternative to paper-based collection.<sup>50</sup>

Although electronic presentment is much faster than the paper-based presentment process that preceded it, the collection process is not instantaneous and the so-called "check float" phenomenon remains.<sup>51</sup> Because of funds availability rules, there are often several days between the date of deposit and the date that funds are actually received

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<sup>47</sup> See Check Clearing for the 21st Century Act (Check 21 Act), Pub. L. No. 108-100, § 4(b), 117 Stat. 1177, 1180 (2003) (codified as amended at 12 U.S.C. § 5003(b) (2012)); Mucklestone, *supra* note 42, at 39–41.

<sup>48</sup> See Mucklestone, *supra* note 42, at 41. "MICR" stands for "magnetic ink character recognition." See CHECK FRAUD GUIDE, *supra* note 32, at 2; *Check 21 Act Frequently Asked Questions*, FDIC, <http://www.fdic.gov/regulations/resources/21actfaq/> (last updated Oct. 26, 2004). The MICR line on a check provides the information necessary to process a check: the payor bank's routing number, the drawer's account number, and the check number. See CHECK FRAUD GUIDE, *supra* note 32, at 2; *Check 21 Act Frequently Asked Questions*, *supra*; see also Overby, *supra* note 15, at 360 n.60 (describing the manipulation of MICR lines by fraudsters to slow the check collection process and elongate the float time—the time between when funds from a deposited check become available and when the bank receives the funds from the payor bank—to allow more time for fraudulent transactions).

<sup>49</sup> See 12 U.S.C. § 5003(b); Mucklestone, *supra* note 42, at 41. This means that a substitute of a fraudulent original will be subject to the same rules as the original would have been. See 12 U.S.C. § 5003(b); Mucklestone, *supra* note 42, at 41.

<sup>50</sup> See Mucklestone, *supra* note 42, at 40. Despite the conception of the Check 21 Act prior to the 9/11 terrorist attacks, the attacks further highlighted the paper-based check system's vulnerability because air freight was grounded for several days after the attacks, grinding the check system to a halt. See Bauer & Gerdes, *supra* note 35, at 1. In the days following the 9/11 attacks, "Grounded checks peaked at a value of over \$45 billion." *Id.* For more information on the intersection of the terrorist attacks and the financial community, see generally 88 BD. OF GOVERNORS OF THE FED. RESERVE SYS. ANN. REP. (2001), available at <http://www.federalreserve.gov/boarddocs/rptcongress/annual01/ar01.pdf>.

<sup>51</sup> See Expedited Funds Availability Act, 12 U.S.C. § 4002 (2012) (prescribing funds availability schedules that interact with the time required for check clearing to produce float); Regulation CC, 12 C.F.R. § 229.12 (2013) (same); see also James McAndrews & William Roberds, *The Economics of Check Float*, 85 EC. REV. 17, 18–20 (2000), available at <http://www.frbatlanta.org/filelegacydocs/roberds.pdf> (discussing check float as an explanation for the continued prevalence of payments by check in the United States); Michelle Singletary, *Technology Sinks the Check Float*, WASH. POST (Mar. 15, 2007), <http://www.washingtonpost.com/wp-dyn/content/article/2007/03/14/AR2007031402244.html> (discussing conversion of payments under \$25,000 from check to electronic-based automated clearinghouse payments as a way to reduce the risk of loss from check float).



by the depositary bank.<sup>52</sup> Thus, the customer has access to the funds represented by the check before the check has affirmatively been honored by the payor bank.<sup>53</sup> “Check kiting,” a common type of check fraud, takes advantage of this float period by depositing a fraudulent check in one account, then drawing the funds during the float period and depositing them in another account.<sup>54</sup> Float also underlies scams known as “Nigerian check fraud schemes,” in which someone receives a check from a supposed humanitarian with instructions to deposit the check and wire a portion of the funds to another account as soon as the funds become available.<sup>55</sup> The fraudster receives the wire and withdraws the funds immediately, leaving the check’s recipient to bear the loss when the float period ends and the check is returned as fraudulent.<sup>56</sup>

The Code attempts to balance the benefits to customers of expedited funds availability with the potential risk for fraud created by float.<sup>57</sup> The Code prescribes certain deadlines for banks to either credit a customer’s account for a deposit or to pay or return checks presented for payment from a customer’s account.<sup>58</sup> But the bank also enjoys an unconditional right to charge back the customer’s account if a deposited item is subsequently returned.<sup>59</sup> This chargeback right is only lim-

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<sup>52</sup> See 12 U.S.C. § 4002; 12 C.F.R. § 229.12 (implementing the Expedited Funds Availability Act schedule for making deposited funds available).

<sup>53</sup> See 12 U.S.C. § 4002; 12 C.F.R. § 229.12.

<sup>54</sup> See, e.g., *Williams*, 458 U.S. at 281 n.1 (illustrating a typical check kiting scheme). See generally *Kiting*; LEGAL INFO. INST. (Aug. 19, 2010, 5:18 PM), <http://www.law.cornell.edu/wex/kiting> (defining kiting and providing illustrations of common kiting schemes).

<sup>55</sup> See, e.g., *Valley Bank*, 147 P.3d at 189–90 (illustrating the classic Nigerian check fraud scheme). For a more extensive treatment of Nigerian check fraud schemes, see generally Clark H.C. Lacy, *The Witch’s Brew: Nigerian Schemes, Counterfeit Cashier’s Checks, and Your Trust Account*, 61 S.C. L. REV. 753 (2010).

<sup>56</sup> See U.C.C. § 4-201(a) (2002) (indicating that the credit is provisional until the final settlement/funds are collected); *id.* § 4-202 (requiring a bank to timely return dishonored items in order for the bank to have presumptively exercised ordinary care in the return process); *id.* § 4-212(b) (indicating that the presenting bank can treat any item not received by the close of business on the third day following presentment as if it were dishonored by sending the drawer or indorser notice of the facts); *id.* § 4-214 (providing the right of chargeback to banks when provisional credit has been given to a customer, notwithstanding the fact that the customer may have taken out the funds already); see also *Valley Bank*, 147 P.3d at 188–89 (describing this scheme); U.C.C. § 4-105(6) (describing a “presenting bank” as “a bank presenting an item except a payor bank”).

<sup>57</sup> Compare Regulation CC, 12 C.F.R. § 229.12 (2013) (providing for the availability of funds before the check has cleared), with U.C.C. § 4-214 (providing banks with the right of chargeback). See McAndrews & Roberds, *supra* note 51, at 18–22.

<sup>58</sup> See U.C.C. § 4-214.

<sup>59</sup> See *id.*

ited by the requirement that the bank must share liability for whatever losses were caused by its own delay in returning the item.<sup>60</sup>

## 2. Fraud on the Instrument

### a. *Types of Fraud*

At the broadest level, fraud on the check itself takes two forms: alteration and forgery.<sup>61</sup> An alteration is an unauthorized change in a check that modifies or changes the maker's obligation or the payee's right to payment.<sup>62</sup> This includes any unauthorized addition of words or numbers to a completed check, as well as any additions or changes to an incomplete check.<sup>63</sup> Thus, an alteration occurs when a fraudster takes a legitimate check and changes important information, such as the amount or payee.<sup>64</sup> For example, Business X writes a check to Landscaper for \$150 to pay for monthly grounds maintenance and sends it to Landscaper in the mail.<sup>65</sup> Usurper takes Landscaper's mail, check and all, and notices that there is enough blank space to the right of Landscaper's name and the amount to change the payment information to "Landscaper or Usurper, \$150,000" using his home publishing software.<sup>66</sup> Usurper makes the changes and brings the check to his bank for deposit.<sup>67</sup> Alternatively, Business X's Bookkeeper may begin writing a check to Landscaper, inputting the amount, signing the check, and writing "Landscaper, February" in the Memo line—but leaving the Order line blank.<sup>68</sup> Usurper, a janitor at Business X, takes the check from Bookkeeper's desk, writes in his name on the Order line, and cashes the check at his bank.<sup>69</sup>

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<sup>60</sup> See *id.*

<sup>61</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 2–10; see also Rogers, *supra* note 41 at 453–54 (noting that Articles 3 and 4 allocate losses from forged indorsements or altered instruments).

<sup>62</sup> See U.C.C. § 3-407(a) (2002) (defining "alteration"); see also Suffolk Credit Union v. Fed. Nat'l Mortg. Ass'n, No. 10-2763 (GEB), 2011 WL 830262, at \*7 (D.N.J. March 7, 2011) (illustrating an alteration scheme). See generally ROGERS, *supra* note 16 (discussing the history of alteration and its treatment by the courts). For Code purposes, a check is an instrument, but not all instruments are checks. See U.C.C. § 3-104(f).

<sup>63</sup> See U.C.C. § 3-407(a).

<sup>64</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 2.

<sup>65</sup> See *id.* at 3.

<sup>66</sup> See *id.*

<sup>67</sup> See *id.*

<sup>68</sup> See *id.*

<sup>69</sup> See *id.*

The Code initially allocates losses from alterations to the depository bank.<sup>70</sup> Using the first illustration above, the unauthorized alteration would discharge Business X's obligation under the instrument except as according to its original terms (\$150 to Landscaper).<sup>71</sup> In the second example, though, payment to Usurper was, effectively, part of the check's original terms since Bookkeeper left the Order line blank.<sup>72</sup> Thus, the check would be enforceable against Business X according to the completed terms so long as Bank took the item for value, in good faith, and without notice of the alteration.<sup>73</sup>

Forgery comes in many more flavors than alteration, but it has two main varieties.<sup>74</sup> In the first, the fraudster forges the drawer's signature on a check payable from the drawer's account.<sup>75</sup> For instance, assume that Usurper, a janitor at Business X, steals a check from Bookkeeper's desk, marks it "Payable to the Order of Usurper, \$4,500.00," and forges Bookkeeper's authorizing signature on the signature line.<sup>76</sup> Usurper has forged the drawer's signature on the check.<sup>77</sup> In the second type of forgery, the fraudster forges the beneficiary's indorsement on a check written by the drawer and signs it over to himself.<sup>78</sup> For example, assume that Usurper steals a check from Bookkeeper's desk bearing

<sup>70</sup> See U.C.C. § 3-407 (2002) (placing the loss from alterations initially on the payor bank, requiring it to recredit the customer's account for any amount above the originally authorized amount); *id.* § 4-208(a) (providing a warranty against alterations to the payor bank, allowing the payor bank to recover the amount of the alteration from the depository bank).

<sup>71</sup> See *id.* § 3-407(c).

<sup>72</sup> See *id.*

<sup>73</sup> See *id.* Within the context of liability for alterations, a payor bank takes a check for value when it incurs an obligation to pay the third party presenting it for payment. See *id.* § 3-303(a)(5). "Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing. See *id.* § 3-103(a)(4). A person has notice when the person actually knows the fact, has received a notification duly delivered in a form reasonable under the circumstances at the recipient's place of business or another location held out to be the appropriate forum for sending notices, or where the person should have known the information based on all the facts and circumstances known to the person at the time in question. See *id.* § 1-202.

<sup>74</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 4-22 (describing various forgery-based check fraud schemes); Rogers, *supra* note 41, at 457-62.

<sup>75</sup> See Rogers, *supra* note 41, at 455-56; see also U.C.C. § 4-401 cmt. 1 (providing that "[a]n item containing a forged drawer's signature . . . is not properly payable").

<sup>76</sup> See Rogers, *supra* note 41 at 458-59; see also U.C.C. § 4-401 (2002) (providing for when a bank may charge a customer's account).

<sup>77</sup> See Rogers, *supra* note 41, at 458-59; see also U.C.C. § 4-401 (defining properly payable items and when the bank may pay them).

<sup>78</sup> See *Lee Newman*, 87 Cal. App. 4th at 76 (describing a forged indorsement fraud); Rogers, *supra* note 41, at 458; see also U.C.C. § 4-401 cmt. 1.

Bookkeeper's authorizing signature and made payable to Landscaper.<sup>79</sup> If Usurper signs on behalf of Landscaper to transfer the check to himself and then presents the check for deposit at his own bank, he has forged the beneficiary's indorsement.<sup>80</sup>

In either case, the Code initially places the loss on the banks because the items presented are not properly payable.<sup>81</sup> The Code authorizes the bank to pay only items which are properly payable.<sup>82</sup> If the item is not authorized, or if the bank does not pay it in accordance with any agreements between itself and its customer, the item is not properly payable.<sup>83</sup> In the forged indorsement scenario, the depository bank takes the loss.<sup>84</sup> In the forged drawer signature scenario, the payor bank takes the loss.<sup>85</sup> Absent a defense, then, the Code allocates unavoidable forgery losses among the payment system providers, rather than its users.<sup>86</sup>

#### b. *Bank Defenses to Forgery and Alteration*

Nevertheless, there are several defenses that allow banks to shift all or part of the losses from forgery and alteration to each other or to customers.<sup>87</sup> As between the banks, the payor bank (a "transferee" for purposes of the presentment warranty) may be able to assert a breach of presentment warranty against the bank that transferred the check to it

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<sup>79</sup> See Rogers, *supra* note 41, at 457–58; see also U.C.C. § 4-401.

<sup>80</sup> See Rogers, *supra* note 41, at 457–58; see also U.C.C. § 4-401.

<sup>81</sup> Compare U.C.C. § 4-401(a) (describing that "[a] bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft," where "[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"), with *id.* § 4-401 cmt. 1 ("An item containing a . . . forged indorsement is not properly payable."). See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 15-3 (5th ed. 2000) (indicating that an item that is not properly payable cannot be charged to the customer's account); Rogers, *supra* note 41, at 455 (citing BARKLEY CLARK & BARBARA CLARK, 1 THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS § 10.03[2] (2002)) (same).

<sup>82</sup> See U.C.C. § 4-401 (2002).

<sup>83</sup> See *id.*

<sup>84</sup> See *id.*; Rogers, *supra* note 41, at 465.

<sup>85</sup> See U.C.C. § 4-401; Rogers, *supra* note 41, at 465.

<sup>86</sup> See Rogers, *supra* note 41, at 466.

<sup>87</sup> See, e.g., U.C.C. § 3-404 (placing the risk of loss on customers in imposter or fictitious payee scenarios); *id.* § 3-405 (placing the risk of loss on employers in most employee embezzlement scenarios); *id.* § 4-406 (placing a duty on customers to discover alteration or unauthorized signatures within thirty days of the related statement).

for payment (a “transferor,” typically the depository bank).<sup>88</sup> The presentment warranty requires the payor bank to show that the transferor had actual knowledge that the check was a forgery.<sup>89</sup> Because the payor bank must prove that the depository bank had actual knowledge—rather than merely notice—the presentment warranty typically leaves the loss with the payor bank rather than the depository bank.<sup>90</sup>

Although a payor bank may not be successful under a presentment warranty, the payor bank can almost always shift the loss from a forged indorsement or alteration to the depository bank because of the Code’s transfer warranty.<sup>91</sup> Where multiple banks form a chain of transfer, each bank in the chain makes a transfer warranty to each subsequent bank in the chain.<sup>92</sup> Each transferee warrants that it was entitled to enforce the check and that there were no alterations on it.<sup>93</sup> Because most forged or altered checks are not enforceable, the payor bank can almost always shift the loss from a forged indorsement or alteration to the depository bank.<sup>94</sup>

In the event that the loss falls on the payor bank, several additional defenses provide the means by which the bank may often transfer the risk of loss to its customer.<sup>95</sup> First, the bank is not liable for a forgery or alteration where the customer’s failure to exercise ordinary care “substantially contributed” to the alteration or forgery and the bank paid the check or took it for value or collection in good faith.<sup>96</sup> This de-

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<sup>88</sup> See U.C.C. § 3-417 (2002); Overby, *supra* note 15, at 362–65. Under the Code, the bank sending the check for collection warrants that it is authorized to enforce the instrument, and that the check is genuine free of alteration. See U.C.C. § 3-417; Overby, *supra* note 15, at 362–65.

<sup>89</sup> See U.C.C. § 3-417; Overby, *supra* note 15, at 362–65.

<sup>90</sup> See U.C.C. § 3-417; Overby, *supra* note 15, at 362–65. Compare U.C.C. § 1-202(b) (“‘Knowledge’ means actual knowledge.”), with *id.* § 1-202(a) (“[A] person has notice of a fact if the person: (1) has actual knowledge, (2) has received a notice or notification of it, or (3) from all the facts and circumstances known to the person at the time in question, has reason to know that it exists.”).

<sup>91</sup> See U.C.C. § 4-207 (presentment warranties); *id.* § 4-208 (transfer warranties).

<sup>92</sup> See U.C.C. §§ 4-207 to -208; Overby, *supra* note 15, at 362–65.

<sup>93</sup> See U.C.C. §§ 4-207 to -208 (2002); Overby, *supra* note 15, at 362–65.

<sup>94</sup> See U.C.C. §§ 4-207 to -208; Overby, *supra* note 15, at 362–65. Note, however, that the losses from a forged drawer’s signature remains with the payor bank because the items were not properly payable. See U.C.C. §§ 4-208, 4-401; Overby, *supra* note 15, at 362–65.

<sup>95</sup> See U.C.C. § 3-404 (fictitious payees and imposters); *id.* § 3-405 (employer’s responsibility for fraudulent indorsement by employee); *id.* § 3-406 (negligence contributing to a forgery or alteration); *id.* § 3-417 (presentment warranties); *id.* § 4-207 (transfer warranties); *id.* § 4-208 (presentment warranties); *id.* § 4-406 (customer’s duty to discover and report unauthorized signature or alteration).

<sup>96</sup> See U.C.C. §§ 3-404 to -406, 3-417, 4-207 to -208, 4-406; Overby, *supra* note 15, at 371–72. “Substantial contribution” generally means that there is a causal connection between

fense, known as the “holder in due course” rule, is available regardless of whether the bank also acted negligently.<sup>97</sup> This makes sense because, as between the bank and the customer, the customer was in the better position to have prevented the loss.<sup>98</sup>

A second defense deals with situations in which fraud is ongoing.<sup>99</sup> If a customer receives bank statements, the customer must notify the bank of any unauthorized payments within thirty days.<sup>100</sup> If the customer fails to notify the bank, it loses its right to recover for any subsequent fraudulent items made by the same fraudster.<sup>101</sup> Here again, the bank may raise the defense regardless of its own negligence in handling the item.<sup>102</sup> Assume that Usurper began forging checks from Business X’s account in January, with the first fraudulent item appearing on the statement dated January 31.<sup>103</sup> Bookkeeper goes on vacation, leaving the unopened statement on her desk until March 13.<sup>104</sup> Usurper, meanwhile, has negotiated seven more checks, totaling \$10,000.<sup>105</sup> Although Bookkeeper notifies the bank upon opening the statements on March 13, Business X’s bank will only be liable for the first check; the rest are subject to the ongoing fraud defense.<sup>106</sup> This rule makes sense

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the customer’s negligence and the forgery or alteration. *See Overby, supra* note 15, at 371–72. This causation standard “is meant to be less stringent than a direct and proximate cause test.” *See* U.C.C. § 3-406 cmt. 2.

<sup>97</sup> *See* U.C.C. § 3-406; *Overby, supra* note 15, at 371–72. This is a change from the pre-1990 version of Article 3, which required the bank to have acted in accordance with reasonable commercial standards in order to raise this defense. *See Overby, supra* note 15, at 371–72.

<sup>98</sup> *See Overby, supra* note 15, at 359.

<sup>99</sup> *See* U.C.C. § 4-406 (2002).

<sup>100</sup> *See id.* The customer has a duty to report any items bearing forged drawer signatures within thirty days of the receipt of the statement on which they appear. *See id.* If the fraud is continuous, the customer is precluded from asserting the forgery for all but the items passed within the thirty days after the receipt of the statement revealing the first fraudulent item. *See id.* Regardless of whether the forgery is ongoing or an isolated event, the customer has one year from the date of the statement showing the forged item in which to report the loss to the bank. *See id.*

<sup>101</sup> *See id.* This is true so long as the bank paid the item or items in good faith. *See id.* In addition, the bank must prove that it suffered a loss because of the customer’s failure to notify it in situations where the signature on the item was unauthorized or there was an alteration on the item. *See id.*; *Overby, supra* note 15, at 373. Because many fraud schemes involve ongoing fraud, this is a particularly potent defense. *See Overby, supra* note 15, at 372–74.

<sup>102</sup> *See Overby, supra* note 15, at 372–74.

<sup>103</sup> *See generally* U.C.C. § 4-406 (providing a defense to banks for ongoing fraudulent transactions).

<sup>104</sup> *See id.*

<sup>105</sup> *See* U.C.C. § 4-406 (2002).

<sup>106</sup> *See id.*

as a policy matter because the customer could easily have avoided the subsequent losses by simply reviewing the bank statement and alerting the bank to the fraud.<sup>107</sup>

Third, the bank may assert a statute of limitations defense if the customer does not discover and report an unauthorized signature or alteration within one year of its appearance on a bank statement.<sup>108</sup> Assume that Usurper forges Bookkeeper's signature on a check drawn from Business X's account in January, but instead of opening the bank statements sent to Business X, Bookkeeper merely puts them in a desk drawer for the auditors.<sup>109</sup> When the audit team arrives the following March and discovers the fraud, Business X's bank has a complete defense from liability because Business X waited more than a year to report the fraud.<sup>110</sup>

Fourth, the Code places liability on the customer instead of the bank where the customer was duped into making payments to a fictitious payee or to an imposter.<sup>111</sup> In the fictitious payee scenario, a customer is tricked into writing a check to satisfy a debt that is not actually owed.<sup>112</sup> For instance, Usurper may send an invoice to Business X's accounts payable department requesting payment for grounds keeping services ostensibly performed for Business X during Landscaper's summer vacation.<sup>113</sup> Bookkeeper sends a check to Usurper, who indorses

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<sup>107</sup> See Overby, *supra* note 15, at 359.

<sup>108</sup> See U.C.C. § 4-406; Overby, *supra* note 15, at 373.

<sup>109</sup> See generally *Cagle's, Inc. v. Valley Nat'l Bank*, 153 F. Supp. 2d 1288, 1298 (M.D. Ala. 2001) (discussing the impact of common law negligence claims on the Code's statute of limitation defense); *Johnson Dev. Co. v. First Nat'l Bank of St. Louis*, 999 S.W.2d 314, 318–19 (Mo. Ct. App. 1999) (discussing one circumstance under which a common law negligence claim would not impede the Code's statute of limitations defense); U.C.C. § 4-406 (providing a statute of limitations defense to banks on claims resulting from fraudulent transfers).

<sup>110</sup> See generally U.C.C. § 4-406. Of course, if the audit occurred in July, and Business X notified the Bank in August, the statute of limitations would not shield the bank from liability. See *id.* Importantly, there is no statute of limitations imposed for fraudulent indorsements of a payment to a third party. See *id.*; Overby, *supra* note 15, at 374. Assume now that Usurper stole a check that Business X had written to Landscaper and had forged Landscaper's indorsement before cashing the check. See U.C.C. § 4-406. There would be no statute of limitations to preclude Business X from asserting that the item was fraudulent because the forgery was made to the payee's indorsement, not the drawer's signature. See *id.*

<sup>111</sup> See *Peters Family Farm*, 2011 WL 497467, at \*1 (illustrating the typical fictitious payee scheme where the accountant had been appropriating checks that were signed by the company president to pay non-existent tax liabilities); U.C.C. § 3-404 (2002); Overby, *supra* note 15, at 374–75.

<sup>112</sup> See Overby, *supra* note 15, at 374–75 (describing this type of fraud). See generally U.C.C. § 3-404 (providing rules for fictitious payee scenarios).

<sup>113</sup> See generally U.C.C. § 3-404.

the check and cashes it at Business X's bank.<sup>114</sup> In the imposter scenario, the customer would have written a check to make a legitimate payment, but delivered it to someone who was not actually the intended recipient's agent.<sup>115</sup> For another example, Usurper may place a call to Business X's accounts payable department posing as Landscaper's new accountant and requesting that payment for Landscaper's services be forwarded to a new address.<sup>116</sup> When Bookkeeper complies with this request, Usurper forges Landscaper's indorsement and cashes the check for his own benefit at Business X's bank.<sup>117</sup> In both scenarios, the forged indorsement is deemed effective so long as the bank pays the item in good faith.<sup>118</sup> Thus, the customer bears the loss because the customer is tasked with verifying its obligations and the status of any representatives with whom it works.<sup>119</sup>

Finally, the bank has a complete defense in situations where a fraudulent signature or indorsement is made by an employee entrusted with responsibility for instruments.<sup>120</sup> Responsibility for instruments arises when an employee has authority to: sign or indorse instruments on behalf of the employer-customer; process instruments received by the employer for bookkeeping purposes, such as bringing deposits to the bank or making bookkeeping entries, or otherwise disposing of the instruments; or prepare payments in the employer-customer's name.<sup>121</sup> For instance, Bookkeeper hires Usurper as an accounts payable officer at Business X.<sup>122</sup> Usurper prepares a check for \$150,000 payable to his

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<sup>114</sup> See *id.*

<sup>115</sup> See Overby, *supra* note 15, at 374–75 (describing this type of fraud). See generally U.C.C. § 3-404 (providing rules for imposter scenarios).

<sup>116</sup> See generally U.C.C. § 3-404 (providing rules for imposter scenarios).

<sup>117</sup> See U.C.C. § 3-404 (2002).

<sup>118</sup> See *id.*

<sup>119</sup> See Overby, *supra* note 15, at 375.

<sup>120</sup> See *Cagle's*, 153 F. Supp. 2d at 1298 (holding a company liable for losses incurred when an accounts payable employee wrote large checks from the company account payable to herself and deposited them in her personal bank account); *C-Wood Lumber*, 233 S.W.3d at 281–82 (holding a lumber mill liable for losses where an employee-treasurer embezzled funds); U.C.C. § 3-405; Overby, *supra* note 15, at 375.

<sup>121</sup> See *Cagle's*, 153 F. Supp. 2d at 1298; *Sebastian*, 61 F. Supp. 2d at 391 (involving fraud committed by former company president); *C-Wood Lumber*, 233 S.W.3d at 281–82; U.C.C. § 3-405. Note that the employee may still have responsibility for instruments if the employee is authorized to “act otherwise with respect to instruments in a responsible capacity.” See U.C.C. § 3-405. This does not include simple access to instruments or responsibility for storing or transporting incoming or outgoing mail, or other similar responsibilities. See *id.*

<sup>122</sup> See generally U.C.C. § 3-405 (providing the bank with a complete defense in situations where a fraudulent signature or indorsement is made by an employee entrusted with responsibility for instruments).



own side business, Business Y, and includes a fraudulent invoice to back up the payment.<sup>123</sup> After Bookkeeper signs the check, Usurper indorses it over to himself and cashes it at Business X's bank.<sup>124</sup> Although a reasonable person might think it highly unlikely that a business would sign a large check over to an individual, Business X will still take the loss because an employer is in the best position to avoid this type of loss through employee supervision and oversight.<sup>125</sup>

In sum, the Code begins with the premise that the bank takes the loss for fraudulent or altered items, and then provides a series of defenses for the bank to use to recover part or all of the loss.<sup>126</sup> This recovery can come from other banks in the form of presentment or transfer warranties.<sup>127</sup> In addition, Banks may recover from customers by exercising defenses for comparative negligence, the holder in due course provision, failure to review bank statements, statute of limitations, fictitious payee liability, or the employer negligence provision.<sup>128</sup>

### B. *The Intersection of Articles 3 and 4 and Common Law Negligence*

Commentators level significant criticism at the loss allocation provisions in Articles 3 and 4.<sup>129</sup> This criticism stems in large part from the fact that the revised loss allocation system shifted certain losses from the banking system to the customers who use it, regardless of whether

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<sup>123</sup> See U.C.C. § 3-405 (2002).

<sup>124</sup> See *id.*

<sup>125</sup> See *id.*; Overby, *supra* note 15, at 375–76. Employee supervision and oversight is a more effective method of preventing losses from this type of fraud than requiring banks to make an inquiry of Usurper at presentment or of Business X before payment to Usurper. See Overby, *supra* note 15, at 372.

<sup>126</sup> See U.C.C. § 3-404 (imposters and fictitious payees); *id.* § 3-405 (employer's responsibility for fraudulent indorsement by employee); *id.* § 4-401 (when banks may charge customer accounts); *id.* § 4-406 (customer's duty to discover and report unauthorized signature or alteration).

<sup>127</sup> See U.C.C. § 3-416 (transfer warranties); *id.* § 3-417 (presentment warranties); *id.* § 4-207 (transfer warranties); *id.* § 4-208 (presentment warranties).

<sup>128</sup> See U.C.C. §§ 3-404 to -405, 4-406; *id.* § 3-406 (negligence contributing to a forged signature or alteration of instrument).

<sup>129</sup> See, e.g., Frederick K. Beutel, *The Proposed Uniform Commercial Code Should Not Be Adopted*, 61 YALE L. J. 334, 335 (1952) (describing Article 4 as "an unfair piece of class legislation . . . [that] will probably be declared unconstitutional in many states"); Gail K. Hillebrand, *Revised Articles 3 and 4 of the Uniform Commercial Code: A Consumer Perspective*, 42 ALA. L. REV. 679, 697–98 (1991); Hull, *supra* note 15, at 610–11; Overby, *supra* note 15, at 352 (citing Juliana J. Zekan, *Comparative Negligence Under the Code: Protecting Negligent Banks Against Negligent Customers*, 26 U. MICH. J.L. REFORM 125, 166–76 (1992)).

the rules, as applied, result in arguably unfair outcomes.<sup>130</sup> After the revisions, banks have no duty to inspect items received for deposit, despite prior case law in certain jurisdictions that held otherwise and often allowed customers to recover losses from the banks.<sup>131</sup>

Additionally, ordinary care is the post-revision standard with which banks must comply when processing checks, but it requires only that banks “[observe] reasonable commercial standards prevailing in the area in which the [bank] is located, with respect to [the banking industry generally],” leading one commentator to summarize the rule as requiring banks to simply do “whatever anyone else is doing.”<sup>132</sup> This is viewed as problematic because banks are free to lower the level of security provided in the check processing system without bearing additional liability for fraudulent checks.<sup>133</sup>

Comparing the Article 3 and 4 loss allocation scheme with the allocation scheme for electronic payments under federal laws and regulations and the Code’s Article 4A further enhances the perception of Articles 3 and 4’s allocation provisions as inequitable.<sup>134</sup> Federal

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<sup>130</sup> See, e.g., *Bradley v. First Nat’l Bank of Walker*, 711 N.W.2d 121, 127 (Minn. Ct. App. 2006) (placing the risk of loss on a customer even where the bank allowed a non-signer to initiate transactions from the customer’s account); *Valley Bank*, 147 P.3d at 192 (noting that a customer bore the obligation to repay the bank for chargeback under section 4-214, notwithstanding the customer’s reliance on information from bank personnel when initiating the underlying transaction); Overby, *supra* note 15, at 388. The banking industry is still absorbing substantial fraud losses, however, because not all check fraud situations involve provable negligence or trigger any of the defenses available to banks. Overby, *supra* note 15, at 387–88; see Hillebrand, *supra* note 129, at 697–98. For a comprehensive discussion of the policies and issues considered during the revision process of Articles 3 and 4, see generally Edward L. Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the U.C.C.*, 43 BUS. LAW. 621 (1988). For a more complete and nuanced summary of the changes to Articles 3 and 4 during the 1990 revisions, see generally Alvin C. Harrell & Fred H. Miller, *The New U.C.C. Articles 3 and 4: Impact on Banking Operations*, 47 CONSUMER FIN. L.Q. REP. 283 (1993).

<sup>131</sup> See U.C.C. § 3-103(a)(9) (2002) (defining ordinary care and noting that reasonable commercial standards do not require sight review unless bank policies require sight review); Overby, *supra* note 15, at 379; see also *Medford Irrigation Dist. v. W. Bank*, 676 P.2d 329, 332–33 (Or. Ct. App. 1984) (holding that the absence of any review for items under \$5000 did not meet the bank’s duty to exercise ordinary care).

<sup>132</sup> See U.C.C. § 3-103(a)(9); Overby, *supra* note 15, at 379–80.

<sup>133</sup> See Overby, *supra* note 15, at 353, 380. For a discussion of the conflict between freedom of contract and the finality doctrine under Articles 3 and 4, see generally Michael Coutu, Note, *Check Fraud and the Variation of Section 4-401: Why Banks Should Not Be Able to Vary the U.C.C.’s Standard Risk Allocation Scheme*, 54 B.C. L. REV. 275 (2013).

<sup>134</sup> See Fair Credit Billing Act, 15 U.S.C. § 1666 (2012) (providing caps on consumer liability for credit card fraud); Electronic Fund Transfer Act, 15 U.S.C. § 1693 (2012) (providing caps on consumer liability for debit card fraud); Regulation CC, 12 C.F.R. § 229.12 (2013) (providing funds availability timetables for deposited checks); U.C.C. § 4A-102 (specifically foreclosing resort to outside areas of law in electronic payments).

consumer debit and credit card fraud loss allocation rules are particularly customer friendly.<sup>135</sup> If a fraudster uses a customer's card number to initiate fraudulent transactions but the customer did not lose the debit or credit card, the customer's liability for those losses is capped at \$50, provided that the customer reports the loss within sixty days of the statement showing the transactions.<sup>136</sup> If the fraud occurred because the customer lost the debit or credit card, a consumer's liability ranges between \$0 and \$500, again provided that the customer notifies the bank of the fraud within sixty days of the statement showing the transactions.<sup>137</sup> Like the Articles 3 and 4 scheme, these approaches maintain the customer's duty to review account statements.<sup>138</sup> Unlike Articles 3 and 4, however, the loss allocation scheme for debit and credit card-based fraud places a cap on liability when the customer notifies the bank of the theft.<sup>139</sup>

The Code's loss allocation for fraudulent electronic transfers is likewise more balanced.<sup>140</sup> Article 4A covers electronic funds transfers by wire, ACH, and credit or debit cards.<sup>141</sup> Article 4A provides that the

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<sup>135</sup> See 15 U.S.C. §§ 1666, 1693.

<sup>136</sup> See 15 U.S.C. §§ 1666, 1693; *Lost or Stolen Credit, Debit, and ATM Cards*, FED. TRADE COMM'N, <http://www.consumer.ftc.gov/articles/0213-lost-or-stolen-credit-atm-and-debit-cards> (last visited Oct. 20, 2013).

<sup>137</sup> See 15 U.S.C. §§ 1666, 1693; *Lost or Stolen Credit, Debit, and ATM Cards*, *supra* note 136.

<sup>138</sup> Compare 15 U.S.C. §§ 1666, 1693 (imposing a duty on customers to report frauds within sixty days of loss), with U.C.C. § 4-406 (2002) (imposing a duty on customers to review statements). The customer's liability for fraud losses increases from \$0 for notification before any fraudulent transactions are posted to a maximum of \$500 if the customer notifies the bank within 60 days of the statement date. See 15 U.S.C. §§ 1666, 1693.

<sup>139</sup> See 15 U.S.C. §§ 1666, 1693. This is a markedly different result than the likely results under the Code. See *Valley Bank*, 147 P.3d at 189-92 (describing how one defrauded person was forced to cash in his pension account and take out a second mortgage to satisfy a debt owed to his bank from the operation of a chargeback provision); U.C.C. § 4-214 (2002) (bank's right of chargeback).

<sup>140</sup> See U.C.C. § 4A-202; *infra* notes 141-144 and accompanying text (illustrating this proposition).

<sup>141</sup> See U.C.C. § 4A-102. The Federal Reserve processes checks, ACH, and wires. See Mucklestone, *supra* note 42, at 43-45. The national wire transfer system, known as Fedwire, is ideal for businesses or consumers making large or time-sensitive, one-time electronic payments through the Federal Reserve. See *id.* The "automated clearinghouse system," or ACH, is another popular electronic payment system commonly used by consumers and businesses alike for recurring expenses, such as payroll, taxes, utility payments, credit card payments, and the like. See *id.* at 44. The Federal Reserve processed approximately 11.45 billion items totaling \$21.37 trillion via ACH in 2010. See 2010 Annual Report, *supra* note 33, at tbl.12. Credit and debit cards are two types of popular payment methods, especially for point-of-sale or online transactions. See *Debit Card Interchange Fees and Routing*, 75 Fed. Reg. 81,725, 81,725-26 (Dec. 28, 2010); Mucklestone, *supra* note 42, at 44.

bank will take the loss for fraudulent electronic payments unless the parties have agreed upon the use of a commercially reasonable security procedure to authenticate the customer's payment orders, and the bank proves that it complied with the security procedure and any other written agreement or customer instructions in accepting the payment order and that it acted in good faith.<sup>142</sup>

Commercial reasonableness requires that the security procedure reflect the wishes of the customer expressed to the bank; the circumstances of the customer known to the bank, including the size, type, and frequency of payment orders normally issued by the customer to the bank; alternative security procedures offered to but declined by the customer; and security procedures in general use by customers and banks similarly situated.<sup>143</sup> Because it has an objective, industry-wide element and a subjective, customer-specific element, this standard is much stricter than the "what everyone else is doing" standard that defines ordinary care for check fraud liability purposes.<sup>144</sup>

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<sup>142</sup> See U.C.C. § 4A-201 to -202. At least one court has held that banks cannot reach their defenses in the Code's electronic funds transfer loss allocation provisions unless they use commercially reasonable security procedures to verify online payments. See *Patco Constr. Co. v. People's United Bank*, 684 F.3d 197, 209 (1st Cir. 2012). For a discussion of commercial reasonableness under Article 4A, see generally Melissa Waite, Comment, *In Search of the Right Balance: Patco Lays the Foundation for Analyzing the Commercial Reasonableness of Security Procedures under U.C.C. Article 4A*, 54 B.C. L. REV. E. SUPP. 217 (2013), <http://lawdigitalcommons.bc.edu/bclr/vol54/iss6/17/>. Interestingly, the U.S. Court of Appeals for the Fifth Circuit in *Patco* considered whether the Code displaced a common law negligence claim. See 684 F.3d at 216. The court held that it did, on the facts presented, because the Code defined both the standard for the duty of care and its limitation on liability. See *id.*

<sup>143</sup> See U.C.C. § 4A-202. Most banks follow the Federal Financial Institution Examination Council's recommendations for online payment security. See FED. FIN. INSTS. EXAMINATION COUNCIL, AUTHENTICATION IN AN INTERNET BANKING ENVIRONMENT 2-3 (2005), [http://www.ffiec.gov/pdf/authentication\\_guidance.pdf](http://www.ffiec.gov/pdf/authentication_guidance.pdf). These guidelines recommend that security procedures include something that a user knows, something that a user is, and something that a user has. See *id.* A password and an ATM PIN are common examples of something that a user knows which will verify his or her identity. See *id.* An ATM card and a security token are common examples of something that a user has to verify his or her identity. See *id.* A security token is a small device, often attached to a keychain, that displays a code that the user must input into the online payment system to verify a transaction. See *id.* The code changes at set intervals, usually one minute. See *id.* These items are combined with something unique to the user, such as the user's IP address, fingerprint, or voice. See *id.* Successfully initiating a fraudulent transaction in a system that incorporates all of these features is much more difficult than cashing a fraudulent paper check with a forged signature on it, especially now that checks are processed electronically. See *id.*

<sup>144</sup> See U.C.C. § 4A-202; Overby, *supra* note 15, at 380. It bears mentioning that if the bank proves that its security procedures were commercially reasonable, the customer will take the loss unless the customer can prove that the perpetrator was not someone entrusted with duties to act for the customer relating to payment orders or the security pro-

## II. COURTS TAKE DIFFERENT APPROACHES TO COMMON LAW NEGLIGENCE

This Part begins by discussing the uncertain status of common law negligence claims under the Uniform Commercial Code.<sup>145</sup> It then discusses the various interpretive approaches that courts use to determine whether negligence claims should be preempted by the Code's provisions.<sup>146</sup>

### A. Common Law Negligence Under the Code

Customers who are victims of fraudulent transactions often pursue common law causes of action to avoid the statute of limitations, the customer's duty to review statements, or the bank's right of chargeback as provided by the Code.<sup>147</sup> Because these plaintiffs are often sympathetic, there is a strong temptation for courts to allow these claims when viewed in the context of Articles 3 and 4's history and pro-bank image.<sup>148</sup>

But the Code is not clear as to whether and under what contexts common law claims should be allowed in check fraud scenarios because Articles 3 and 4 have no explicit preemption provision.<sup>149</sup> Some view section 3-406 as explicitly displacing common law negligence actions because it requires an analysis substantially similar to that of common law comparative negligence.<sup>150</sup> In this view, a common law action that

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cedure, and that he or she did not obtain access to transmitting facilities of the customer or information facilitating a breach of the security procedure from a source controlled by the customer. See U.C.C. § 4A-202. This means that, like in check fraud liability, unavoidable losses in the payment system are borne by the banks, but avoidable losses (like employee embezzlement or weak Internet security at a customer's office that allows hackers to access the banking system) will be borne by the party best able to have prevented the loss. See *id.*; Overby, *supra* note 15, at 380; Rogers, *supra* note 41, at 466.

<sup>145</sup> See *infra* notes 147–175 and accompanying text.

<sup>146</sup> See *infra* notes 176–220 and accompanying text.

<sup>147</sup> See U.C.C. § 4-406 (2002) (customer's duty to check statements); *id.* § 4-111 (statute of limitations); *id.* § 4-214 (right of chargeback); Overby, *supra* note 15, at 390.

<sup>148</sup> See, e.g., Valley Bank of Ronan v. Hughes, 147 P.3d 185, 192 (Mont. 2006) (describing how one defrauded person was forced to cash in his pension account and take out a second mortgage to satisfy a debt owed to his bank from the operation of a chargeback provision); Overby, *supra* note 15, at 383 (noting that elderly and infirm banking customers are prime victims for check fraud).

<sup>149</sup> Compare U.C.C. § 1-103(b) (providing a general back door for the admittance of common law claims), and Overby, *supra* note 15, at 391 (observing that “[a]rticles 3 and 4 contain no express ‘displacement’ provision”), with U.C.C. § 4A-102 cmt. (providing that, unless explicitly incorporated, common law claims should not be allowed under Article 4A).

<sup>150</sup> See U.C.C. § 3-406 (precluding individuals whose failure to exercise ordinary care substantially contributes to an alteration or forgery from asserting the fraud against a per-

imposes losses on the drawer would be displaced by the statutory language in section 3-406 because it 3-406 creates a preemption, rather than an independent cause of action.<sup>151</sup> Nevertheless, section 3-406 does not explicitly displace common law negligence actions.<sup>152</sup>

Without an explicit displacement provision, common law negligence actions are often analyzed under the Code's general preemption provision in section 1-103.<sup>153</sup> Section 1-103(b) provides that "[u]nless displaced by the particular provisions of the Uniform Commercial Code, the principles of law and equity . . . supplement its provisions."<sup>154</sup> The official comments caution that:

The text of each section should be read in the light of the purposes and policy of the rule or principle in question, as also of the Uniform Commercial Code as a whole, and the application of the language should be construed narrowly or broadly . . . in conformity with the purposes and policies involved.<sup>155</sup>

Further, the official comments clarify that "while principles of common law and equity may supplement provisions of the Uniform Commercial Code, they may not be used to supplant its provisions, or the purposes and policies those provisions reflect."<sup>156</sup> As a general matter, then, the Code is intended to preempt any common law claim that is "inconsistent with either its provisions or its purposes and policies."<sup>157</sup>

The Code identifies its three main policy objectives in section 1-103(a).<sup>158</sup> First, the Code attempts to simplify, clarify and modernize

son who pays the instrument or takes it for value or collection in good faith to the extent that their negligence contributed to the losses, and establishing that the bank has the burden of proving that the customer failed to exercise ordinary care); ROBERT A. HILLMAN ET AL., COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE 14-51 to -54 (1985) [hereinafter HILLMAN 1985]; ROBERT A. HILLMAN ET AL., COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE: 1991 CUMULATIVE SUPPLEMENT S14-31 to -32 (1991) [hereinafter HILLMAN 1991].

<sup>151</sup> See U.C.C. § 3-406; HILLMAN 1985, *supra* note 150, at 14-51 to -54.

<sup>152</sup> See U.C.C. § 3-406; HILLMAN 1985, *supra* note 150, at 14-51 to -54.

<sup>153</sup> See U.C.C. § 1-103 (2002); *cf.* Overby, *supra* note 15, at 390-92 (describing how courts have struggled with section 1-103 analyses without meaningful guidance in Articles 3 and 4).

<sup>154</sup> U.C.C. § 1-103(b).

<sup>155</sup> *Id.* § 1-103 cmt. 1.

<sup>156</sup> *Id.* § 1-103 cmt. 2.

<sup>157</sup> *Id.*

<sup>158</sup> See *id.* § 1-103(a). Article 1's provisions apply to each of the other Code Articles. See *id.* § 1-102 ("This article applies to a transaction to the extent that it is governed by another article of the Uniform Commercial Code.").

the law governing commercial transactions.<sup>159</sup> Second, the Code seeks to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties.<sup>160</sup> Third, the Code aims to make the law uniform among the various jurisdictions in the areas it covers.<sup>161</sup> To achieve these goals, the Code advocates for liberal construction and application of its provisions wherever they apply.<sup>162</sup> The official comments also note that the Code is “the primary source of commercial law rules in the areas that it governs, and its rules represent choices made by its drafters and the enacting legislatures about the appropriate policies to be furthered in the transactions it covers.”<sup>163</sup> Other important policies specific to Articles 3 and 4 include promoting the transferability of instruments and the use of checks, placing the loss on the best risk bearer, and placing the loss on the party best able to have prevented the harm.<sup>164</sup>

Basing preemption analysis in policy is particularly difficult because check fraud scenarios often implicate competing policy objectives.<sup>165</sup> For example, disallowing common law negligence claims may promote uniformity of the law among jurisdictions by providing a reliable and predictable outcome for check fraud situations.<sup>166</sup> But allowing those common law claims supports the transferability of instruments because the transferee is protected from bearing the ultimate loss if it can recover from the drawer.<sup>167</sup> Allowing such claims also supports placing the loss with the negligent party, thereby encouraging drawers to be more vigilant in their efforts to deter fraud.<sup>168</sup>

Common law negligence claims brought by drawers against depository banks highlight the problem with conflicting policies in the

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<sup>159</sup> See U.C.C. § 1-103(a) (2002).

<sup>160</sup> See *id.*

<sup>161</sup> See *id.*

<sup>162</sup> See *id.*

<sup>163</sup> *Id.* § 1-103 cmt. 2.

<sup>164</sup> See Hull, *supra* note 15, at 614. Under this rubric, the party best able to avoid the loss under the facts of the case may not always end up taking the loss under the Code's allocation scheme. See *id.* Nor is the loss always placed on the best risk bearer, because the bank is often the best risk bearer, given its ability to spread losses through insurance and account fees. See *id.* See generally Robert D. Cooter & Edward L. Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63 (1987) (arguing that applying economic analysis to loss allocation in payment systems leads to a set of rules consistent with both consumer protection and economic efficiency).

<sup>165</sup> See HILLMAN 1985, *supra* note 150, at 14-51 to -54; HILLMAN 1991, *supra* note 150, at S14-51.

<sup>166</sup> See U.C.C. § 1-103(a) (2002) (advocating for uniformity of law).

<sup>167</sup> See HILLMAN 1985, *supra* note 150, at 14-52.

<sup>168</sup> See *id.*

common law claim preemption analysis.<sup>169</sup> For example, assume that Employee, who verifies and tracks check payment information for Business X, is forging Bookkeeper's authorizing signature on fraudulent checks in large amounts payable to Employee.<sup>170</sup> Permitting Business X to bring a negligence claim against Employee's bank could undermine the Code's provisions by shifting the risk of loss for employee embezzlement from Business X onto the depository bank and runs counter to the Code's policy of promoting uniformity and predictability across jurisdictions.<sup>171</sup> Section 3-405 would place the loss on Business X over Business X's bank (the payor bank), suggesting that the Code intends to leave the risk of loss in employee embezzlement situations on the employer.<sup>172</sup> But section 3-405 only applies to the payor bank, and the Code recognizes that all banks have a duty to exercise ordinary care in section 4-103.<sup>173</sup> Taken together, these provisions could suggest that the drawer's common law negligence claim against the depository bank might be allowed, even if the negligence claim against the payor bank is preempted.<sup>174</sup> This result would support the Code's policy of promoting the transferability of instruments.<sup>175</sup>

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<sup>169</sup> See *id.* at 14-54.

<sup>170</sup> See generally U.C.C. § 3-405 (providing for employer's liability for fraudulent indorsement or signature by an employee).

<sup>171</sup> See *id.*; HILLMAN 1985, *supra* note 150, at 14-51.

<sup>172</sup> See U.C.C. § 3-405 (2002).

<sup>173</sup> See U.C.C. §§ 3-405, 4-103. Notably, the provisions of Article 4 are meant to supersede those in Article 3 wherever they conflict. See U.C.C. § 4-102(a). Although these provisions do not directly conflict, there is some question whether the ordinary care provision imposes a duty of care on the payor bank in the employee embezzlement situation. See U.C.C. §§ 3-405, 4-102(a). For example, one official comment to Article 4 provides:

The rules of the section are applied only to collecting banks. Payor banks always have the problem of making proper payment of an item; whether such payment is proper should be based upon all of the rules of Articles 3 and 4 and all of the facts of any particular case, and should not be dependent exclusively upon instructions from or an agreement with a person presenting the item.

*Id.* § 4-203 cmt.

<sup>174</sup> See U.C.C. § 1-103 ("Unless displaced by the particular provisions of the Uniform Commercial Code, the principles of law and equity . . . supplement its provisions."); *id.* § 3-405 (placing the risk of loss on employers in cases of employee embezzlement); *id.* § 4-103 (requiring banks to exercise ordinary care); HILLMAN 1991, *supra* note 150, at §14-33. Of course, the depository bank could take advantage of the holder in due course doctrine. See U.C.C. § 3-418; *supra* notes 96-98 and accompanying text (describing this defense and indicating that it is available even where a bank acts negligently). A holder in due course is someone who took an instrument in good faith and for value or who in good faith changed position in reliance on the payment or acceptance of it. U.C.C. § 3-418(c).

<sup>175</sup> See HILLMAN 1985, *supra* note 150, at 14-52.



### B. Courts Interpret the Code in Different Ways

Absent clear guidance, courts have come to differing conclusions regarding the status of negligence claims under the Code.<sup>176</sup> Courts generally agree that common law negligence claims are displaced where allowing them would thwart the purposes of the Code.<sup>177</sup> But they articulate a variety of tests to determine whether a common law claim thwarts the purposes of the Code and often reach different results after applying them.<sup>178</sup> Generally speaking, it appears that courts allow common law negligence claims when the particular facts of the case justify reaching beyond the Code to maintain simple fairness in the results, especially when the bank is engaged in poor business practices.<sup>179</sup> This Section discusses these varying approaches and their results in check fraud cases since the 1990 amendments.<sup>180</sup>

The majority of courts use the comprehensive rights and remedies test to determine whether a common law claim has been displaced by the Code.<sup>181</sup> The courts ask whether allowing the common law claims

<sup>176</sup> Compare, e.g., *Valley Bank*, 147 P.3d at 192 (allowing a common law negligence claim by a customer against a bank), with *C-Wood Lumber Co. v. Wayne Cty. Bank*, 233 S.W.3d 263, 281–82 (Tenn. Ct. App. 2007) (rejecting a common law negligence claim by a customer against a bank).

<sup>177</sup> See, e.g., *Cagle's, Inc. v. Valley Nat'l Bank*, 153 F. Supp. 2d 1288, 1298 (D. Ala. 2001); *Sebastian v. D&S Express, Inc.*, 61 F. Supp. 2d 386, 391 (D.N.J. 1999).

<sup>178</sup> Compare, e.g., *Valley Bank*, 147 P.3d at 192 (allowing a common law negligence claim after analyzing the Code under a scope test), with *C-Wood Lumber*, 233 S.W.3d at 281–82 (rejecting a common law negligence claim after analyzing the Code under a comprehensive rights and remedies test).

<sup>179</sup> See, e.g., *Lombino v. Bank of Am.*, 797 F. Supp. 2d 1078, 1083–84 (D. Nev. 2011) (allowing a negligence claim where a customer relied on bank employee's representations of the check collection process); *Old Republic Nat'l Title Ins. Co. v. Bank of E. Asia Ltd.*, 291 F. Supp. 2d 60, 69 (D. Conn. 2003) (allowing a negligence claim where a bank opened an account based on power of attorney without meeting the actual client); *Valley Bank*, 147 P.3d at 191–92 (same).

<sup>180</sup> See *infra* notes 181–220 and accompanying text.

<sup>181</sup> See, e.g., *Adams v. Martinsville DuPont Credit Union*, 573 F. Supp. 2d 103, 113 (D.D.C. 2008) (“In instances where both [the Code and common law] provide a means of recovery, it has been generally held that the U.C.C. displaces the common law to ensure uniformity . . . .”); *AmSouth Bank v. Tice*, 923 So. 2d 1060, 1066 (Ala. 2005) (“[T]hose common-law claims are displaced or preempted if allowing the common-law claim would create ‘rights, duties, and liabilities inconsistent’ with those set forth in [the Code].”) (internal citation omitted); *Advance Dental Care, Inc. v. SunTrust Bank*, 816 F. Supp. 2d 268, 270–71 (D. Md. 2011) (“[C]ommon law negligence claims can proceed only in the absence of an adequate U.C.C. remedy . . . .”); *Suffolk Credit Union v. Fed. Nat'l Mortg. Ass'n*, No. 10-2763, 2011 WL 830262, at \*5 (D.N.J. March 7, 2011) (“[P]arallel Code and common law claims may be maintained except in circumstances where (1) the Code provides a comprehensive remedial scheme and (2) reliance on the common law would undermine the purposes of the Code.”). Minnesota, Colorado, Tennessee, Georgia, and Ohio have also

would “create rights, duties, and liabilities inconsistent with those set forth in the [provisions of the UCC].”<sup>182</sup> For instance, in 1999 in *Sebastian v. D&S Express*, the U.S. District Court for the District of New Jersey considered a common law negligence action based on the company’s former president making checks payable to fictitious payees and then cashing them with the same teller at the defendant bank over the course of four years.<sup>183</sup> Although the plaintiff argued that the bank should have been aware of the fraud because of its duration and the fact that the same teller cashed the checks every time, the court held that the common law negligence claim was preempted because the UCC provision at issue, section 3-404, applied a standard very similar to the common law negligence standard.<sup>184</sup> Section 3-404 essentially codifies comparative negligence, because it provides that when a bank taking a check for value or collection fails to exercise ordinary care in paying or taking the check and the failure substantially contributes to the loss resulting from paying the check, the person bearing the loss may recover from the bank to the extent the failure to exercise ordinary care contributed to the loss.<sup>185</sup> This duplication led the court to conclude that the Code covered the entire field of available legal theories.<sup>186</sup> Thus, the common law claim was preempted because the Code provided a comprehensive remedy.<sup>187</sup>

Nevertheless, in applying the comprehensive rights and remedies test, at least one jurisdiction has recognized a carve-out for situations in which a special relationship existed between the parties.<sup>188</sup> For exam-

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used this approach. See *Promissor, Inc. v. Branch Bank & Trust Co.*, No. 108-CV-1704-BBM, 2008 WL 5549451, at \*2 (D. Ga. Oct. 31, 2008); *Shelby Res., LLC v. Wells Fargo Bank*, 160 P.3d 387, 391–92 (Colo. App. 2007); *Bradley v. First Nat’l Bank of Webster*, 711 N.W.2d 121, 127 (Minn. Ct. App. 2006); *Peters Family Farm v. The Sav. Bank*, No. 10CA2, 2011 WL 497476, at \*4 (Ohio Ct. App. Jan. 28, 2011); *C-Wood Lumber*, 233 S.W.3d at 281–82. *But see Metz v. Unizan Bank*, 416 F. Supp. 2d 568, 581 (D. Ohio 2006) (applying a statutory interpretation analysis); *Notredan, LLC v. Old Republic Exch. Facilitator Co.*, 875 F. Supp. 2d 780, 788 (W.D. Tenn. 2012) (applying a scope analysis); *Chi. Title Ins. Co. v. Allfirst Bank*, 905 A.2d 366, 377 (Md. 2005) (same).

<sup>182</sup> See *Braden Furniture Co., Inc. v. Union State Bank*, 109 So. 3d 625, 630 (Ala. 2012); *supra* note 181 (collecting cases).

<sup>183</sup> See 61 F. Supp. 2d at 387.

<sup>184</sup> See *id.* at 391.

<sup>185</sup> See *id.*; U.C.C. § 3-404 (2002).

<sup>186</sup> See *Sebastian*, 61 F. Supp. 2d at 391.

<sup>187</sup> See *id.*

<sup>188</sup> See, e.g., *In re Clear Advantage Title*, 438 B.R. 58, 65 (Bankr. D.N.J. 2010) (“Courts have recognized tort liability of a financial institution where a special relationship has been established, such as fiduciary, *confidential*, contractual, or legal or where there was fraud or misrepresentation on the part of the defendant bank.”) (emphasis added); *City Check*

ple, in 2010, the U.S. Bankruptcy Court for the District of New Jersey adopted this approach in *In re Clear Advantage Title*.<sup>189</sup> A staff attorney and title examiner at Clear Advantage Title was creating payments for fictitious loans with the defendant bank, then indorsing checks on behalf of the company and asking for treasurer's checks in the same amount payable to personal creditors such as his children's private school and a jeweler.<sup>190</sup> Typically, the bank would not have been liable for the loss under the Code because the staff attorney was an employee with responsibility for checks.<sup>191</sup> Importantly, though, the deposit agreement between Clear Advantage and the bank established that only account signers would be able to make withdrawals, including through checks, from the account.<sup>192</sup> And though the staff attorney was not an account signer, the bank allowed him to obtain over \$425,000 from the scheme.<sup>193</sup> As a result, the court held that the deposit agreement reflected the type of contractual relationship that created a duty which existed independent of the Code and required the bank to inquire of the employee before allowing him to withdraw funds from the corporate account.<sup>194</sup>

Other courts use a scope test to determine whether the common law is preempted.<sup>195</sup> This test asks whether the Code governs the factual circumstances underlying the dispute.<sup>196</sup> The results depend on how broadly or narrowly the courts define the boundaries of the factual circumstances.<sup>197</sup> For instance, in 2006, in *Valley Bank of Ronan v.*

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*Cashing v. Mfrs. Hanover Trust Co.*, 764 A.2d 411, 416–17 (N.J. 1999) (“Absent a special relationship, courts will typically bar claims of noncustomers against banks.”).

<sup>189</sup> See *In re Clear Advantage Title*, 438 B.R. at 65.

<sup>190</sup> See *id.* at 62.

<sup>191</sup> See *id.* at 65; U.C.C. § 3-405 (2011).

<sup>192</sup> See *In re Clear Advantage Title*, 438 B.R. at 62.

<sup>193</sup> See *id.*

<sup>194</sup> See *id.* at 65; see also *City Check Cashing*, 764 A.2d at 418 (noting that absent a “special relationship between the parties created by agreement, undertaking or contract, that gives rise to a duty, the sole remedies available are those provided in the Code”).

<sup>195</sup> See *Notredan*, 875 F. Supp. 2d at 788; *Lombino*, 797 F. Supp. 2d at 1083–84; Edward Orecchio, M.D., PLLC v. Conn. River Bank, No. 1:08-CV-164, 2009 WL 2160583, at \*3 (D. Vt. July 14, 2009); *Allfirst Bank*, 905 A.2d at 377; *Valley Bank*, 147 P.3d at 191.

<sup>196</sup> See *Valley Bank*, 147 P.3d at 191 (“Because [the fact situation presented is] not addressed with specificity by the UCC, common law and equitable principles supplement the UCC and govern the legal rights and responsibilities that apply . . .”).

<sup>197</sup> Compare, e.g., *Lombino*, 797 F. Supp. 2d at 1084 (allowing a negligence claim where the conduct underlying the claim was the defendant’s “duty to tell [the plaintiff] the truth” about the collections process because the fact pattern fell outside the scope of the Code), with *Notredan*, 875 F. Supp. 2d at 788 (rejecting a negligence claim where the bank honored a check payable to the plaintiff without its indorsement because the fact pattern fell within the scope of the Code).

*Hughes*, the Montana Supreme Court used a narrow interpretation of the facts to show that the claim arose outside the bounds of the Code.<sup>198</sup> A customer brought a fraudulent bank check to his bank for deposit and inquired as to how long it would take for the funds to be collected.<sup>199</sup> A bank officer replied that the bank check was the “same as cash” and he could therefore use the funds however he wished at any time.<sup>200</sup> He initiated a payment out of the account using those funds, and the check was subsequently returned as fraudulent.<sup>201</sup> The customer brought a negligence claim against the bank based on the bank officer’s representations about the check.<sup>202</sup> The court held that the negligence claim was not preempted by the Code, reasoning that the plaintiff’s claims encompassed both the check’s processing and the bank’s communication to him about that process.<sup>203</sup> Because communications between the bank and its customer are not specifically addressed by the UCC, common law governed the legal rights and responsibilities that applied to the bank’s representations to the plaintiff, upon which he relied to his detriment.<sup>204</sup>

In contrast, in 2012 in *Notredan, LLC v. Old Republic Exchange Facilitator Co.*, the U.S. District Court for the Western District of Tennessee used the scope test broadly to invalidate a common law negligence claim.<sup>205</sup> There, the plaintiff had hired Old Republic to assist with a real estate transaction.<sup>206</sup> Old Republic received a check payable to the plaintiff but not indorsed.<sup>207</sup> Undaunted, the Old Republic employee deposited the check into a trust account, taking a portion of the money out as a fee.<sup>208</sup> Notredan brought a negligence action against Old Republic’s bank for breaching its duty by allowing deposit of an unindorsed item.<sup>209</sup> The court held that the negligence claim was preempted by the Code because it “embod[ies] a delicately balanced statutory scheme governing the endorsement, negotiation, collection, and payment of checks.”<sup>210</sup> Because this dispute dealt with the in-

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<sup>198</sup> See 147 P.3d at 191.

<sup>199</sup> See *id.* at 188–89.

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* at 191.

<sup>203</sup> See *Valley Bank*, 147 P.3d at 191.

<sup>204</sup> See *id.*

<sup>205</sup> See 875 F. Supp. 2d at 788.

<sup>206</sup> See *id.* at 783.

<sup>207</sup> See *id.*

<sup>208</sup> See *id.*

<sup>209</sup> See *id.*

<sup>210</sup> See *id.* at 788 (quoting *C-Wood Lumber*, 233 S.W.3d at 281).

dorsement and payment of checks, the Code provided all available loss allocation rules.<sup>211</sup>

Courts have also created conflicting case law based on the Code's statutory language.<sup>212</sup> Connecticut courts assume that if the state legislature had intended for the Code to preempt common law claims, it would have made that explicit in the statutory language.<sup>213</sup> In contrast, the U.S. District Court for the District of Ohio has held that common law claims were preempted because statutory provisions such as those in the Code should govern to the exclusion of prior, non-statutory law, unless there is a clear legislative intention that the statutory provisions are merely cumulative.<sup>214</sup>

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<sup>211</sup> See *Notredan*, 875 F. Supp. 2d at 788.

<sup>212</sup> Compare, e.g., *Old Republic*, 291 F. Supp. 2d at 69 (holding that a common law negligence action was allowed under the Code because "[t]he Code provides that principles of law and equity shall supplement its provisions unless there is a particular provision of the Code that displaces the common law"), with *Metz*, 416 F. Supp. 2d at 581–82 (holding that a common law negligence action was not allowed under the Code because "Articles 3 and 4 of the UCC establish the standard of care applicable to a bank's handling of a negotiable instrument, thus displacing common law negligence").

<sup>213</sup> See, e.g., *Old Republic*, 291 F. Supp. 2d at 69 (observing that "[t]he Code provides that principles of law and equity shall supplement its provisions unless there is a particular provision of the Code that displaces the common law," and remarking that "[t]he court has discovered no particular provision of the Code that would displace a remitter's common law claim . . . of negligence against a depository bank"); *Van Der Werff v. Shawmut Bank Conn.*, No. CV 950554654, 1996 WL 686916, at \*3 (Conn. Super. Ct. Nov. 20, 1996) ("[I]n the absence of explicit statutory language . . . that [1-103] displaces common law claims for negligence, the Court concludes that the plaintiff is free to bring both a common law claim for negligence and a claim under [the Code]."); see also *Lester Constr., LLC v. People's United Bank*, No. CV095024042S, 2009 WL 5698131, at \*6 (Conn. Super. Ct. Dec. 18, 2009) (applying the same test as the Connecticut Superior Court in 1996 applied in *Van Der Werff*); *Roger Kaye, M.D., P.C. v. T.D. Banknorth*, No. FSTCV085007268S, 2009 WL 1532513, at \*2 (Conn. Super. Ct. May 6, 2009) (holding that no specific provision preempted the plaintiff from bringing a common law negligence claim); *Leaksealers, Inc. v. Conn. Nat'l Bank*, No. CV 92 0517952, 1995 WL 384611, at \*4–5 (Conn. Super. Ct. June 20, 1995) (noting that "the intent of the legislature is to be found . . . in what it did say," that the Code "does not state that it precludes common law claims based on factual situations within it," and that "[t]herefore, the plaintiff is not precluded from bringing a common law cause of action for negligence against the defendant" (internal citations omitted)). It is worth noting that neither the Connecticut Supreme Court nor Appellate Court has appeared to have ruled on the role of section 1-103(b) on common law negligence in check fraud. See *Roger Kaye*, 2009 WL 1532513, at \*2 (noting the absence of a definitive indication from the Connecticut Supreme Court or Appellate Court on the issue of common law claims in check fraud).

<sup>214</sup> See *Metz*, 416 F. Supp. 2d at 581. The Missouri Court of Appeals took a nuanced approach to statutory interpretation in the 1999 case *Johnson Development Company v. First National Bank of St. Louis*. See 999 S.W.2d 314, 318–19 (Mo. Ct. App. 1999). There, the intermediate appellate court held that common law negligence claims that arose during the Code's one-year statute of limitations were permissible because they would not contradict

In general, courts seem to allow common law negligence claims when the specific facts of the case and simple fairness justify placing liability in a way that is inconsistent with the Code—particularly where banks engage in poor business practices.<sup>215</sup> Common law negligence claims were allowed where the bank opened an account without meeting the client or receiving proper documentation;<sup>216</sup> where the bank allowed a non-signer to initiate transactions on accounts;<sup>217</sup> where the bank failed to make an inquiry before depositing a check payable to the bank into a customer's account;<sup>218</sup> and where the bank's employees made misstatements regarding the check collection process upon which the customers subsequently relied.<sup>219</sup> Though courts arrive at these results using different preemption tests, results that appear anomalous upon initial consideration can be systematized using this rubric.<sup>220</sup>

### III. YIELDING TO THE CODE: WHY THE UCC SHOULD PREEMPT COMMON LAW NEGLIGENCE CLAIMS

This Part argues that a strict reading of the Code should require that common law negligence claims be preempted by the Code.<sup>221</sup> Given this reality, and because it preempts virtually all common law claims, the comprehensive rights and remedies test applied by the majority of courts is the best preemption test from a strictly legal stand-

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any of the Code's "particular provisions." *See id.* The negligence claims arising outside of the Code's statute of limitations, however, were preempted by the statute of limitations provision. *See id.*

<sup>215</sup> *See Lombino*, 797 F. Supp. 2d at 1083–84 (allowing a negligence claim where the customer relied on the bank employee's representations of the check collection process); *Old Republic*, 291 F. Supp. 2d at 69 (allowing a negligence claim where the bank opened an account based on the power of attorney without meeting the client); *Valley Bank*, 147 P.3d at 191–92 (allowing a negligence claim where the customer relied on the bank employee's representations of the check collection process).

<sup>216</sup> *See Old Republic*, 291 F. Supp. 2d at 69.

<sup>217</sup> *See In re Clear Advantage Title*, 438 B.R. at 65.

<sup>218</sup> *See Allfirst Bank*, 905 A.2d at 377.

<sup>219</sup> *See Lombino*, 797 F. Supp. 2d at 1084; *Valley Bank*, 147 P.3d at 191–92. Connecticut courts' blanket acceptance of common law negligence actions in check fraud scenarios may also reflect a desire for fairness because it can be seen as an implicit statement of dissatisfaction with the loss allocation scheme provided by the Code. *See, e.g., Lester Contr.*, 2009 WL 5698131, at \*6; *Van Der Werff*, 1996 WL 686916, at \*3.

<sup>220</sup> *See, e.g., Old Republic*, 291 F. Supp. 2d at 69 (allowing a common law negligence claim because Articles 3 and 4 do not expressly prohibit them); *In re Clear Advantage*, 438 B.R. at 65 (allowing a common law negligence claim under a special relationship exception to the comprehensive rights and remedies test); *Valley Bank*, 147 P.3d at 191 (allowing a common law negligence claim because the facts giving rise to the claim were deemed outside the scope of the Code).

<sup>221</sup> *See infra* notes 226–242 and accompanying text.

point.<sup>222</sup> On the one hand, this is sensible because loss allocation rules protect the banking industry from additional liability due to federal regulation and allow banks to take advantage of cost-saving technology.<sup>223</sup> Nevertheless, the drafters should consider whether there are more equitable ways to allocate check fraud losses during the next revision cycle because many courts have had difficulty applying these rules.<sup>224</sup> Until then, banking customers should consider pursuing electronic payment methods as an alternative to payment by check because electronic payments are safer, and the rules governing loss allocation for these payments are more equitable than those governing check fraud loss allocation.<sup>225</sup>

*A. Common Law Negligence Claims Generally Should Not Be Allowed  
Under a Fair Reading of the Code*

In general, allowing common law negligence claims in check fraud cases arguably contradicts a fair reading of the Code.<sup>226</sup> Allowing common law claims conflicts with section 1-103 because common law claims undermine the Code's predictability and consistency.<sup>227</sup> In fact, in revising section 1-103, the drafters specifically broadened its language to enhance its preemptive effect.<sup>228</sup> They did not want courts to allow the Code's purposes and policies to be frustrated by an unduly narrow reading of the preemption provision that asked only whether the text of the statutes specifically preempted or contradicted the Code's scheme.<sup>229</sup> Instead, they intended the Code to preempt the common law wherever a common law claim would conflict with the Code's enu-

<sup>222</sup> See *infra* notes 243–246 and accompanying text.

<sup>223</sup> See *infra* notes 247–259 and accompanying text.

<sup>224</sup> See *infra* notes 260–276 and accompanying text.

<sup>225</sup> See *infra* notes 277–288 and accompanying text.

<sup>226</sup> See U.C.C. § 1-103(b) cmt. 2 (2002) (“[The preemptive power of the Code] extends to displacement of other law that is inconsistent with the purposes and policies of the Uniform Commercial Code, as well as with its text.”); *infra* notes 227–233 (illustrating how common law negligence claims are inconsistent with the purposes and policies of the Code).

<sup>227</sup> See U.C.C. § 1-103(b) (“[The Uniform Commercial Code] must be liberally construed and applied to . . . simplify, clarify, and modernize the law governing commercial transactions [and] . . . to make uniform the law among the various jurisdictions.”); see also *Patco Constr. Co. v. People’s United Bank*, 684 F.3d 197, 216 (1st Cir. 2012) (suggesting that common law negligence claims are uniformly considered preempted in the context of electronic payment fraud scenarios under Article 4A).

<sup>228</sup> See U.C.C. § 1-103 cmt. 2 (describing that the intended effect of revised section 1-103 is to clarify the broad preemption power of the Code).

<sup>229</sup> See *id.*; see also *Patco*, 684 F.3d at 216 (disallowing a common law negligence claim because it was inconsistent with the duties and liabilities set forth in Article 4A).

merated purposes and policies.<sup>230</sup> Allowing common law negligence claims in check fraud cases undermines the Code's goal of creating predictable outcomes by opening the door to highly variable tort damages.<sup>231</sup> At the same time, the benefits of enhancing the negotiability of instruments by allowing common law negligence claims are less obvious.<sup>232</sup> On balance, then, the Code's overarching policies of predictability, consistency, and comprehensive coverage of commercial disputes are better served by a broad reading of the Code's applicability.<sup>233</sup>

Nevertheless, the case law highlights some of the imperfections with the loss allocation scheme of Articles 3 and 4.<sup>234</sup> The view of the negligence remedy as a safety valve for unfair results may explain why Articles 3 and 4 do not include a provision specifically precluding common law negligence claims even after two revisions.<sup>235</sup> The drafting committee may have seen the value in maintaining common law negligence claims as a release for situations when fairness considerations dictate a result other than that which would be achieved by a strict and exclusive application of the Code's loss allocation scheme.<sup>236</sup> Of course,

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<sup>230</sup> See U.C.C. § 1-103 cmt. 2.

<sup>231</sup> See *id.* § 1-103(b) (goals of the Code); *id.* § 1-103 cmt. 2 (providing that principles of common law may not supplant the goals of the Code); HILLMAN 1985, *supra* note 150, at 14-51; see also *Valley Bank of Ronan v. Hughes*, 147 P.3d 185, 188-89 (Mont. 2006) (illustrating that whereas the bank was potentially liable for a large sum of money pursuant to a common law negligence action, the bank would not be liable pursuant to the Code's right of chargeback).

<sup>232</sup> See U.C.C. § 1-103(b) (goals of the Code); *id.* § 1-103 cmt. 2 (providing that principles of common law may not supplant the goals of the Code); HILLMAN 1985, *supra* note 150, at 14-51; see also *Valley Bank of Ronan v. Hughes*, 147 P.3d 185, 188-89 (Mont. 2006) (noting that, although the bank faced potential liability under a common law negligence claim, the bank had a clear right under the Code to charge back the customer's account).

<sup>233</sup> See U.C.C. § 1-103 (2002) (articulating the policies promoted by the Code); HILLMAN 1985, *supra* note 150, at 14-51.

<sup>234</sup> See, e.g., *Old Republic Nat'l Title Ins. Co. v. Bank of E. Asia, Ltd.*, 291 F. Supp. 2d 60, 69 (D. Conn. 2003) (observing that Articles 3 and 4 do not expressly prohibit common law claims); *In re Clear Advantage Title*, 438 B.R. 58, 65 (Bankr. D.N.J. 2010) (allowing a common law negligence claim where the plaintiff and defendant bank had established a special relationship that imposed additional duties on the bank, which existed independently of Articles 3 and 4); *Valley Bank*, 147 P.3d at 191 (allowing a common law negligence claim because the loss allocation scheme in Articles 3 and 4 did not contemplate the facts at issue in the case).

<sup>235</sup> See generally U.C.C. arts. 3 & 4. See Overby, *supra* note 15, at 351 n.3. The 2002 amendments did not address the loss allocation provisions. See *id.*

<sup>236</sup> See Overby, *supra* note 15, at 351 n.3 (suggesting the 2002 revision committee did not take up check fraud rules because they are contentious); cf. *Lombino v. Bank of Am.*, 797 F. Supp. 2d 1078, 1084 (D. Nev. 2011) (allowing a negligence claim where the customer relied on a bank employee's representations of the check collection process); *Old Republic*, 291 F. Supp. 2d at 69 (allowing a negligence claim where the bank opened an account based on the power of attorney without meeting the actual client); *In re Clear Ad-*



the absence of a preemption provision may have been nothing more than a happy accident.<sup>237</sup>

Article 4A, dealing with electronic payments, also supports a strict preemption reading.<sup>238</sup> Article 4A explains that, although competing interests are commonplace within funds transfer scenarios, those competing interests were necessarily considered and balanced during the drafting process.<sup>239</sup> As such, the resulting rules reflect a balance of those interests and are “intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by . . . [Article 4A].”<sup>240</sup> For this reason, resorting to common law claims is generally not appropriate in cases involving electronic funds transfers.<sup>241</sup> If the Code generally rejects common law claims for electronic payments, an extension of this policy to payments made by check is highly reasonable.<sup>242</sup>

Through this lens, the comprehensive rights and remedies test is the best preemption test for courts to use to determine whether com-

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*vantage*, 438 B.R. at 65 (allowing a negligence claim where bank permitted a non-account signer to conduct transactions from an account in violation of the deposit account agreement); *Valley Bank*, 147 P.3d at 191–92 (allowing a negligence claim where the customer relied on a bank employee’s representations of the check collection process).

<sup>237</sup> Cf. Memorandum from Fred H. Miller, Chair, Study Comm. on Payments Issues, & Linda J. Rusch, Reporter, Request for Comments on Issues Under U.C.C. Articles 3 and 4, at 3 (Mar. 16, 2009), available at <http://www.law.gonzaga.edu/files/PaymentsWhitePaper.pdf>. (soliciting comments regarding the availability of common law contract and negligence actions under Articles 3 and 4 for the Study Committee on Payment Issues, sponsored by the Uniform Law Commission and American Law Institute). The fact that the revision committee solicited comments regarding whether Articles 3 and 4 allow common law negligence claims perhaps suggests that the drafting committee had no opinion on the matter. Cf. *id.*

<sup>238</sup> See U.C.C. § 4A-102 cmt. According to one official comment of an Article 4A provision:

Funds transfers involve competing interests . . . [which] were represented in the drafting process and . . . [were] thoroughly considered. The rules that emerged represent a careful and delicate balancing of those interests and are intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by particular provisions of this Article. Consequently, resort to principles of law or equity outside of Article 4A is not appropriate to create rights, duties and liabilities inconsistent with those stated in this Article.

*Id.*

<sup>239</sup> See U.C.C. § 4A-102 cmt. (2002).

<sup>240</sup> See *id.*

<sup>241</sup> See *id.*; see also *Patco*, 684 F.3d at 216 (disallowing a common law negligence claim because it was inconsistent with the duties and liabilities set forth in Article 4A).

<sup>242</sup> Cf. U.C.C. § 4A-102 cmt. 1 (“[R]esort to principles of law and equity outside of Article 4A is not appropriate to create rights, duties, and liabilities inconsistent with those stated in this Article.”).

mon law negligence claims should be allowed in check fraud scenarios.<sup>243</sup> It reads the Code's applicability broadly and preempts virtually all common law negligence claims, consistent with the policy imperatives and official comments in section 1-103 and Article 4A's approach.<sup>244</sup> At the same time, it preserves an opening for common law claims in the rare instance where the public policy of incentivizing good business practices outweighs the Code's policy goals.<sup>245</sup> And because these cases are so rare, allowing common law negligence claims in these limited instances has very little negative impact on predictability or parties' rights because these decisions are strongly tied to the specific set of factual circumstances presented in each case.<sup>246</sup>

### B. The Loss Allocation Scheme Provides Latent Benefits

It is unlikely that the loss allocation rules as presently constituted are driven by a desire to protect the banking lobby at the expense of its customers.<sup>247</sup> As prominent Code scholar Grant Gilmore satirically noted, "[I]uncheon at the Bankers' Club is not given over to devising ways and means of hoisting the poor customer each day a little higher

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<sup>243</sup> Compare *id.* § 1-103(b) (illustrating the policy goals of the Code, including consistency and predictability), and *supra* notes 226–233 and accompanying text (suggesting that because common law claims inject a measure of unpredictability, the goals of the Code are better preserved by considering these claims preempted), with *Bradley v. First Nat'l Bank of Walker*, 711 N.W.2d 121, 127 (Minn. Ct. App. 2006) (illustrating how the comprehensive rights and remedies test is particularly predisposed to conclusions of common law claim preemption, where the court placed the risk of loss on the customer even where the bank allowed a non-signer to initiate transactions from the customer's account).

<sup>244</sup> See *AmSouth Bank v. Tice*, 923 So. 2d 1060, 1066 (Ala. 2005) (illustrating how the comprehensive rights and remedies test operates to preempt common law claims); *Bradley*, 711 N.W.2d at 127 (same); U.C.C. § 1-103(b) (indicating that predictability is an important goal of the Code); *id.* § 1-103 cmt. 2 (remarking that the Code's "rules represent choices made by its drafters and the enacting legislatures about the appropriate policies to be furthered in the transactions it covers"); *id.* § 4A-102 cmt. (remarking that the rules of Article 4A were "intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by" that Article).

<sup>245</sup> See, e.g., *Lombino*, 797 F. Supp. 2d at 1084 (allowing a negligence claim where a customer relied on the bank employee's representations of the check collection process); *Old Republic*, 291 F. Supp. 2d at 69 (allowing a negligence claim where the bank opened an account based on the power of attorney without meeting the client); *Valley Bank*, 147 P.3d at 191–92 (allowing a negligence claim where a customer relied on the bank employee's representations of the check collection process).

<sup>246</sup> See *supra* note 245 (collecting cases).

<sup>247</sup> See Grant Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L. J. 364, 376 (1952). But see Overby, *supra* note 15, at 353 (citing Zekan, *supra* note 129, at 166–76) (describing the banks as "winners" in a "winner takes all approach" to loss allocation under Articles 3 and 4).

on his own petard.”<sup>248</sup> Rather, the loss allocation scheme reflects the practical difficulties of banks in maintaining the paper check payment system on which their customers rely.<sup>249</sup>

The bank’s absolute right of chargeback protects banks from liability that would otherwise result from the intersection of check float and expedited funds availability.<sup>250</sup> Prior to the Expedited Funds Availability Act and Regulation CC, banks would place a hold on a customer’s account for the amount of a deposited check until the funds affirmatively came in.<sup>251</sup> Now, banks must make funds from check deposits available long before the money has actually arrived at the depository bank.<sup>252</sup> Where expedited funds availability in Regulation CC removed the bank’s self-protection method of placing funds on hold until they were collected, the absolute right of chargeback now protects banks from the dangers inherent to check float.<sup>253</sup> And so long as the customer is responsible about taking checks from reliable sources and maintaining sufficient funds in the account to cover a chargeback until a check clears, the provision will almost never become a problem for the customer.<sup>254</sup>

The Code’s revisions to the standard of ordinary care also reflect a realistic balance between the bank’s interests in economic efficiency and the customer’s interest in maintaining a check-based payment system.<sup>255</sup> Checks are the most expensive form of payment from a processing standpoint, but the country’s continued reliance on the paper

<sup>248</sup> Gilmore, *supra* note 247, at 376.

<sup>249</sup> Compare McAndrews & Roberds, *supra* note 51, at 18–22 (suggesting that the United States is tied to the check payment system), with Regulation CC, 12 C.F.R. § 229.12 (2013) (providing for expedited funds availability), and U.C.C. § 4-214 (2002) (providing banks with the right of chargeback).

<sup>250</sup> See 12 C.F.R. § 229.12; U.C.C. § 4-214.

<sup>251</sup> See Mucklestone, *supra* note 42, at 39–41.

<sup>252</sup> See *id.* at 41–42.

<sup>253</sup> See 12 C.F.R. § 229.12; U.C.C. § 4-214.

<sup>254</sup> See McAndrews & Roberds, *supra* note 51, at 18–20. This is true unless he or she relies on the bank’s erroneous representations about the collection process, in which case the bank would be liable under a common law negligence theory. See *Valley Bank*, 147 P.3d at 191–92.

<sup>255</sup> Compare Bauer & Gerdes, *supra* note 35, at 1–3 & fig.2 (illustrating the economic efficiency created by electronic presentment), with U.C.C. § 3-103(a)(9) (2002) (describing that with regard to “ordinary care,” that “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”), and *id.* § 3-103. at cmt. 4 (noting that a portion of the ordinary care definition is “limited to the duty of a bank to examine an instrument taken by a bank for processing for collection or payment by automated means,” such as electronic presentment).

check payment system renders a strong push toward electronic payments unreasonable, even though such a move could save the banking industry billions of dollars.<sup>256</sup> For example, the Check 21 Act, which provides for federal approval of electronic presentment, has resulted in significant savings and reduced the processing cost per check to less than one third of its pre-electronic presentment cost.<sup>257</sup> The drafters likely removed the court-created sight review requirement from the standard of ordinary care so that the banks would not incur liability as a result of making the economically rational choice to convert to electronic presentment, especially after the passage of the Check 21 Act.<sup>258</sup> This result is consistent with good policy because it reduces the costs that are ultimately passed on to bank customers and reflects the Code's desire to grow and change in response to new commercial and technological developments.<sup>259</sup>

Although preemption should be the general rule for common law negligence claims in check fraud cases, the drafters should consider whether there are more equitable ways to allocate check fraud losses during the next revision cycle because the rules as presently constituted are unclear and contentious.<sup>260</sup> As an initial matter, the drafters should include an explicit statement either precluding common law negligence actions in check fraud scenarios, or declaring the circumstances under which a common law negligence action is available under Articles 3 and 4.<sup>261</sup> This would end the uncertainty inherent in a policy-based analysis under section 1-103(b).<sup>262</sup>

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<sup>256</sup> See Bauer & Gerdes, *supra* note 35, at 3 fig.2; McAndrews & Roberds, *supra* note 51 at 17–18. The United States maintained its reliance on paper-based checks even as electronic payments became increasingly available and other developed countries moved toward electronic forms of payment. See McAndrews & Roberds, *supra* note 51, at 17. In the United States, 75% of noncash payments in 1997 were made via check, compared with 36% in Canada and 31% in the United Kingdom for the same year. See *id.*

<sup>257</sup> See Check Clearing for the 21st Century Act (Check 21 Act), Pub. L. No. 108-100, § 4(b), 117 Stat. 1177, 1180 (2003) (codified as amended at 12 U.S.C. § 5003(b) (2012)); Bauer & Gerdes, *supra* note 35, at 1–3 & fig.2.

<sup>258</sup> See *supra* note 255 and accompanying text (illustrating how electronic presentment is advantageous for its economic efficiency and how the Code has reduced the duties of banks in this context).

<sup>259</sup> See U.C.C. § 1-103 cmt. 1 (“The Uniform Commercial Code is drawn to provide flexibility so that . . . it will provide its own machinery for expansion of commercial practices.”); Bauer & Gerdes, *supra* note 35, at 3 fig.2; Mucklestone, *supra* note 42, at 39.

<sup>260</sup> See Hillebrand, *supra* note 129, at 697–98; Overby, *supra* note 15, at 353 (citing Zekan, *supra* note 129, at 166–76).

<sup>261</sup> See *supra* notes 145–220 (illustrating how uncertainty has prompted a variety of different tests among courts, which has led to differing results); *cf.* U.C.C. § 3-420 (2002) (defining availability of conversion claims for instruments); *id.* § 4A-102 cmt. (2002) (pro-

In addition, the drafters should consider providing a separate set of rules for businesses than for individual consumers.<sup>263</sup> The Code and other laws already provide separate rules for consumers and businesses in other contexts.<sup>264</sup> The current loss allocation structure works well in the business context because it best reflects the policy of placing the risk of loss on the best risk avoider, especially because a significant proportion of check fraud scenarios in the business context are perpetrated by employees.<sup>265</sup> Employee embezzlement is easier for the employer to prevent through oversight and other internal controls than for the bank to prevent through the check clearing system, and the current loss allocation scheme is well-suited to address these types of situations by assigning the risk of loss on the employer.<sup>266</sup>

For individual consumers, however, the Code should place the risk of loss on the bank, subject only to the current comparative negligence rule.<sup>267</sup> Under this paradigm, the Code would still allow a customer's failure to review bank statements to be a factor in the negligence analysis.<sup>268</sup> This resulting system would best reflect the overarching policy of consumer protection evidenced by other areas of payment law, while still holding the customer accountable for avoidable losses.<sup>269</sup>

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hibiting resort to common law in electronic payment situations unless Article 4A expressly incorporated the common law in a particular context).

<sup>262</sup> See HILLMAN 1985, *supra* note 150, at 14-51 to -52 (discussing the competing policies involved in transactions covered by Articles 3 and 4).

<sup>263</sup> See *infra* notes 264–269 and accompanying text (supporting this proposition).

<sup>264</sup> See, e.g., 11 U.S.C. § 522 (2012) (providing different exemption rules for individuals and other entities); 15 U.S.C. §§ 1693, 1666 (2012) (providing consumer-protective rules for debit and credit card fraud); U.C.C. § 2-314 (providing an implied warranty of merchantability to a buyer of goods of the kind for which the seller is a merchant); *id.* § 9-320(b) (allowing a consumer-purchaser to avoid a creditor's security interest where the creditor failed to file on the good purchased from the consumer-debtor).

<sup>265</sup> See Overby, *supra* note 15, at 372.

<sup>266</sup> See U.C.C. § 3-405(b) (imposing the risk of loss on an employer for the actions of an employee entrusted with certain responsibilities); Overby, *supra* note 15, at 375; see also Cagle's, Inc. v. Valley Nat'l Bank, 153 F. Supp. 2d 1288, 1298 (M.D. Ala. 2001) (holding a company liable for losses incurred when accounts payable employee wrote large checks from the company account payable to herself and deposited them in her personal bank account); C-Wood Lumber Co. v. Wayne Cty. Bank, 233 S.W.3d 263, 281–82 (Tenn. Ct. App. 2007) (holding a lumber mill liable for losses where employee-treasurer embezzled funds).

<sup>267</sup> See *infra* notes 268–269 and accompanying text (supporting this proposition); see also U.C.C. § 3-406 (2002) (imposing a comparative negligence burden on consumers).

<sup>268</sup> See Overby, *supra* note 15, at 373.

<sup>269</sup> See, e.g., 11 U.S.C. § 522 (providing broader exemption rules for individuals than for other entities in the bankruptcy context); 15 U.S.C. §§ 1693, 1666 (providing consumer-protective rules for debit and credit card fraud); *cf.* Adams v. Martinsville DuPont Credit Union, 573 F. Supp. 103, 113 (D.D.C. 2008) (holding the consumer accountable as

For both business and consumer customers, the Code should provide a new provision assigning the risk of loss to the bank wherever customers rely on representations by bank employees about the check clearing process and that reliance leads to customer losses.<sup>270</sup> Absent such an inquiry into funds availability, a customer should bear the risk of loss for sending out funds during the float period because float is such a well-known phenomenon and so many customers take advantage of it.<sup>271</sup> But a customer who relies on a bank for information regarding the check clearing process before initiating a payment based on deposited funds acts both reasonably and responsibly.<sup>272</sup> Furthermore, Nigerian check fraud schemes are so well-documented that a customer's question about funds availability in connection with an outgoing wire or other payment should cause alarms to sound in any bank employee's mind.<sup>273</sup> Simply put, banks should be held accountable for information provided to customers about the bank's own services.<sup>274</sup> Whereas businesses are in the best position to prevent employee fraud through oversight, banks are in the best position to prevent fraud that takes advantage of check float when a customer inquires about funds availability, because the bank knows the check clearing process and

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a result of an avoidable loss—namely one resulting from the theft of the consumer's checks from his vehicle, which the consumer allowed to clear); *Van Der Werff v. Shawmut Bank Conn.*, No. CV 950554654, 1996 WL 686916, at \*3 (Conn. Super. Ct. Nov. 20, 1996) (protecting the consumer by allowing a common law negligence claim where the consumer acted responsibly to avoid the loss by promptly notifying the bank after her checkbook was stolen).

<sup>270</sup> See *Lombino*, 797 F. Supp. 2d at 1083–84 (allowing a negligence claim where the customer relied on a bank employee's representations of the check collection process); *Old Republic*, 291 F. Supp. 2d at 69 (allowing a negligence claim where the bank opened an account based on the power of attorney without meeting actual client); *Valley Bank*, 147 P.3d at 191–92 (allowing a negligence claim where the customer relied on a bank employee's representations of the check collection process); cf. *Adams*, 573 F. Supp. 2d at 113 (rejecting negligence claim despite consultation with the bank manager).

<sup>271</sup> See *McAndrews & Roberds*, *supra* note 51, at 18–22 (“[F]loat continues to offer a key motive for the continued use of checks.”).

<sup>272</sup> See, e.g., *Lombino*, 797 F. Supp. 2d at 1083–84 (protecting the customer by allowing a common law negligence claim when the bank customer inquired about the check clearing process prior to initiating the outgoing wire transfer); *Valley Bank*, 147 P.3d at 191–92 (same); cf. *Adams*, 573 F. Supp. at 113 (rejecting a negligence claim despite consultation with the bank manager).

<sup>273</sup> See, e.g., *Valley Bank*, 147 P.3d at 191–92 (illustrating a typical Nigerian check fraud scheme); *Staying Safe from “Nigerian” Scams*, ADA COUNTY SHERIFF'S OFF., <http://www.ada.sheriff.org/StayingSafe/NigerianScams.aspx> (last visited Oct. 10, 2013); *Common Fraud Schemes*, FBI, <http://www.fbi.gov/scams-safety/fraud> (last visited Oct. 10, 2013).

<sup>274</sup> See *Lombino*, 797 F. Supp. 2d at 1083–84; *Valley Bank*, 147 P.3d at 191–92.

likely has substantial knowledge about typical fraud schemes.<sup>275</sup> Simple fairness requires that this loophole be closed.<sup>276</sup>

Until Articles 3 and 4 are revised, though, the loss allocation scheme may be beneficial because it incentivizes bank customers to move away from payment by check.<sup>277</sup> Whereas bank accounts may not be optional in today's society, payment by check is optional.<sup>278</sup> Payments by wire transfer, ACH, or credit or debit cards benefit banks and their customers because they are easy and cost-efficient.<sup>279</sup> The banking customer can easily pay with these methods at a point of sale, from his or her home or office computer, or even from a mobile phone.<sup>280</sup> Banks benefit because electronic transactions are far less expensive: a debit card transaction, for instance, costs thirty-five cents less to process than a check for the same amount.<sup>281</sup> Converting just one out of every four check transactions into a debit card transaction in 2010 would have yielded over \$700 million in savings.<sup>282</sup> Furthermore, fraud committed by these payment methods fall under the more equitable rules in Regulation CC and Article 4A, providing benefits to both consumer and business banking customers.<sup>283</sup> And because Article 4A's preemption language renders common law claims largely unavailable, both banks and customers can rely on the predictability of the rules.<sup>284</sup>

Finally, whereas technological advances are making check fraud easier to commit and harder to detect, they are making electronic payments safer and also making fraud easier to catch.<sup>285</sup> Standard security procedures incorporate a constantly evolving variety of knowledge

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<sup>275</sup> See *Lombino*, 797 F. Supp. 2d at 1083–84; *Valley Bank*, 147 P.3d at 191–92.

<sup>276</sup> See *Lombino*, 797 F. Supp. 2d at 1083–84; *Valley Bank*, 147 P.3d at 191–92.

<sup>277</sup> See 15 U.S.C. §§ 1666, 1693 (2012); *Lombino*, 797 F. Supp. 2d at 1084 *Old Republic*, 291 F. Supp. 2d at 69; *AmSouth Bank*, 923 So. 2d at 1066; *Valley Bank*, 147 P.3d at 191–92; U.C.C. § 1-103(b) (2002); *id.* at cmt. 2; *id.* § 4A-102 cmt. 1.

<sup>278</sup> See Overby, *supra* note 15, at 353.

<sup>279</sup> See Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,725, 81,725–26 (Dec. 28, 2010); Mucklestone, *supra* note 42, at 43–45.

<sup>280</sup> See FED. FIN. INSTS. EXAMINATION COUNCIL, *supra* note 143, at 2–3.

<sup>281</sup> See Debit Card Interchange Fees and Routing, 75 Fed. Reg. at 81,725–26; 2010 Annual Report, *supra* note 33 (providing figures illustrating that a thirty-five cent savings per item results in billions of dollars of savings for the federal government).

<sup>282</sup> See Debit Card Interchange Fees and Routing, 75 Fed. Reg. at 81,725–26; 2010 Annual Report, *supra* note 33.

<sup>283</sup> See Regulation CC, 12 C.F.R. 229.12 § (2013); U.C.C. §§ 4A-102, 4A-202 (2002).

<sup>284</sup> See U.C.C. § 4A-102 cmt. 1.

<sup>285</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 1 (noting that technology is making check fraud easier to commit); FED. FIN. INSTS. EXAMINATION COUNCIL, *supra* note 143, at 2–3.

and physically based security features to verify transactions.<sup>286</sup> And because a banking customer can access account activity statements from any computer or mobile phone, fraud is far less likely to go unnoticed with reasonable diligence by the account holder, especially because users access transaction information through the same portal they use for payment processing services.<sup>287</sup> Also, removing the physical check from circulation means that there is no way to fraudulently indorse a third party's payment or for an employee to alter the amount of a paycheck or expense reimbursement.<sup>288</sup>

### CONCLUSION

Technology has changed the payment landscape over the last several decades, both for paper-based check payments and electronic funds transfers. A strict reading of the Code arguably requires that common law negligence claims in check fraud scenarios be preempted by the Code, making the comprehensive rights and remedies test the most accurate reflection of the Code's purposes and policies. At the same time, other tests and the inconsistent results of their applications suggest that the loss allocation rules are perceived as one-sided and that the drafters should consider whether there are more equitable ways to allocate check fraud losses during the next revision cycle. Nevertheless, the allocation provisions provide important protections for banks that make maintenance of the check payment systems possible. Until such revisions are made, banking customers should consider moving to electronic payments because they are safer, and the rules governing loss allocation for electronic payments are more equitable than those for check fraud loss allocation.

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<sup>286</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 1 (noting that technology is making check fraud easier to commit); FED. FIN. INSTS. EXAMINATION COUNCIL, *supra* note 143, at 2–3; *Mobile Banking Security from Bank of America*, BANK OF AM., <https://www.bankofamerica.com/privacy/online-mobile-banking-privacy/mobile-banking-security.go> (last visited Oct. 3, 2013) (discussing security features available through an online banking platform and mobile banking app).

<sup>287</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 1; FED. FIN. INSTS. EXAMINATION COUNCIL, *supra* note 143, at 2–3; *Mobile Banking Security from Bank of America*, *supra* note 286.

<sup>288</sup> See CHECK FRAUD GUIDE, *supra* note 32, at 1; FED. FIN. INSTS. EXAMINATION COUNCIL, *supra* note 143, at 2–3; Mucklestone, *supra* note 42, at 41–45 (noting that payment by check requires the depository bank to present a copy of the check to the payor bank, and discussing electronic alternatives to payment by check).



