Forged Facsimile Signatures and Basic Principles

of the Law of the Check Collection System

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A basic principle in the law of payment by check is that the customer does not bear the risk of payments made over a forgery of the customer's signature. Section 4-401 of the Uniform Commercial Code provides that a bank may charge to the customer's account any item that is "properly payable." The current version of section 4-401 goes on to state that an item is properly payable if the item is "authorized by the customer and is in accordance with any agreement between the customer and the bank." Although formally the Article 4 provisions say only that the bank may charge the account for any item that is properly payable, the inverse proposition—that if an item is not payable then the bank may not change the customer's account—is routinely taken to be both true and a basic principle of the Article 4 scheme.[1] Equally clear is the basic proposition that a check bearing a forgery of the drawer's signature is not properly payable.[2]

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[1] JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 15-2 (5th ed. 2000); 5 WILLIAM D. HAWKLAND ET AL., UNIFORM COMMERCIAL CODE SERIES § 4-401:2 (1999); 1 BARKLEY CLARK & BARBARA CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 3.10[2][b] (2002); 1 DONALD I. BAKER, ROLAND E BRANDEL, AND JAMES H. PANNABACKER, THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS ¶ 12.02[4][a] (2003).

[2] U.C.C. § 4-401 cmt. 1 ("An item containing a forged drawer's signature or forged indorsement is not properly payable."). Citations to Articles 3 and 4 of the U.C.C. are to

If the drawer is an organization of any size, manual signatures on checks will not be feasible. Accordingly the routine practice is that a check drawn by an organization will bear a facsimile signature. The customer and bank will enter into an agreement authorizing the bank to honor checks bearing the facsimile signature. Several recent cases concerning the effect of such resolutions raise significant issues about the basic loss allocation scheme for the check system.

I. FORGED FACSIMILE SIGNATURE CASES

In *Jefferson Parish School Board v. First Commerce Bank*,[3] a drawer's action against the drawee bank for paying checks over forged drawer's signature failed where the drawer had signed a resolution concerning the use of facsimile signatures. According to the resolution, the bank was authorized to honor any checks which bore or purported to bear the facsimile signature of the authorized parties, "regardless of by whom or by what means the actual or purported facsimile signature or signatures thereon may have been affixed thereto, if such facsimile signature or signatures resemble the facsimile specimens" on file with the bank.[4] The appellate court affirmed the grant of summary judgment in favor of the bank, on the grounds that the resolution was effective and under the resolution there was no factual issue concerning the bank's authority to charge the customer's account.

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the current version, including the major changes made in 1990. The prior version is cited as Former U.C.C.

[3] 669 So.2d 1298 (La. App. 1996)

[4] *Id*. at 1300.

According to the *Jefferson Parish* opinion, the only issue posed was whether the resolution was effective. The Court treated this issue under section 4-103(1), which provides that

> The effect of the provisions of this Article may be varied by agreement, but the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable.

Though the court did not discuss the point in any detail, its conclusion seems to have been that the agreement either did not disclaim the bank’s responsibility to exercise ordinary care, or that it established a standard of care which was not manifestly unreasonable, to wit, that the bank was authorized to pay checks thatbore a signature which “resembled” the authorized signature.[5]

The *Jefferson Parish* case does not state explicitly how the malefactor produced the bogus checks. In general, one can imagine two versions of the bogus facsimile check scenario. In the first category are cases in which the malefactor produces the bogus checks by getting access to the machine used to produce genuine checks. In the second category are cases in which the malefactor produces bogus checks without in any fashion making unauthorized use of the facsimile signature machine or any other facilities under the control of the actual drawer. Such cases are probably increasingly common because modern desktop publishing technology makes it a fairly simple matter for a malefactor to produce a bogus check, using a genuine check as a model, even though the malefactor did not gain any access to the machine used to produce genuine facsimile signed checks. It

[5] *Id*.

appears that *Jefferson Parish* was a case of the second sort, for the report indicates that the customer contended that the bank would be unable to produce any evidence of negligence on the drawer's part in safeguarding blank checks or the facsimile signature machine. Of course, under the court's view of the law, that fact made no difference. However the bogus checks were produced, the bank was authorized by the resolution to honor them, so long as, in the language of the resolution, the signature "resembled" an authorized facsimile signature.

The distinction between bogus facsimile signature checks produced with and without any unauthorized access to the facsimile signature machine does not appear to have been discussed in any of the cases dealing with forged facsimile signatures, yet it may well play an important role in the law.

The modern story of facsimile signature fraud begins with the well-known case of *Perini Corp. v. First National Bank*.[6] Checks bearing the facsimile signature of an authorized representative of the drawer, Perini Corp., were made payable to "Quisenberry Contracting Co." and "Southern Contracting Co." The checks were indorsed in the name of one "Jesse D. Quisenberry" and in that form were accepted for collection by the depository bank, the First National Bank of Habersham County, Georgia. The checks were forwarded for payment to the payor banks, Brown Brothers, Harriman & Company and Morgan Guaranty Trust Company of New York, and were paid. When Perini Corp discovered the unauthorized payments, it bought suit against the banks.[7] The case is

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[6] 553 F.2d 398 (5th Cir. 1977).

[7] Perini entered into an agreement with one of the drawee banks, Brown Brothers, that it would assert no claim against that bank but could assert the bank's claims against other

known primarily for its treatment of the so-called "double forgery" issue. Inasmuch the checks were deposited with an indorsement that differed from the designation of the payee, it was possible to treat them as bearing a forged indorsement. If so, then it was arguable that the depository banks bore the loss. By contrast if one ignored the discrepancy between the name of the payee and the indorsement, then the significant flaw in the checks was the forgery of the signature of the drawer, Perini Corp., in which case the loss would ordinarily be borne by the payor bank.

In the *Perini* case itself, however, there was little doubt that if the principal defect in the checks was the signature of the drawer, the loss would be borne by the drawer rather than the payor bank. The agreement between the drawer and the payor banks authorizing the use of the facsimile signature machine provided that the payor banks were authorized to pay and charge to the customer's account any checks "bearing or purporting to bear the single facsimile signature" of the designated officer of Perini, "regardless of by whom or by what means the actual or purported facsimile signature thereon may have been affixed thereto, if such facsimile signature resembles the facsimile specimen."[8] The drawer did not dispute the contention that if the unauthorized signature of Perini were treated as the only defect in the checks, then the agreement covered the question of liability as between the bank and its customer, and the agreement was enforceable.[9]

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parties in the suit. The other drawee bank, Morgan Guaranty, did not enter into such an agreement. 553 F.2d at 402 n.2.

[8] 553 F.2d at 400.

[9] 553 F.2d at 403 ("One answer is clear, however. Perini has no recourse on the unauthorized signature of R. A. Munroe against Morgan or Brown Brothers. Perini's resolution authorizing the drawees' payment of checks bearing signatures resembling the machine-embossed facsimile signature precludes that course of action. Perini makes no contrary contention.")

Accordingly, the case gives relatively little information about how the checks were produced. It appears, however, that the wrongdoer gained access to the check forms and facsimile signature machine from the drawer. The opinion does note that

> The precautions taken by Perini to safeguard against abuse of the machine are much in dispute. Pre-printed company checks may or may not have been left in an unlocked cabinet. Operation of the machine itself required three different keys, but Perini may or may not have kept those keys in separate hands.
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> In any event, sometime prior to September 7, 1971, someone stole a number of pre-printed Perini checks and gained access to the signature machine or developed a perfect copy of the facsimile signature it produced.[10]

In *Cumis Insurance Society, Inc. v. Girard Bank*,[11] a credit union maintained a checking account with a commercial bank pursuant to a facsimile signature agreement providing that the bank was authorized to honor checks "bearing or purporting to bear the facsimile signature or any signature or signatures resembling the facsimile specimens … with the same effect as if the signature or signatures were manual signatures."[12] Five checks drawn on the account were honored by the drawee bank. Significantly, all five bore the same check number, the same date, and were made out for the same amount. When the problem was discovered the customer brought suit to force the bank to recredit its account. The drawee bank defended on the basis of the resolution authorizing it to honor any checks purporting to bear the facsimile signature.

In a somewhat less than satisfying opinion, the court held that the exculpatory provisions in the agreement were not effective to save the drawee bank from liability.

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[10] 553 F.2d at 403.

[11] 522 F. Supp. 414 (E.D. Pa. 1981).

[12] 522 F. Supp. at 416.

The court began with the proposition that under Pennsylvania law an exculpatory agreement is to be construed strictly against the drafting party. Then, the court proceeded to find, or perhaps create, ambiguities in the agreement. First the court suggested that the coverage of the agreement was ambiguous as between an unauthorized use of the actual facsimile signature machine or a signature created without the use of the machine.[13] Then, the court suggested that the language of the agreement saying that the facsimile signature could be treated by the bank as having "the same effect as if the signature or signatures were manual signatures" might be read as meaning that the signature was effective only if genuine.[14] Ultimately, the court concluded that the agreement was sufficiently ambiguous that the liability of the bank should be determined under the general principles under which the bank bears responsibility for an authorized check.[15]

While the opinion in *Cumis* is far from satisfying, the result is not without appeal. Inasmuch as multiple checks bearing the same check number were presented, it is extremely unlikely that the fraud was committed by an unauthorized use of the facsimile

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[13] Presumably that is what the court has in mind by its reference to "either the unauthorized use of the genuine facsimile stamp or a forged facsimile stamp." 522 F. Supp. at 421.

[14] *Id*.

[15] *Cumis* was followed in *Kaiser Aluminum & Chemical Corp. v. Mellon Bank*, 43 UCC Rep. Serv. 928 (W.D. Pa. 1997), aff'd mem. 162 F.3d 1151 (3rd Cir. 1998). The district court opinion in *Kaiser* is at least as unsatisfying as the *Cumis* opinion. One can conclude from it only that the court did not like the exculpatory provision concerning the facsimile signature. Just how the court got from that point to the conclusion that the agreement was unenforceable is rather unclear. It is, however, worth noting that so far as appears from the opinion, the forged facsimile signature checks may well have been produced by an outsider. The opinion does note that "the only evidence in the record concerning the conduct of Kaiser is the evidence adduced by Kaiser which clearly supports the inference that no one involved with it in any way failed to exercise ordinary care that substantially contributed to the making of the forged signatures on the checks." 43 UCC Rep. Serv. at 933.

signature machine, as appears to have been the case in *Perini*. At the very least, the wrongdoer in *Cumis* must have produced multiple copies of a single check, though it is not clear from the facts whether the wrongdoer produced those copies from a check that was actually issued by the drawer and bore a genuine facsimile signature, or from a single blank original purloined from the drawer.

In most of the cases upholding agreements absolving the drawee bank from responsibility for paying a check bearing a facsimile it seems clear from the facts that the wrongdoer produced the checks by unauthorized use of the actual facsimile machine. For example, the pre-Code case of *Phoenix Die Casting Co. v. Manufacturers and Traders Trust Co.*,[16] was a double forgery case essentially equivalent to the well-known *Perini* case. A check bearing what appeared to be an authorized facsimile signature of Phoenix's officer Braun, was made payable to Braun himself. Apparently the malefactor produced the check and supplied the forged indorsement of Braun as payee. The check was paid by the drawee bank. The drawer's action against the drawee bank failed on the ground that the facsimile signature agreement authorized the drawee bank to pay any checks bearing the facsimile signature of an authorized signer, regardless of who caused that facsimile signature to be placed on the check. It is clear that the malefactor produced the bogus check by gaining unauthorized access to blank checks and the facsimile machine. As the opinion notes, "the affidavits and documents in the record demonstrate conclusively that the facsimile signature was not affixed by Braun but by an employee of

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[16] 289 N.Y.S.2d 254 (App. Div. 1968)(applying pre-Code law).

the plaintiff who acted without authority and committed a criminal act by drawing the check."[17]

So too, the post-Code cases that approve the use of resolutions placing on the drawer the risk of loss from forged facsimile signatures appear to involve "insider" fraud. In *Wilmington Trust Co. v. Phoenix Steel Corp.*,[18] Phoenix Steel maintained an account with Wilmington Trust pursuant to a facsimile signature agreement that authorized the bank to pay any checks bearing a facsimile signature of certain designated officials. The appellate court ruled that summary judgment should have been granted for the bank dismissing the drawer's action against the bank for having paid checks bearing an unauthorized facsimile signature. It was undisputed that the malefactor was an employee of the drawer who had obtained access to blank checks and the facsimile signature machine. Similarly, in *Wall v. Hamilton County Bank*,[19] summary judgment for the drawee bank was affirmed where the bank paid checks bearing facsimile signatures. Indeed, in *Wall* in appeared that the facsimile signature may have been placed on blank checks by an authorized person and the checks were then stolen from the drawer.[20]

In *Arkwright Mutual Ins. Co. v. NationsBank, N.A.*,[21] the drawee bank paid twenty-seven checks bearing the forgery of the drawer's facsimile signature. The facsimile signature agreement authorized the bank to honor checks "when bearing or purporting to bear" the facsimile signature of an authorized official of the drawer, and

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[17] 289 N.Y.S.2d at 255-56.

[18] 273 A.2d 266 (Del. 1971).

[19] 276 So.2d 182 (Fla. App. Ct. 1973).

[20] *Id.* at 182.

[21] 212 F.3d 1224 (11th Cir. 2000).

provided that the customer agreed that any such facsimile signature “will be effective as [the customer’s] signature regardless of whether the person affixing it was authorized to do so.”[22] An agreed motion for summary judgment posed only the issue of whether the agreement was effective to shift the loss from the bank to the drawer. The Court of Appeals held that the agreement was effective, and remanded for further proceedings on the issue—not encompassed by the parties’ stipulations on the summary judgment motion—of whether the bank exercised ordinary care in paying the forged checks. Although the facts were not developed in detail, it appears that the malefactor was an insider. The court notes in a footnote that “each check bore a different serial number corresponding to actual FPL checks that FPL had internally voided or canceled through its check production process without notice to Nationsbank.”[23] It seems inconceivable that anyone other than an insider could have known what check numbers to use to avoid detection.

In the insider fraud cases, that is, cases in which the wrongdoing was attributable to some failure in the customer's internal procedures for safeguarding the facsimile machine, the result would presumably be the same even if there were no resolution absolving the bank from liability for honoring checks bearing facsimile signatures. Section 3-406 provides that "[a] person whose failure to exercise ordinary care substantially contributes to … the making of a forged signature on an instrument is precluded from asserting … the forgery against a person who, in good faith, pays the instrument …." In a forged facsimile signature case not involving a specific resolution

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[22] *Id*. at 1227.

[23] *Id*. at 1228 n.3.

concerning the use of the facsimile signature machine, the drawer would contend that the signature was unauthorized. The drawee bank would respond that customer's own conduct had substantially contributed to the making of the unauthorized signature and therefore the customer is precluded from denying the authenticity of the signature under the basic rule of section 3-406. Indeed, the comments to section 3-406 state that "the most obvious case" of negligence triggering the preclusion rule "is that of a drawer who makes use of a signature stamp or other automatic signing device and is negligent in looking after it." Thus, the effect of an agreement that the drawee bank is permitted to pay checks bearing facsimile signatures is only to resolve, in advance, what would be a fairly straightforward issue of negligence.

Thus, the significant cases are the outsider fraud cases, in which the wrongdoing is not attributable to any lapse of security within the organization of the drawer. In this category, the only clear rulings are those in the *Cumis* and *Jefferson Parish* cases. The opinion in *Cumis*, based on a somewhat tendentious reading of the facsimile signature resolution, is not particularly appealing on its own terms. By contrast, the *Jefferson Parish* opinion seems to be very much in the tradition of forged facsimile signature case decisions. Yet if we confine our attention to the outsider fraud scenario, the result and approach in *Jefferson Parish* raises more problematic issues about the basic principles of loss allocation for the check system, or, indeed, for payment systems generally.

If we take seriously the approach taken in *Jefferson Parish*, then the only limit on the enforceability of an agreement shifting to the customer the loss resulting from payment over a forgery of a drawer's facsimile signature is the rule of section 4-103(a), which provides that:

> The effect of the provisions of this Article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure; but the parties may by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable.

This section imposes two limits on variation by agreement: First, an agreement cannot disclaim responsibility for a failure to exercise ordinary care. Second, an agreement cannot disclaim responsibility for a lack of good faith. It is unclear whether this limitation imposes any particular stringent limitations on an agreement disclaiming responsibility for payment of facsimile signed checks.

The concept that an agreement cannot disclaim responsibility for failure to exercise ordinary care seems to present little obstacle to the enforceability of facsimile signature agreements. The basic issue under consideration is not who bears the loss of unauthorized signatures where someone was at fault. Rather the issue is who bears the loss in the case where no one was at fault, or, at least, where the loss could not have been prevented by the bank conducting its check payment operations in the ordinary fashion. Indeed, the Article 3 definition of "ordinary care" makes quite clear that there is no invariable statutory requirement of particular action by a bank in the conduct of check payment operations. Section 3-103(a)(7) provides that

> "Ordinary care" in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4.

The comments indicate that the specific provision that ordinary care does not invariably require manual examination is intended primarily to address the sequential forgery rules set out in section 4-406. But there is nothing in the text to suggest that the definition is limited to that scenario. Rather we have a general definition of "ordinary care" that explicitly rejects any notion that the concept can serve as a statutory basis for imposing a requirement of manual examination of instruments where that is not the customary practice.

It is also far from clear whether the requirement of good faith imposes any significant limitations on facsimile signature agreements. According to section 4-104(c), the Article 3 definition of "good faith" applies in Article 4. Section 3-103(a)(4) defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing." It would be hard to argue that an agreement in which a bank disclaims responsibility for forged facsimile signatures violated the requirement of "honesty in fact." The core of that concept seems to be consistency between word and deed. For example, difficult issues might be posed where a party seizes upon general language in an agreement to authorize action that the parties probably never had in mind in drafting the provision in question. A disclaimer of liability for forgery seems to raise no such problems. Such an agreement would not be a subterfuge, but would be intended to mean precisely what it says, and would have been drafted for precisely the scenario under consideration.

The content of the second aspect of the good faith definition—observance of reasonable commercial standards of fair dealing—is unclear. As the comments makes clear, the requirement of good faith does not impose a general requirement of conduct consistent with ordinary practice of others in a similar situation. The requirement is not a general requirement of "observance of reasonable commercial standards," it is only a requirement of observance of reasonable commercial standards "of fair dealing." Standing alone, it is not immediately obvious that a disclaimer of liability is a violation of concepts of "fair dealing." Indeed the many cases upholding exculpatory provisions in facsimile signature agreements seem to suggest that no substantial issue of "fair dealing" is presented.

Let us tentatively assume that the requirements of good faith and ordinary care do not impose significant limitations on agreements disclaiming responsibility for forgery of the drawer's signature and consider the consequences. The usual form of facsimile signature agreement absolves the drawee bank of responsibility for paying a check bearing a forgery of an authorized facsimile signature so long as the signature on the check "resembles" a genuine signature on file with the bank.[24] Is the requirement that the signature "resemble" an authorized signature necessary to the effectiveness of the agreement? If one assumes that it is the routine practice of payor bank's to conduct a manual examination of checks before making final payment, the requirement of "resemblance" might make some sense. If a bogus facsimile signature were so poorly produced that any ordinary physical examination would have raised questions about its authenticity, and the routine practice of payor banks were to conduct such an examination, then it might make sense to say that a bank's payment of a check bearing a

[24] *See., e.g., Jefferson Parish*, 669 So.2d at 1300; *Perini*, 553 F.2d at 400; *Cumis*, 522 F. Supp. at 416.

crude, easily-detectable forgery of the facsimile signature was not a payment made in the exercise of ordinary care. Yet it is by now widely known that payor banks do not regularly conduct a manual examination of checks in the payment process. Some degree of sampling may be routine, but it is certainly not the case that all checks are subject to individual examination. Thus, it is hard to see why it should be essential to the effectiveness of a facsimile signature agreement that it be limited to cases in which the signature "resembles" the genuine facsimile signature.

If one concludes that the common limitation of "resemblance" in facsimile signature agreements is not necessary to effectiveness of the agreement, what of the requirement that the check bear any facsimile signature at all? Suppose a facsimile signature agreement provided that the bank would not be responsible for payment of any check provided that the MICR encoding correctly identified the payor bank and the account.[25] Could one say that the agreement violated section 4-103(a) by disclaiming the bank's obligation of good faith and ordinary care? It is a bit hard to see why. To be sure, the payor bank could still conduct whatever degree of random manual examination it felt prudent. If the bank examined the check, found no signature, but went ahead and paid the check, it would not be difficult to conclude that that bank had failed to exercise ordinary care. But that is a trivial case.[26] If the check in question happens to be one of

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[25] The MICR line on a check routinely identifies the amount of the check as well as the payor bank and the account; however it has long been clear that a check can be properly payable even though the account balance is not sufficient to cover the amount of the check. U.C.C. § 4-401(a).

[26] Moreover, the agreement could easily be modified to deal with this case. The agreement could provide that the bank will not be liable for paying any check with the correct MICR encoding, unless the check was paid as a result of a failure by the bank to exercise ordinary care.

the few selected for manual examination, the payor bank will notice the absence of the signature and presumably will dishonor the check. Saying that the bank might be liable if it does manually examine and pays despite the absence of any signature is a matter of little importance. The issue is whether the bank would be liable in the case where no manual examination of the particular check was conducted. If the agreement provides that the bank is not liable in such a case, and if the bank's conduct in paying that check did not "vary unreasonably from general banking usage,"[27] it is not immediately obvious why that fact that the particular check lacked a signature should make any difference. By hypothesis the fact that the check should not have been paid would not have been detected by an ordinarily prudent bank whether it bore a perfect forgery of the facsimile signature, a crude forgery of the facsimile signature, or no facsimile signature at all.

Once one sees that the common provision in facsimile signature agreements that the bank can charge the account for any item bearing a signature that "resembles" an authorized facsimile signature is unnecessary, the question naturally arise whether the fact that the drawer has authorized the use of a facsimile signature makes any difference. Suppose that the customer has not authorized facsimile signatures. The account, for example, might be an ordinary personal checking account where facsimile signatures are uncommon. Suppose that the agreement provided that the bank would not be liable for paying any check bearing the correct MICR code for the payor bank and the account. Would that agreement be enforceable, at least in the case in which the particular check was one of the many that was not subject to random manual inspection under the bank's customary practice? If we take the approach of the facsimile check cases seriously, it is

[27] U.C.C. § 3-103(a)(7).

hard to see why the agreement should not be enforceable. By hypothesis we are dealing with cases of forgery that could not have been prevented by the bank's exercise of its ordinary spot check procedures. If the only limitation on the enforceability of facsimile signature agreements is the weak requirement of section 4-103 that an agreement cannot disclaim responsibility for a lack of good faith and ordinary care, then it is hard to see why the principle of those cases is not equally applicable to cases that do not involve facsimile signatures, or to cases where the check in question bears no signature at all.

Thus far, we have confined our attention to cases in which the drawer's signature was forged. Let us also consider cases in which the drawer draws a genuine check and sends it off toward the payee, but the check is stolen before arriving at the payee. The scalawag forges the indorsement of the payee and initiates collection. Since the payee is not a customer of the payor bank, that bank would have no way of knowing anything about the signature of the payee, and so would be expected to pay the check. Under section 4-401 the payor bank can charge the item to the customer's account if it is "properly payable." It is perfectly well settled that if a payor bank pays a check bearing a forged indorsement, it has not followed its customer's instruction and the amount of the check cannot be charged to the customer's account.[28] Suppose, however, that an agreement between a payor bank and its customer were to provide that the bank would not be liable for payment of checks bearing forged indorsement. Would such an agreement be enforceable? If, as the *Jefferson Parish* case suggests, the only limit on agreements between banks and their customers is the section 4-103 principle that an

[28] U.C.C. § 4-401 cmt. 1 ("An item containing a forged drawer's signature or forged indorsement is not properly payable."); WHITE & SUMMERS, *supra* note 1 § 15-3; CLARK & CLARK, *supra* note 1, ¶ 12.02.

agreement cannot disclaim the obligations of good faith and ordinary care, it is extremely hard to see why such an agreement would be not be enforceable. After all, there is at least some theoretical basis, however weak it may be in modern practice, for a contention that a payor bank should be aware of its own customer's signature. By contrast, there is no way that a payor bank could determine whether the indorsement of a payee of its customer's check was forged.

Thus, we see that far more is at stake in such cases as *Jefferson Parish* than the specific issue of responsibility for unauthorized facsimile signatures. Rather, those cases pose the far more profound issue of whether the basic loss allocation scheme of the check system can be varied by agreement.

II. Basic Principles of Loss Allocation in the Check System

The outsider fraud version of the forged facsimile signature case situation thus raises basic questions about the fundamental principles of loss allocation for the check collection system. Or, more precisely, the case raises the question of whether there are any fundamental principles. In essence, the approach taken by *Jefferson Parish* amounts to saying that there are no fundamental principles of loss allocation. Rather, the matter is entirely subject to whatever agreement the parties happened to have entered into. If the payor bank happens to accept responsibility for unpreventable losses, so be it. But, if the agreement provides that the customer bears the risk of unpreventable losses, that too is fine. To be sure, the statutory provisions will come into play if there are grounds for an assertion that the loss could have been prevented if either the payor bank or the customer had been more careful. Yet the starting place—who bears the risk in cases where the loss was not preventable by anyone's exercise of ordinary care—would be the product purely of agreement. Let us consider, then, whether that is a plausible approach to the law of the check system, or of payment systems in general.

The question of loss allocation for the check system must take account of the fact that in the check system, unlike most other payment systems, the flow of information and the flow of funds move in opposite directions. The information directing the funds transfer is contained on the check, but the check is delivered to the payee, rather than to the banks involved in the funds transfer. Thus the check—qua funds transfer information device—moves from the originator of the funds transfer to the beneficiary of the funds transfer.[29] The beneficiary of the funds transfer then initiates the bank collection process, by depositing the check with its own bank and beginning the process which will carry the check to the originator's bank for payment. In the useful terminology of the ill-fated Uniform New Payments Code, the check system deals with "draw orders" that "pull" bank credit to the beneficiary from the originator.[30] By contrast, in the ordinary form of

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[29] For convenience the terms used in U.C.C. Article 4A are used herein as general terms for the participants in any funds transfer, regardless of the mechanism or statutory law governing the system. The Article 4A terminology uses two terms—"funds transfer" and "payment order"—to describe the instructions. "Funds transfer," U.C.C. § 4A-104(a), is the generic term for the series of transactions that together constitute the intended transfer of bank credit. "Payment order," U.C.C. § 4A-103(a)(1), is an instruction given by one person, be it user of the system or one of the banks participating in the system, to the party with which it is in contact directing the recipient to process a part of the funds transfer. Thus, a "funds transfer" typically consists of a series of "payment orders." See U.C.C. § 4A-104(a) & cmt. 1. "Originator" is defined in U.C.C. § 4A-104(d) as "the sender of the first payment order in a funds transfer," while "beneficiary" is defined in U.C.C. § 4A-103(a)(2) as "the person to be paid by the beneficiary's bank."

[30] Uniform New Payments Code § 51 (P.E.B. Draft No. 3 1983). The official comment to that section explains the distinction as follows:

electronic funds transfer, the flow of information and the flow of funds move in the same direction—the originator gives an instruction to its own bank directing that payment be made to an account of the beneficiary at the beneficiary's bank. Using the UNPC terminology, an ordinary electronic funds transfer is a "pay order" that "pushes" bank credit from the originator to the beneficiary.

> Subsections (1) and (2) define two key terms, "draw order" and "pay order." A "draw order," such as a check, is initiated by the drawer and transmitted to the payee. If the drawer is the payee or if the check is drawn payable to cash the transmittal is completed by the drawing of the check. A draw order, such as a prearranged debit through an automated clearing house, may be initiated by the payee on behalf of the drawer and sent to an account institution. Seller drafts drawn on buyers, if for acceptance by an account institution, direct the drawee to accept. A "draw order" may be written, e.g. a check, or electronic, e.g. a prearranged debit through a clearing house. All draw orders *pull* credits back to the person entitled to payment in a direction opposite to the one in which the order is transmitted.
>
> A "pay order" goes from the drawer to the drawee directing the drawee to pay or effect payment to the payee. A pay order always has a payee, although the payee may also be the drawer as on a home terminal or telephone instruction ordering a bank to transfer funds from a checking to a savings account. If the drawee holds the account of the payee, the "pay order" asks the drawee to pay the payee; if the payee's account is with another account institution, the drawee is asked to effect payment to the payee. This may be done through another account institution, as by a telex to a correspondent, or through settling account institutions, as by a Fed Wire. The order and the funds are from the drawee to the payee, and the order and funds move in the same direction. Wire transfers, prearranged credits through an automated clearing house, telephone and home terminal transfers are all "pay orders'. In addition, electronic point-of-sale orders are regarded as pay orders. The cardholder orders its issuer to pay the merchant on the transaction. While the merchant may obtain a credit from its own bank based on a written receipt for the transaction or electronic notice of the transaction, "payment" must still be made by the issuer to the merchant's bank for the transaction to be completed.

See also Hal S. Scott, *Corporate Wire Transfers And The Uniform New Payments Code*, 83 COLUM. L. REV. 1664, 1679-80 (1983).

In a “draw order” funds transfer system such as the check system, an unauthorized funds transfer might be caused by intervention at either the originator’s end of the transaction or at the beneficiary’s end of the transaction. In the originator fraud scenario, the fraudster forges the drawer’s signature on a check. The fraudster might direct that payment be made to its own account, or to an account opened in the name of a fictitious person, but the essence of the fraud is that the fraudster initiated a transfer that was never authorized by the actual customer. In the beneficiary fraud scenario, the fraudster takes check that was genuinely drawn by the drawer and diverts payment to the fraudster away from the intended beneficiary. Translating the description of these two basic scenarios from functional terms into the conventional terminology of the check collection system, we can consider two simple check fraud scenarios: forgery of the drawer's signature (originator fraud) and forgery of an indorsement (beneficiary fraud). Let us consider the basic loss allocation approach that has been taken to these two scenarios, taking them up in opposite order.

In the forged indorsement scenario, Drawer draws a genuine check to the order of Payee on its account with Payor Bank and sends it to Payee. Fraudster steals the check from Payee, forges Payee's indorsement, and deposits the check for collection at the bank at which Fraudster maintains an account, herein described as Depository Bank.[31] Depository Bank forwards the check to Payor Bank which pays it. Assuming no negligence, the loss rests with Depository Bank. In the simplest remedial scenario,

[31] Of course, if the funds transfer had not been diverted by Fraudster, the intended payee would also have initiated collection by depositing the check at its depository bank. Thus, other than in cases where the fraudster happens to use the same bank as the intended payee, in the forged check scenario the fraudster causes the check to be collected by the wrong bank acting as depository bank.

Payee, as owner of the check, brings a conversion action against Depository Bank. Payee prevails under section 3-420 because Depository Bank has "obtai[ned] payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment." Fraudster was not a person entitled to enforce, because the instrument was payable to Payee, not Fraudster, and Fraudster's indorsement in the name of Payee is ineffective. The result in this case might be explained on grounds familiar from negligence law on the basis that Depository Bank is perhaps in the best position to have prevented the loss by demanding better identification from Fraudster before cashing the check or opening the account for Fraudster. In fact, however, it is doubtful that negligence concepts are the basis of the loss allocation rule. The result in the forged indorsement case is entirely consistent with ordinary concepts of property and conversion. Suppose that Fraudster had stolen a painting from Payee and sold it to Depository Bank. Depository Bank would be liable to Payee in conversion because Depository bank dealt with the painting for a person not its true owner. The liability of a person who takes stolen property from a thief is not in any sense based on negligence, but simply on the fact that the person has purchased property from a person not its true owner.

In the forged drawer's signature scenario, Fraudster steals a blank check from Drawer, and makes it payable to Payee, forging Drawer's signature. Payee deposits the check for collection at Depository Bank. Depository bank forwards the check to Payor Bank which pays it. When Drawer discovers the loss, it complains to Payor Bank. Payor Bank is required to recredit Drawer's account, because Payor Bank has charged the account for the amount of an item that was not genuinely drawn by its customer.

If Payor Bank seeks to pass the loss to Depository Bank, its cause of action would be an action for restitution of money paid by mistake. Ordinarily a bank that has paid out money to a person not entitled to receive it would prevail in a restitution action, as in the common case of a bank's payment by mistake to person it erroneously believed was its customer, or overpayment to an actual customer.[32] Yet Payor Bank will lose in an action against Depository Bank, or any prior party, under the rule derived from the venerable case of *Price v. Neal*.[33] Under the rule of *Price v. Neal*, there is an exception to the usual principle that money paid by mistake can be recovered, so that a drawee that pays a check over the forged indorsement of the drawer cannot recover the money. Thus, in the case of forgery of the drawer's signature, the loss rests with the Payor Bank.

The rationale for the rule of *Price v. Neal* has often been questioned. At the time of the decision, in the late eighteenth century, the result might have been justified by ordinary negligence concepts. The theory would be that the drawee, or payor bank, is expected to know the signature of the drawer, and therefore placing the loss on the drawee is consistent with the notion that the drawee was in the best position to have prevented the loss. As Lord Mansfield is reported to have said in the case itself, "it was incumbent upon the plaintiff [the drawee] to be satisfied 'that the bill drawn upon him was the drawer's hand,' before he accepted or paid it."[34] That rationale was noted, although with some skepticism, in the Comments to former 3-418, "The traditional

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[32] *E.g.*, *Bank of Naperville v. Catalano*, 408 N.E.2d 441 (1980). *See generally* 3 GEORGE E. PALMER, THE LAW OF RESTITUTION § 14.8 (1978); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 6 (Tentative Draft No. 1, 2001)

[33] 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1763).

[34] 3 Burr. at 1357, 97 Eng. Rep. at 872.

justification for the result is that the drawee is in a superior position to detect a forgery because he has the maker's signature and is expected to know and compare it." Under modern conditions, however, that rationale is questionable, and has frequently been doubted. Given the realities of modern high-volume check processing, it is quite unlikely that the payor bank will actually have any significant chance of detecting the forgery of its drawer's signature. Indeed, the weakness of this rationale has long been noted. Over a hundred years ago, James Barr Ames pointed out that "if the drawee's negligence were the test, he ought to be allowed to show, in a given case, that he was not negligent; for example, that the forgery was so skillfully executed as naturally to deceive him."[35] Skepticism about any negligence rationale for the rule has been repeated again and again by writers on commercial law.[36]

The alternative rationale advanced in the comments to the original version of Article 3 was that "a less fictional rationalization is that it is highly desirable to end the transaction on an instrument when it is paid rather than reopen and upset a series of

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[35] James Barr Ames, *The Doctrine of Price v. Neal*, 6 HARV. L. REV. 297, 298 (1891). Ames also correctly notes that the negligence of a person who pays money by mistake is not, in other circumstances, a defense to an action in restitution to recover money paid by mistake. *Id*. In a statement that says as much about changes in the profession's attitudes toward explanation of doctrine as it does about the issue itself, Ames concluded that "the true principle, it is submitted, upon which cases like Price v. Neal are to be supported, is that far-reaching principle of natural justice, that as between two persons having equal equities, one of whom must suffer, the legal title shall prevail." *Id*. At 299.

[36] *See, e.g.*, 4 HAWKLAND, *supra* note 1, § 3-418:2 ("This rationale … does not withstand close scrutiny. The drawee bank may not always be able to detect a forgery, even by use of reasonable care. For instance, the forger may have obtained a facsimile of the drawer's signature, thereby making a perfect forgery."); WHITE & SUMMERS, *supra* note 1, 17-2 at 614 (If Price v. Neal is founded on the theory that any drawee who fails to discover a forged drawer's signature is negligent and thus not entitled to recover payment, there should be an exception to that doctrine for those cases in which the signature is so cleverly forged that a banking employee using due care could not discover the forgery.")

commercial transactions at a later date when the forgery is discovered." That contention has fared no better with the commentators. As White and Summers observe, there is no apparent basis for permitting transactions to be re-opened in forged indorsement cases yet precluding that result in cases of forgery of the drawer's signature.[37]

Not surprisingly, then, when a fresh look was taken at the law of the check system, at the time of the ill-fated proposed Uniform New Payments Code in the early 1980s, the rule of *Price v. Neal* appeared to be headed for extinction. Section 204 of the New Payments Code provided that "each customer, transmitting account institution or transferor of an unauthorized draw order is liable to all parties to whom the draw order is subsequently transmitted and who pay accept or give value in exchange for the order in good faith, if it has transmitted an unauthorized order …."[38] The commentary announced, with near glee, that this section "marks the death knell for Lord Mansfield's famous opinion in Price v. Neal."[39] As is wel~~l~~ known, the proposed Uniform New

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[37] WHITE & SUMMERS, *supra* note 1 §17-2 at 614.

[38] Uniform New Payments Code § 204(1) (P.E.B. Draft No. 3 1983). The treatment of Price v. Neal in the New Payments Code is discussed at length in Steven B. Dow & Nan S. Ellis, *The Proposed Uniform New Payments Code: Allocation of Losses Resulting from Forged Drawers' Signatures*, 22 HARV. J. LEGIS. 399 (1985).

[39] Uniform New Payments Code § 204(1) cmt. 2 (P.E.B. Draft No. 3 1983). Inasmuch as drafts of the proposed Uniform New Payments Code are not widely available, it may be worth setting forth at length the comments on the rule of Price v. Neal:

> Subsection (1), applicable to draw orders, marks the death knell for Lord Mansfield’s famous opinion in Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762), which held that no warranty of the genuineness of the drawer’s signature is given to the payor bank by a person transmitting a check for collection This principle is preserved in Articles 3 and 4, by the limited warranties given to the payor or acceptor under U.C.C. 3-417 (1) and 4-207 (1), and by the rule that payment is final in favor of a holder in due course or a person who has in good faith changed position in reliance on payment, U.C.C. 3-418. ….

Payments Code encountered substantial objection—perhaps because, as its name suggests, it was a wholly new and unified treatment of the law of all payment systems—

> The rationale for the rule is not convincing. First, the traditional justification that the drawee is in a superior position to detect the forgery seems dubious today. Given the computerized payment of checks, necessitated by the high volume of items submitted for payment, it is uneconomical for an account institution to check the validity of all signatures. This is reflected by the reality that banks do not check signatures under a certain dollar amount even though they will be liable. It is cheaper to bear the liability than to avoid it. Of course, signatures on checks over a certain dollar amount are scrutinized, and the dollar amount screen often depends on the type of account, e.g. corporate or consumer.
>
> The second rationale for the rule is finality–the need for repose on transactions. If there is a close decision on the superior position rationale, the argument is that the issue should be resolved by making the payor bank liable to avoid reopening the transaction. *See* Comment 1 to U.C.C. 3-418. It must be recognized, however, that there is no such repose in cases of forged endorsements where warranties are now given to the payor bank, *see* U.C.C. 3-417 (1) (a); 4-207(1) (a).
>
> Not only is the rationale for the rule questionable, but the rule can be thought of as not giving adequate incentives to payees to check on the bona fides of people drawing checks to them. Under existing law, a merchant cashing a check need not be concerned with whether a person paying by check is actually the owner of the account on which the check is drawn. If *Price v. Neal* is abolished such incentives would exist. Check cashing outside the banking system is much less computerized thus allowing better opportunities for verifying the identity of a check casher. … Absent *Price v. Neal*, not only would the depositary bank be liable to the payor on a forged drawer's check, but the depositor would be liable to the depositary. If the depositor was not the payee, as on a third party check, loss would ultimately lie with the payee, the taker from the thief. Of course, the payee might be out of the picture, so the third and arguable innocent party would be at risk, but endorser insolvency or dishonesty is a risk generally run by endorsees on third party checks. Account institutions should generally support abolishing Price v. Neal because risks now borne by them could be shifted to their customers.
>
> In addition, application of *Price v. Neal* makes no sense in cases of check truncation, where the drawer's signature is not available for inspection by the payor account institution – assuming technology could not capture the signature at a reasonable cost. Since, on balance, the rule has no convincing justification and some significant costs in today's high speed check processing environment, it is abolished.

and the ambitious project was abandoned.[40] The revision of Articles 3 and 4 that emerged from the more limited project that took the place of the proposed Uniform New Payments Code continues the rule of *Price v. Neal*.[41] Perhaps the appetite of those participating in the revision for significant change had simply been worn down, or perhaps the banks that might be expected to seek a change to the rule preferred to fight other battles.[42] In any event the rule of *Price v. Neal* is continued by the revision and the commentators appear to regard the rule as a product of history that is unjustifiable under modern conditions, but unlikely to change.[43]

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[40] For a brief account of the history of the ill-fated New Payments Code project, and its transformation into the more limited project for addition of Article 4A on wholesale wire funds transfers and revision of Articles 3 and 4, see Fred H. Miller, *U.C.C. Articles 3, 4 and 4A: A Study in Process and Scope*, 42 ALA. L. REV. 405 (1991).

[41] U.C.C. § 3-418(a) & (c). The commentary abandons any effort at providing a policy rationale for the rule, noting merely that, "Subsections (a) and (c) are consistent with former Section 3-401 and the rule of *Price v. Neal*." *Id*. cmt. 1. *See also* U.C.C. § 3-417 cmt. 3 ("subsection (a)(3) retains the rule of Price v. Neal … that the drawee takes the risk that the drawer's signature is unauthorized unless the person presenting the draft has knowledge that the drawer's signature is unauthorized.")

[42] As one observer has noted:

> To begin with, the revision does not change the basic rule of *Price v. Neal*. Although this rule has been much criticized, it does not create operational problems. In fact, it is clearly the simplest rule from an operational perspective, because it requires that drawee banks simply absorb certain losses that they might otherwise pass on by litigation or negotiation under a negligence or a quasi-negligence regime. Apparently, this operational simplicity is enough of an advantage so that banks have not been anxious to change Price v. Neal and escape additional liability. The revision, as might be expected from its underlying policy, leaves the rule unchanged on the basis of these operational considerations.

Edward L. Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the UCC*, 43 BUS. LAW. 621 (1988).

[43] *See, e.g.,* Lary Lawrence, AN INTRODUCTION TO PAYMENT SYSTEMS 245 (1997) ("Why, you may ask, does the payor bank suffer the loss? I wish that I could give you some

Given the uniform and long-standing criticism of the rule of *Price v. Neal*, the surprising thing is that it has so long endured. It is, of course, possible that this is simply an example of inertia. But before abandoning any effort to justify the rule, it is worth giving the matter another thought.

The seeming anomaly of the rule in *Price v. Neal* emerges clearly from a diagram of the forged indorsement and forged drawer's signature scenarios.

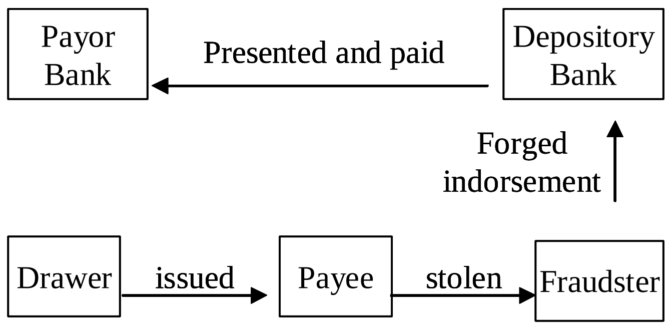

Figure 1-1 Forged Indorsement

In the forged indorsement scenario, the loss rests with the person who took the instrument from the Fraudster, that is, the Depository Bank. The result seems consistent with basic negligence concepts and sound policy, in that the Depository Bank is probably in the best position to have avoided the loss by exercising greater care before taking the instrument from the Fraudster.

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logical explanation. All of the proffered explanations appear to be more like rationalizations.")

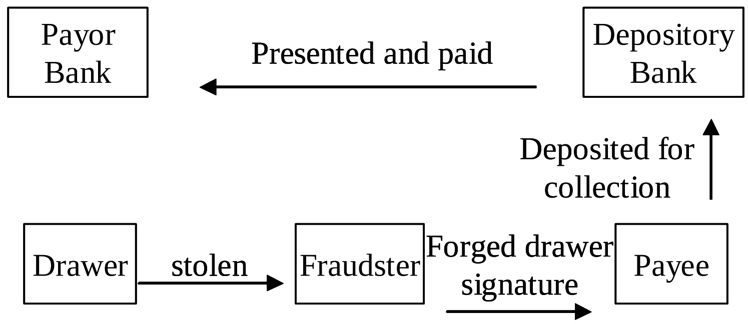

Figure 1-2 Forged Drawer Signature

In the forged drawer signature scenario, the loss rests with the Payor Bank, under the rule of *Price v. Neal*. This seems rather peculiar since the Payor Bank did not, in any sense, dealt with the Fraudster. Once one passes the unrealistic eighteenth century concept that it was somehow negligent for the Payor Bank to fail to detect the forgery, one is left with little reason for placing the loss with the Payor Bank rather than with the person who took the instrument from the Fraudster, who at least had some opportunity to prevent the loss by more careful dealing.

In considering whether the rule of *Price v. Neal* is in fact an anomaly, it is important to state the issue correctly. The issue addressed by the rules on forged indorsements and the *Price v. Neal* rule is not who bears the loss if some party might be charged with negligence. That question is addressed by other provisions of the Code ensuring that if there is a basis for a finding that someone's negligence substantially contributed to the forgery, that person will bear the loss. Rather, the question is who bears the loss in the absence of a particularized showing of negligence, or, more to the point, who bears the loss if there is no basis for concluding that anyone's negligence contributed to the loss. In other words, the issue is not who should bear the loss in most cases, but who should bear the loss in those cases where the loss was, as a practical matter, unpreventable. Once the issue is correctly framed, it seems doubtful that negligence principles help much in resolving it. To say that the loss should be borne by the person in the best position to have avoided it provides no guidance on the question of loss allocation where, by hypothesis, the loss was unavoidable.

Moreover, one must avoid the fallacy of confusing descriptions of the role that actors play in a particular transaction with descriptions of the parties themselves. There is no such thing as a "Payor Bank" or a "Depository Bank." There are only banks. In some transactions a given bank acts as payor of checks and in others the same bank acts as a depository. The terms do not designate different actors or different categories of actors, but simply the role that the particular actor happens to have played in a particular transaction.   There is a far more significant description of the banks, whether payor or depository. They are the providers of the check payment system. Viewed as such, the basic diagrams of the forged indorsement and forged drawer signature scenarios may be recast as follows:

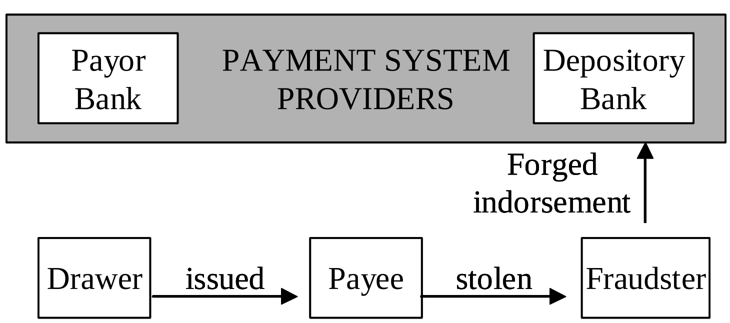

Figure 2-1 Forged Indorsement

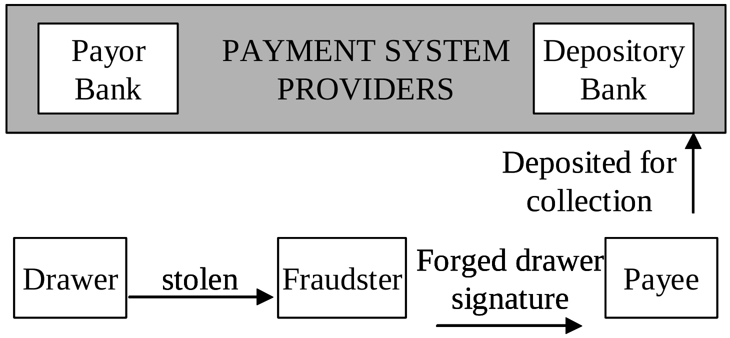

Figure 2-2 Forged Drawer Signature

Under the existing rules, the loss in the forged indorsement scenario is borne by the providers of the payment system. As it happens, the particular participant that bears the loss is the one that offered the depository rather than the payor function, but from the standpoint of overall allocation of the costs of forgery losses, that is a minor point. Under the existing rules—specifically under the rule of *Price v. Neal*—the loss in the forgery of the drawer's signature scenario is also that the providers of the payment system bear the risk of unavoidable losses. In the forged drawer signature scenario, the particular bank that bears the loss is the payor bank rather than the depository bank. Again, however, the question of which bank bears the loss is a secondary point. The significant point is that the loss is borne by one of the providers of the payment system rather than by a user of the system.

Now, consider what would happen if the rule of *Price v. Neal* were reversed. As usually imagined, that would mean, in the current drafting structure, changing the warranties given on presentment of an item from a warranty of "no knowledge" of forgery of the drawer's signature to a flat warranty that the drawer's signature was genuine. Thus the Payor Bank could recover from the Depository Bank for breach of warranty. In turn, the Depository Bank could recover from the Payee for breach of the transfer warranty of the genuineness of the drawer's signature. The result would be that the loss rests with the Payee. From the standpoint of potential ability to prevent the loss, that seems to make sense. However, once the question is properly framed as who bears the loss of unpreventable forgeries; the change makes much less sense.

It is worth remembering that in the real world there is no such thing as a "Drawer" or a "Payee." There are only people who use the check system.[44] Sometimes a user plays the role of drawer and sometimes the role of payee. But, that is a matter of detail. The important distinction is that one is either a user of the payment system or a provider of the payment system. Making that simplification, we can recast our diagrams as follows:

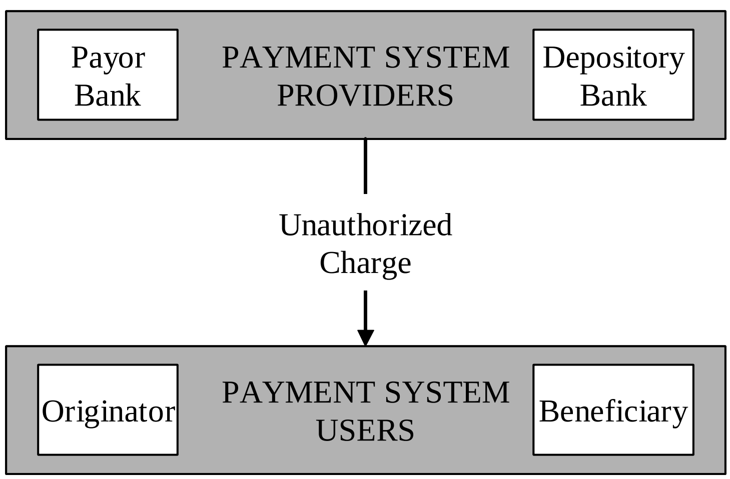

Figure 3-1

The combination of the rules of forged indorsements and forged drawers signatures produces a simple result. By contrast, if the rule of*Price v. Neal* were rejected, there

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[44] For present purposes, however, we can retain the notion that there is a class of persons properly identified as "Fraudsters."

would be no uniform general principle. Rather the outcome in the general class of unauthorized charge cases would be that whether the loss is borne by the payment system providers or the payment system users would depend on the quirk of where and how the fraudster intervened in the payment transaction. If the fraudster intervened at the originator end, the risk of unpreventable losses would be borne by a user. If the fraudster intervened at the beneficiary end, the risk of unpreventable losses would be borne by a provider.

Thus, correctly viewed, the rule of *Price v. Neal* is not at all anomalous. Quite the contrary, the rule of *Price v. Neal* is entirely consistent with the rules on forged indorsements. The anomalous situation is the one that would prevail if the rule of *Price v. Neal* were eliminated. If such a change were made, the result would be that the burden of unpreventable losses is borne not by the providers of the payment system but by the users of the system.[45]

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[45] The *Price v. Neal* principle has been changed in a relatively minor respect by the most recent revisions of Articles 3 and 4. The change involves the recently-developed practice of consumers agreeing with utility companies and others to whom they make routine payments that the payee, rather than drawer, can create an item that will be collected through the check system for the amount of the consumer's monthly bill. As applied to such an item, the ordinary rule of *Price v. Neal* that would impose the loss from unauthorized items on the payor bank can well be considered inappropriate. Instead, it seems appropriate to impose on the entity that created the item the burden of assuring itself that the customer has genuinely consented. That change is effected by the 2002 amendments to Articles 3 and 4. The amendments define a "remotely-created consumer item" as "an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer." U.C.C. § 3-103(16). The revision then creates a warranty by the transferor or presenter that the item has been authorized by the consumer. U.C.C. §§ 3-416(a)(6); 3-417(a)(4); 4-207(a)(6); 4-208(a)(4). The effect of the changes is that a user does bear the risk of loss, but the limitation of the change to remotely-created consumer items assures that that change applies only in cases where the user who will bear the risk of loss is the party that submitted the item for collection. So limited, the change is essentially consistent with the

Thus, the rules on forged indorsements and the rules on forged drawers' signatures together embody a very basic but important principle: *The burden of unpreventable losses should rest with the providers of the payment system rather than with the users of the payment system.*

III. Basic Principles of Loss Allocation in the Other Payment Systems

We may test our conclusions about the loss allocation principle for the check system by considering how the law of other payment systems treats two basic questions:

1. Whether the risk of unpreventable losses is borne by the providers of the payment system or the users of the payment system, and

2. If the default rule places the risk of unpreventable losses on the providers of the payment system, whether an agreement shifting that loss to the users of the payment system would be enforceable.

A. Bank Credit Cards

Prior to 1970, there was no statutory law on the allocation of fraud losses from credit cards. The case law had not reached any uniform approach to fraud loss allocation. The earliest cases involved identifying coins or other tokens issued by department stores to their customers for use in connection with credit purchases. Several early cases dealt with the question of customer liability for unauthorized charges made by persons who had stolen the credit coins. An early Pennsylvania case treated the credit coin as analogous to a negotiable instrument in bearer form, thereby concluding that the

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basic principal that the providers of the payment system bear the risk of loss for unpreventable losses.

customer was liable for unauthorized use.[46] By contrast another case of about the same era concluded that the analogy to bearer negotiable instruments was inapt, concluding that the customer bore no responsibility for unauthorized charges.[47] A somewhat later case, involving a gasoline company credit card, concluded that on the particular facts, the customer was liable for the charges made by a thief, but the court indicated in passing that "ordinarily [the customer] should not be held liable for the debt created by the use of it by a thief or one not authorized to obtain credit on it."[48]

In these early cases, however, there appears to have been no agreement on the matter of unauthorized use, so the attitude of common law courts toward private agreements on loss allocation remained unclear. Perhaps the best-known case of the pre-statutory era on that issue was the 1960 Oregon decision in *Union Oil Co. v. Lull*.[49] A car was stolen and the thief ran up charges on a gasoline company credit card that had been left in the car. An agreement concerning the use of the card, printed on the back of the card itself, provided that:

> The customer to whom this card is issued guarantees payment within 10 days of receipt of statement, of price of products delivered to services rendered to anyone presenting this card, guarantee to continue until card is surrendered or written notice is received by the company that it is lost or stolen.[50]

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[46] Wanamaker v. Megary, 24 Pa. Dist. 778 (Phila. Mun. Ct. 1915).

[47] Lit Bros. v. Haines, 98 N.J. 658, 121 A. 131 (1923).

[48] Gulf Refining Co. v. Plotnick, 24 Pa. D. & C. 147, 151(C.P. Lancaster County 1935).

[49] 349 P.2d 243 (Ore. 1960).

[50] *Id*. at 245

The Oregon court rejected the cardholder's contention that the cardholder's liability for unauthorized use should be limited to cases "where, through his fault, the card was used by one not authorized to do so," ruling that such a construction was clearly contrary to the agreement and "nothing in the transaction … would justify this modification of the conditions clearly expressed on the card."[51] The court, however, seized upon the use of the term "guaranty" as the device by which the agreement imposed fraud loss on the cardholder. That unfortunate bit of draftsmanship enabled the court to draw upon the well-established principle that "promises of the uncompensated surety, guarantor or indemnitor are to be strictly construed, it sometimes being said that such promisors are favorites of the law."[52] Drawing on suretyship principles, the Court easily concluded that the cardholder's liability for unauthorized use was conditioned upon the exercise of due care by the merchants accepting the card. Furthermore, and perhaps most significantly, the Court concluded that the card issuer bore the burden of proving that the merchants accepting the card made reasonable inquiry to determine whether the person presenting the card was its authorized user. As one well-known commentator has observed, "[b]ecause such a burden of proof would be nearly impossible to sustain in many situations, the court seems to have bent over backwards to protect the consumer against such notice clauses."[53]

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[51] *Id*. at 247. One wonders how "clear" the terms could have been given that a rather lengthy legend was apparently printed on the back of the card itself. The cardholder, however, had not at trial raised the issue whether the legend should be disregarded on contract of adhesion grounds, so the appellate court declined to consider that issue. *Id*. at 246-47.

[52] *Id*. at 249.

[53] 2 CLARK & CLARK, *supra* note 1 ¶ 15.03[1].

The common law development of the law of cardholder liability for unauthorized use came to a halt with the enactment of federal legislation in 1970.[54] The federal statute limits cardholders' liability for "unauthorized use," defined as a use of the card by a person "who does not have actual, implied, or apparent authority for such use and from which the cardholder receives no benefit."[55] Under the federal statute, the cardholder is never liable an unauthorized use beyond the amount of $50, and then only if the cardholder accepted the card, the issuer gave adequate notice of potential liability, the issuer provided a means of notification in the event of loss or theft, the unauthorized use occurred before notice was given to the issuer, and the issuer provided a method for identification of the authorized user, such as a signature requirement.[56]

The provision on liability for unauthorized use of credit cards was added to the Federal Consumer Credit Protection Act in 1970 by a rider attached to a statute on a different subject.[57] For legislative history of the credit card measure, one must look to the hearings and report on the credit card bill as it had previously been adopted in the Senate.[58]

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[54] P.L. 91-508, Tit. V, 84 Stat. 1114, 1126-27 (1970).

[55] Truth in Lending Act § 103(o), 15 U.S.C. § 1602(o). Most of the caselaw deals with disputes about whether a use of the credit card by a relative or friend of the named cardholder was "authorized," commonly in the setting of disputes among family members in connection with divorce or equivalent breakdown of non-marital relationships. See 2 CLARK & CLARK, *supra* note 1 ¶ 15.03[2][a] (2002).

[56] Truth in Lending Act § 133(a)(1), 15 U.S.C. § 1643(a)(1).

[57] P.L. 91-508, Tit. V, 84 Stat. 1114, 1126-27 (1970).

[58] S. 721, 91st Cong., 2d Sess. (1970), S. REP. NO. 91-739, 91st Cong., 2d Sess. (1970); *Unsolicited Credit Cards: Hearings on S. 721 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency*, 91st Cong. 2d Sess. (1970) [hereinafter cited as "Hearings on S. 721"].

It is quite clear from the hearing and report that the principal issue of concern to the Congress was unsolicited mailings of credit cards. Unsolicited mass mailing of credit cards was, in large measure, the way that the bank credit card industry was born and grew. The practice, however, was considered to pose substantial problems in that it might encourage unwise overuse of credit by consumers, and in that it posed very significant problems arising out of theft of cards from the mail prior to their receipt by the intended addressee. Section 132 of the Federal Consumer Credit Protection Act,[59] prohibits unsolicited mailing of credit cards.

The provision of § 133 limiting a card holder's liability for unauthorized use of an accepted credit card seems to have been regarded more as a nice addition to the package of legislation on unsolicited credit cards than as a legislative response to a problem perceived to be serious. Although there was much mention in the hearing of problems faced by consumers in rectifying billings for merchandise purchased by someone who stole an unsolicited card from the mail, there is little in the legislative history to suggest that there was a serious problem of credit card issuers actually attempting to collect from consumers for purchases actually made by an unauthorized user, either before or after notice of the loss or theft of the card. Arthur Brimmer, a member of the Board of Governors of the Federal Reserve System, testified as follows:

> In the case of the misuse of cards stolen or lost after being accepted by the cardholder it is generally true that the customer has no liability for fraud losses after the bank has been informed that the card is lost or stolen. As for the liability of the cardholder prior to informing the bank, there is much more variation in banks' policies. Some banks seek to collect in these cases from the customer for all losses occurring before the bank was notified. Others do not attempt to collect even where the

[59] 15 U.S.C. 1642, added by the 1970 Act.

> customer does not report the loss or theft of the card. Still other banks (and some State statutes) specify an upper limit on the dollar liability of the customer.
>
> As we understand the situation, the majority of banks follow the practice of absorbing losses, but do not reveal the policy to their customers for fear they might be unduly careless in their handling of the card. This is often true even where the banks inform the customer that his liability if limited to, say, $50 or $100. These announced limits are primarily designed to make the customer take care in the handling of the card and to stimulate prompt reporting of lost or stolen cards. Actual policy, therefore, is often more lenient than announced policy.
>
> We would like to see all banks inform their credit card customers of the potential liability. This and the related aspects of customer liability are too important to leave to uncertainty on the part of the customer. Failure to disclose the terms of liability are not tolerable standards of business conduct for card issuers.[60]

No witness seems to have disagreed with the idea of the limitation on liability, nor to have suggested that it would actually change the practice of card issuers. [61] The only basis for the $50 liability seems to have been a desire to encourage prompt reporting of the loss or theft of cards by holding out the threat of $50 liability. The only disagreement seems to have been on the question of whether the $50 limit was too low to put teeth into the threat.[62]

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[60] Hearings on S. 721, at 19.

[61] *See, e.g.*, Statement of Thomas L. Bailey, Chairman, Bank Card Committee of the American Bankers Ass'n., Hearings on S. 721, at 106; Statement of James E. Brown, Director of Interbank Card Ass'n., Hearings on S. 721, at 118; Statement of Edward J. McNeal, President of the American Retail Federation, Hearings on S. 721, at 124-25.

[62] Consider, in this regard, the following interchange between Senator Proxmire and Edward J. McNeal, President of the American Retail Federation:

> *Senator Proxmire*: Are you familiar with the laws of Massachusetts and Illinois with respect to cardholder liability?
>
> *Mr. McNeal*: I understand there is some limitation on cardholder liability in those States. I believe in the case of Massachusetts it is $100. I am not familiar with ----

Senator Proxmire: $75 in Illinois.

Mr. McNeal: $75 in Illinois.

Senator Proxmire: To your knowledge, has there been any adverse effect on retailing as a result of these laws?

Mr. McNeal: To the best of my knowledge, there has not been.

Senator Proxmire: You do not have any compliments by the merchants that they have been inhibited by this?

Mr. McNeal: Not to my knowledge, sir, but we believe to make a ceiling unrealistically low invites fraud, which I think could create very serious problems.

Senator Proxmire: What would you consider unrealistically low?

Mr. McNeal: Well, we are concerned about the $50 limitation on your bill, sir, and naturally, the higher it was the better we believe it would be, because we believe that this would prevent the indiscriminate disregard by a customer who has an accepted credit card. I think the consumer would guard his card more readily if he was aware that there was some liability if he did not take the necessary precautions.

Senator Proxmire: So many people who have cards are likely to have three, four, or five. It would seem to me he has a liability of $150 to $250 if he lost his wallet or his cards. He would certainly be in a position to have a strong incentive to notify the company.

Mr. McNeal: He would. But in most cases, however, he has requested these cards and therefore he has some duty and responsibility to safeguard their well-being. They are a convenience to him and naturally they are a convenience to the merchant or other person who has distributed them to him.

Senator Proxmire: If you lost your checkbook and somebody forges your name or uses your check, you are not liable at all.

Mr. McNeal: This is correct, and in the case of the overwhelming majority of retailers there is no liability on a person who takes the necessary precautions.

Senator Proxmire: The point I make is, as credit cards replace checks, the consumer gradually loses his rights. With a check he has a clear right, no liability; with a credit card he has unlimited liability now and even under the provision of my bill he would have a $50 liability, and you say he ought to have a bigger liability than that or your implication is that we should.

Since the limitation on cardholders' liability is contained in a federal statute, and since that statute makes no provision for expansion of cardholder liability, an agreement that purported to impose greater liability on the cardholder would obviously be unenforceable. The statute does not even leave this to inference, but states explicitly that "[e]xcept as provided in this section, a cardholder incurs no liability from the unauthorized use of a credit card."[63] Indeed, one might well question whether a cardholder bears any liability for an unauthorized use. The federal statute does not say that the cardholder is liable for the first $50; rather it says that the cardholder is not liable for any amount in excess of $50. Moreover, the statute provides explicitly it does not impose any liability on the cardholder "in excess of his liability … under other applicable law or under any agreement with the card issuer."[64] As noted above, the case law prior to the enactment of the federal statute was far from clear on whether an agreement imposing liability on the cardholder for unauthorized use would be enforceable.

B. Consumer Electronic Funds Transfers

As consumer electronic funds transfer systems began to be implemented in the early 1970's, there was considerable concern about whether there was an adequate body of laws governing the rights and obligations of the participants. Some suggested that little, if anything, need be done, on the theory that Article 4 of the U.C.C. supplied the

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> *Mr. McNeal*: I must say I do not believe that the analogy to the check is exact or accurate today. I believe there is a vast difference between a checking account today and a credit card

Hearings on S. 721, at 127.

[63] Truth in Lending Act § 133(d) 15 U.S.C. § 1643(d).

[64] Truth in Lending Act § 133(c) 15 U.S.C. § 1643(c).

applicable law, or could be made to do so by a minor modification of the § 4-104 (1) (g) definition of "item."[65] Most observers, however, were less sanguine about the ease with which existing check law could be adapted to EFT systems.

Much of the concern began to center around the matter of the rights of consumer users of EFT systems against the financial institutions providing the systems. In 1974, Congress established the National Commission on Electronic Fund Transfers to investigate various issues concerning EFT and report thereon to the Congress.[66] The Commission issued its final report in 1977.[67] The Commission's report dealt with a variety of issues beyond matters of payments system law, such as the impact of EFT on privacy rights, security of EFT systems, bank regulation issues, the impact of EFT on competition, anti-trust concerns, the impact of EFT on monetary policy and regulation, etc. Our present concern is limited to issues of payments system law of the sort for which Articles 3 & 4 of the U.C.C. provide the governing law in the check system. In this area, the Commission's basic recommendation was that given the evolving state of EFT systems, "the appropriate approach to these new financial service concepts is, in general, to permit their further evolution in a relatively unconstrained way …."[68] On the other hand, the commission noted that existing law was in some instances inadequate and that new legislation was called for. "[S]ome aspects of consumer concern are so fundamental that they should be addressed at this time in order to guarantee to consumers a number of

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[65] *See* John J. Clarke, *An Item Is an Item Is an Item: Article 4 of the U.C.C. and the Electronic Age*, 25 BUS. LAW. 109 (1969).

[66] Pub. L., No. 93-495, 93d Cong. 2d Sess. (1974) (codified at 12 U.S.C. § 2403-08).

[67] NATIONAL COMMISSION ON ELECTRONIC FUND TRANSFERS, EFT IN THE UNITED STATES (1977) (hereinafter cited as NCEFT Report).

[68] NCEFT Report at 6.

basic rights in an EFT environment."[69] On the specific issue of liability for unauthorized use, the Commission recommended that "an EFT account holder should have no liability for an unauthorized use of his account unless the depository institution can prove, without benefit of inference or presumption, that the account holder's negligence substantially contributed to the unauthorized use and that the depository institution exercised reasonable care to prevent the loss."[70]

Congress did not wholly adopt the suggestions of the NCEFT. Rather, it followed a model somewhat closer to that used for credit cards, in which the careful consumer's liability for unauthorized use would, in most cases, be limited to $50. The legislative history suggests that no-one thought that the user should liable for unauthorized use, nor that the issue should be left entirely to private agreement; rather the issue was seen as a problem of devising a liability scheme that would include an adequate incentive to ensure careful customer behavior while not imposing the prospect of ruinous liability on the user.[71] The liability scheme ultimately adopted by the federal legislation reflects these

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[69] *Id*.

[70] *Id.* at 58. The Commission further recommended that negligence "should be limited to writing the PIN on the card, keeping the PIN with the card, or voluntarily permitting the account accessing devices, such as the PIN and the card, to come into the possession of a person who makes or causes to be make an unauthorized." *Id*.

[71] The federal EFT Act was ultimately enacted in the closing hours of the 95th Congress as one ornament on what had by then become a Christmas tree bill covering diverse banking law subjects. Title XX of the Financial Institutions Regulating and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat, 3641, 3278 (codified at 15 U.S.C. §§ 1693-93r as an amendment adding Title 1X to the Consumer Credit Protection Act, 15 U.S.C. §1601-92). For the legislative history of the EFT Act, we must look primarily to the reports and hearings on its predecessor bills in the House and Senate. For the views of the NCEFT, see *Consumer Protection Aspects of EFT Systems, Hearing Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing and Urban Affairs*, 95th Cong., 2d Sess. 9-10 (1978) (Statement of Herbert Wegner, Vice-Chairman

concerns by setting forth a somewhat complicated liability system, and by conferring authority on the Federal Reserve System to adopt regulations implementing the statute.[72] As is the case with the federal law on credit cards, the starting place is the definition of an "unauthorized electronic funds transfer" as a transfer from a consumer's account "initiated by a person other than the consumer without actual authority to initiate the transfer and from which the consumer receives no benefit."[73] The statute then establishes a multi-tiered liability scheme.

Initially, the consumer bears no liability for unauthorized use unless the financial institution has satisfied three requirements.[74] The access device must be an "accepted

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of the NCEFT). For general views on the $50 liability limit, see H. REP. NO. 95-1315, 95th Cong., 2d Sess. 9-11 (1978).

[72] Federal Electronic Funds Transfer Act §§ 901-20, 15 U.S.C. §§ 1693-1993r; Federal Reserve System Regulation E, 12 C.F.R. §§ 205.1 – 205.16. For convenience, citations herein are to the Regulation E provisions, without corresponding provisions of the statute itself.

[73] Reg E, 12 C.F.R. § 205(2)(m).

The EFT rules limit liability for use of an access device without "actual authority," 12 C.F.R. § 205(m), while the credit card rules limit liability for use without "actual, implied, or apparent authority," TILA § 103(o), 15 U.S.C. § 1602(o). The difference in wording poses difficulties in EFT cases where the consumer has done something that might constitute a conferral of implied or apparent authority upon another and then seeks to withdraw that authorization. The EFT rules might be read to have no application to such a case, on the grounds that the use was not a use without "actual authority" and hence was not an "unauthorized" use. Regulation E, however, goes on to provide that the term "unauthorized electronic funds transfer" does not include a use by a person to whom the consumer gave the access device "unless the consumer has notified the financial institution that transfers by that person are no longer authorized." 12 C.F.R. § 205(m)(1). That provision might be read to imply that once the consumer gives notice any further use by the other person is an "unauthorized" use to which the liability limits apply. On the other hand, the proviso on notice might be read as independent of the basic definition limiting unauthorized use to uses without actual authority. The interpretive problem is discussed in 1 BAKER, BRANDEL, &. PANNABACKER, *supra* note 1 ¶14.02[3][a] (2003).

[74] Reg E, 12 C.F.R. § 205.6.

access device;"[75] a limitation addressed to the problem, common in the early days of credit cards and consumer EFT, of the mailing of unsolicited cards to consumers.[76] The financial institution must have provided a mechanism by which the authorized user of the device can be identified, such as a PIN or other identification method.[77] The financial institution must have provided written disclosure to the consumer concerning unauthorized use liability and the means of notification of loss or theft of the device.[78]

The first tier liability limit establishes the basic principle that a consumer's liability for an unauthorized electronic fund transfer is limited in amount to $50, provided that the consumer notified the financial institution of loss of theft of the access device within two business days after learning of the loss or theft.[79] The second tier liability limit provides that a consumer who fails to give notice of loss of theft of the access device within two business days may be liable for loss up to $500. The third tier liability rule provides that a consumer who fails to report an unauthorized transfer within sixty days after a periodic statement is sent showing the unauthorized transaction may be liable without limitation if the financial institution establishes that the loss could have been prevented had the consumer properly examined that statement and reported the unauthorized transfer.[80]

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[75] Reg E, 12 C.F.R. §§ 205(a)(1) & (2) & 205.6.

[76] *See* 1 BAKER, BRANDEL, &. PANNABACKER, *supra* note 1 ¶ 14.01; 2 CLARK & CLARK, *supra* note 1 ¶ 15.02[2].

[77] Reg E, 12 C.F.R. § 205.6(a).

[78] Reg E, 12 C.F.R. § 205.6(a).

[79] Reg E, 12 C.F.R. § 205.6(b)(2).

[80] Reg E, 12 C.F.R. § 205.6(b)(3). This provision is adapted from the rule, long a part of the law of the check system, that imposes liability upon a customer for sequential

As is the case with respect to credit cards, federal law leaves absolutely no room for expansion of cardholder liability by private contract Indeed, the provisions concerning the effect of private agreement on cardholder's liability for unauthorized electronic funds transfers are copied directly from the federal legislation on credit cards. Thus, the statute provides that "[e]xcept as provided in this section, a consumer incurs no liability from an unauthorized electronic fund transfer."[81] Moreover, as is the case with the credit card legislation, the federal legislation on EFT provides that the customer's liability may be reduced by other applicable law or agreement.[82]

C. Wholesale Electronic Funds Transfers

Wholesale electronic funds transfers are governed by Article 4A of the U.C.C.[83] Given the size of the typical business-to-business wire transfer, Article 4A establishes the

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forgeries if the customer fails to promptly examine statements and report forged checks. *See* U.C.C. § 4-406; 1 CLARK & CLARK, *supra* note 1 ¶ 10.05.

[81] 15 U.S.C. § 1693g(e)

[82] 15 U.S.C. § 1693g(d); Reg E, 12 C.F.R. § 205.6(b)(6).

[83] To be more precise, Article 4A applies to any "funds transfer," § 4A-102. "Funds transfer" is defined by §4A-104(a) as "the series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order." "Payment order" is defined by § 4A-103(a)(1) as an instruction transmitted directly to a bank by the sender instructing that payment be made to a beneficiary. The key element of the definition is that the instruction for payment be transmitted by the sender directly to the bank that is to make the payment. Thus, Article 4A applies to credit transfers, that is, instructions given by the person making the payment to a bank. It does not apply to transactions, such as check payments, in which the instruction goes from the person making the payment to the person to receive the payment, who in turn initiates collection through the banking system. U.C.C. § 4A-104 cmt. 4. The application of Article 4A is in effect limited to business transactions by U.C.C. § 4A-108, which provides that Article 4A does not apply if any part of the funds transfer is governed by the federal Electronic Funds Transfer Act, 15 U.S.C. § 1693 et seq., which covers any electronic funds transfer from a bank account "established primarily for personal family, or household purposes" 15 U.S.C. § 1693a(2).

most economically significant set of legal rules on fraudulent payment transactions. Indeed, it has been estimated that wire transfers governed by Article 4A account for at least 85% of the dollar value of all payment transactions in the U.S. economy.[84]

The allocation of responsibility for fraudulent orders is governed by a rather complex set of rules set out in sections 4A-201 through 4A-203.[85] The statutory pattern begins with the rule in section 4A-202(a) that a payment order "is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency." Assuming that the receiving bank has accepted the order, the sender becomes obligated to pay the amount of the order to the receiving bank.[86] Standing alone, this rule would impose liability on the customer only if the payment order was in fact authorized by the customer, or some principle of agency law precluded the customer from denying authorization. The customer would incur no liability if the transaction was not authorized or the customer was not otherwise bound under the law of agency.

The actual authorization rule of section 4A-202(a) is, however, supplemented by the rule on "verified" payment orders set out in section 4A-202(b). If the receiving bank

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Although the common application of Article 4A is to wholesale funds transfer initiated by electronic means, the Article actually applies to any business credit transfer, regardless of the means of communication used.

[84] ROBERT L JORDAN, WILLIAM D. WARREN AND STEVEN D. WALT, NEGOTIABLE INSTRUMENTS, PAYMENTS AND CREDITS 237 (5th ed. 2000), citing *Finance: Trick or Treat?*, THE ECONOMIST, Oct. 23, 1999, at 91.

[85] *See generally*, Paul S. Turner, *The UCC Drafting Process and Six Questions About Article 4A: Is There a Need for Revisions to the Uniform Funds Transfer Law?*, 28 LOYOLA L. A. L. REV. 351 (1994); J. Kevin French, *Article 4A's Treatment of Fraudulent Payment Orders—The Customer's Perspective*, 42 ALA. L. REV. 773 (1991);

[86] U.C.C. § 4A-402(b) & (c).

and the customer have agreed that the authenticity of payment orders is to be verified by a security procedure, the security procedure is commercially reasonable, and the bank accepted the order in good faith and in compliance with the security procedure, then the receiving bank can treat the order as the effective order of the customer, even though it was not authorized nor was the customer otherwise precluded from denying authenticity under the law of agency. The content of the test of "commercial reasonableness" of a security procedure is somewhat further explicated by section 4A-202(c), which provides that the question of commercial reasonableness is to be determined by the court, rather than jury, based on such factors as the wishes and circumstances of the customer and practices of similarly situated customers and banks.[87]

The rules of subsections (a) and (b) of section 4A-202 on authorized and verified payment orders are subject to an important qualification by section 4A-203. That rule

[87] The statute also provides that any security procedure is deemed to be commercially reasonable if the bank offered another procedure that was commercially reasonable, but the customer declined to use that procedure and expressly agreed in writing that it would be bound by any orders accepted by the bank in compliance with the procedure chosen by the customer. U.C.C. § 4A-202(c).

In a sense, the special rule of section 4A-202(b) on commercially reasonable security systems can be thought of as an adaptation of general agency principles to the special circumstances of the wire funds transfer business. Suppose that the statute contained no special rules on commercially reasonable security procedures, stating only the basic rule set out in section 4A-202(a) that an order can be treated as the authorized order of the customer if it is in fact authorized or the customer is precluded from denying authority under the law of agency. Suppose further that the bank and customer had in fact agreed upon a security system for testing payment orders and that a particular order, though not in fact actually authorized, passed muster under the security procedure adopted by the bank and customer. If the customer denied authority, a fact issue would arise under the law of agency or related law, concerning whether the customer should be precluded from denying authenticity having agreed to the use of a reasonable security procedure. The special rule of section 4A-202(b) places that inquiry and analysis or a surer footing, by establishing a special rule adapted to the circumstances of the funds transfer business, but the rule is not, in basic approach, very different from the approach that might have been developed by the courts under the general law of agency.

deals with payment order that are not "authorized" but can be treated as "effective" under the special rule of section 4A-202(b) on orders verified pursuant to a commercially reasonable security procedure. Under section 4A-203, the receiving bank is not entitled to charge the amount of an unauthorized payment order to the customer, even though the order passed muster under a commercially reasonable security procedure, if the customer is able to prove that the order was not caused by any person who either was entrusted by the customer with responsibility concerning payment orders or obtained from the customer either access to transmitting facilities or information facilitating a breach of the security system. The principle of section 4A-203 can be seen as a specific instance of the general point discussed above that the rules on allocation of loss from unauthorized payments need to distinguish between internal and external perpetrators of the fraud. Under section 4A-203, if the customer proves that the unauthorized payment order did not originate from anyone internal to the customer's organization, or anyone who obtained information essential to commission of the fraud from someone internal to the customer's organization, then the loss will be borne by the bank. If the customer is unable to make such a showing, then the loss will be borne by the customer.

Read together, the Article 4A rules establish both a substantive rule and a set of rules on the allocation of the burden of persuasion. Viewed solely as substantive rules, that is, assuming that all the relevant facts are known and proven, the principle is fairly simple: the bank bears the loss from external fraud; the customer bears the loss from internal fraud. The complexity is primarily a matter of allocation of the burden of proof. If the order was verified by a commercially reasonable security system, then the burden is on the customer to prove that the loss was not caused by anyone internal to the customer's organization or anyone who obtained essential information from someone internal to the customer's organization. If the customer cannot make such a showing, then the customer bears the loss from an unauthorized but verified payment order.

One of the most striking things about the Article 4A rules on allocation of loss from unauthorized payments is the approach taken to the possibility of variation by agreement. By virtue of the scope provisions, Article 4A is effectively limited in application to transactions between banks and business entities. Under section 4A-108, the Article 4A rules do not apply to any funds transfer any part of which is subject to the federal Electronic Funds Transfer Act,[88] which covers any electronic funds transfer from a bank account "established primarily for personal family, or household purposes."[89] Moreover, the typical transaction to which Article 4A applies is not one between a bank and a small business enterprise that might be regarded as occupying the borderline between the sphere of commercial affairs and consumer affairs. Rather, Article 4A deals with transactions between large commercial entitles. In such situations, the typical approach taken by the commercial law is to defer almost entirely to freedom on contract. Under the basic rule of UCC section 1-102(3), the effect of provisions of the Code may be varied by agreement of the parties, subject to the limitation that an agreement may not disclaim responsibilities of good faith, diligence, and reasonableness. On its face, Article 4A appears to adopt a similar approach.

Section 4A-501 reads much like other provisions of the Code permitting variation by agreement. It provides that "except as otherwise provided in this Article, the rights

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[88] 15 U.S.C. § 1693 et seq.

[89] 15 U.S.C. § 1693a(2).

and obligations of a party to a funds transfer may be varied by agreement of the affected party." The catalog of specific provisions that preclude variation by agreement is, however, rather extensive.

For present purposes, the most important non-variability rule is that set out in subsection (f) of section 4A-202, which provides that the liability system set out in sections 4A-202 and 4A-203 cannot be varied by agreement. Thus, the basic loss allocation rules for unauthorized payment orders—including the rule of section 4A-203 that the bank is liable for an unauthorized order if the customer is able to prove that it was a case of external fraud—is not subject to variation by agreement. The list of non-variable rules is, however, considerably more extensive.

Section 4A-305 provides that if a funds transfer is not completed in a timely fashion, the receiving bank that caused the failure is liable for the loss of the time-value of the money. Significantly, the bank is not otherwise liable for consequential damages—the issue involved in the well-known *Evra Bank* case.[90] Though the main effect of this rule is to exclude consequential damages liability, the remaining liability of

[90] *Evra Corp. v. Swiss Bank Corp.*, 673 F 2d 951 (7th Cir. 1982). In the *Evra Bank* case itself, the Seventh Circuit ruled that consequential damages could not be recovered for failure to complete a funds transfer in a timely fashion. The basis of the Court's decision, however, was that under the venerable case of *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854), consequential damages could not be recovered in the absence of a showing that the defendant was aware of the special circumstances that might give rise to those damages. That approach would leave the banks involved in wholesale funds transfers exposed to the possibility of extensive consequential damages liability in any case in which there was a basis for concluding that the bank had notice of the special circumstances. See U.C.C. §4A-305 cmt. 2.

the bank—for the loss of the time-value of the use of the money—cannot be varied by agreement.[91]

Section 4A-402 establishes the “money-back guaranty” rule, under which the obligation of the originator to pay its own bank is excused if the finds transfer is not completed the beneficiary’s bank. In the absence of this statutory rule, one can well imagine that agreements between originators and their banks would provide that the originator’s bank bears no responsibility for the failure on some other bank to complete the transaction. Under the “money-back guaranty” rule, however, the originator is excused from any liability to pay its own bank if the transaction is not properly completed, even though that might be the result of some other bank’s failure. Under section 4A-402(f), this rule cannot be varied by agreement.

Section 4A-404 provides that once the beneficiary’s bank has accepted a payment order, the bank is obligated to make payment to the beneficiary, and may face liability for consequential damages for failure to do so, if the bank had notice of the circumstances giving rise to the potential consequential damage claim. Under section 4A-404(c) this liability of the beneficiary’s bank cannot be varied or disclaimed by agreement.

Section 4A-405 describes the mechanism by which a beneficiary’s bank makes payment of an order to the beneficiary, the usual mechanism being by credit to an account of the beneficiary and notice of that credit to the beneficiary. Absent some special rule, it would not be surprising to find that banks routinely placed conditions on a beneficiary’s right to receive payment or made the credit provisional or otherwise subject

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[91] U.C.C. § 4A-305(f).

to revocation. Under section 4A-405(c), however, any such condition or provisional credit agreement is generally unenforceable.[92]

Section 4A-406 provides that the originator's underlying obligation to the beneficiary is discharged at the time that the beneficiary's bank accepts a payment order for the benefit of the beneficiary. Subsection (d) of section 4A-406 provides that these rights of the beneficiary can be varied only by agreement between the beneficiary and the originator; that is, an agreement between either of the partiers and any of the banks involved in the funds transfer process would be unenforceable.

Thus, the statement in section 4A-501(a) that "except as otherwise provided in this Article" the rights and obligations of the parties to a funds transfer may be varied by agreement reminds one a bit of the old quip "Well other than that, Mrs. Lincoln, how was the play?" Section 4A-501(a) purports to state the usual rule permitting variation by agreement, but the list of exceptions covers essentially all of the basic liability rules of Article 4A. How is one to account for this radically anti-agreement stance in a part of the commercial code that is singularly designed to cover primarily transactions between sophisticated parties?

There has been considerable discussion and debate in recent years about the drafting process for revisions and new articles of the Uniform Commercial Code. A principal theme in that debate has been whether the process is adequate to the task of

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[92] Subsections (d) and (e) of section 4A-405 establish limited exceptions to the rule that agreements cannot make credits provisional, covering certain payment through automated clearing houses and "doomsday" scenario rules of systems such as CHIPS that provide for multilateral netting and establish loss-sharing rules. *See* U.C.C. § 4A-405 cmts. 3 & 4; Norman R. Nelson, *Settlement Obligations and Bank Insolvency*, 45 BUS. LAW. 1473 (1990)

assuring balanced input from all affected groups.[93] I have no wish to enter into that debate here. Rather, the only point of present significance is that the drafting process for Article 4A was singularly well-suited to the objective of achieving a balance of input from providers of the wholesale wire transfer system and users of the system. The fact that transactions involving consumers were excluded from the coverage of Article 4A meant that the difficult issue of assuring adequate representation of consumer interests was not presented in the Article 4A project. Moreover, the fact that the transactions covered by Article 4A tend to involve large amounts of money, and tend to involve major non-financial firms as users, meant that the users of the system had sufficient economic incentive to participate in the drafting process. The list of Advisors and Additional Participants for the Article 4A project includes not only a representative of the organization representing large users—the National Corporate Cash Management Association—but also representatives of such major individual users as Exxon, General Motors, Sears Roebuck, and Shell Oil.[94] The official comments to section 4A-102 state quite explicitly that the drafting process for the Article 4A was a process of balanced negotiation between providers and users of the system:

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[93] A catalog of articles on the Code revision process is provided in Fred H. Miller, *Realism Not Idealism in Uniform Laws—Observations from the Revision of the UCC*, 39 S. TEX. L. REV. 707, 708-09 n. 5 (1998).

[94] 2B Pt II Uniform Laws Annotated 6. *See generally* Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising UCC Articles 3 and 4*, 26 LOY. L.A. L. REV. 743, 762-65 (1993)(describing role of providers and users in the Article 4A drafting process). The fact of extensive participation by representatives of providers and uses is undisputed, though Prof. Rubin's assessment of the role of industry representatives has been sharply disputed. *See* Donald J. Rapson, *Who Is Looking Out for the Public Interest? Thoughts About the UCC Revision Process in the Light (and Shadows) of Professors Rubin's Observations*, 28 LOY. L.A. L. REV. 249 (1994)

> Funds transfers involve competing interests—those of the banks that provide funds transfer services and the commercial and financial organizations that use the services, as well as the public interest. These competing interests were represented in the drafting process and they 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 the 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.

Professor Warren, one of the two Reporters for the project, has described the participation of the affected groups in the drafting process:

> This process worked at its best in the deliberations on Article 4A. At first, the differences among the three principal players—the Fed, CHIPS and the large corporate users—seemed intractable. … Initially, these three groups seemed to enjoy bashing each other at our meetings. But over the years, owing in no small measure to the intelligence, judgment and firmness of Robert Jordan, who drafted Article 4A, differences were narrowed and a reasonable degree of consensus was achieved. A leading financial services lawyer and veteran of many legislative projects noted that never before had so many people knowledgeable about the legal and operational problems of wholesale wire transfers spent so much time together going over legislative proposals in such exhausting detail. He likened it to peeling the layers of an onion. In the end it worked.[95]

The issue of allocation of responsibility for fraudulent payment orders was one of the matters that prompted extensive debate and negotiation between providers of the payment system and users, with the parties beginning, as one might well expect, with the position that the other side should bear the responsibility. Ultimately a compromise position emerged, the basic elements of which were (1) the users agreed that providers would not bear consequential damage liability for failure to complete a transfer, thereby

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[95] William D Warren, *UCC Drafting: Method and Message*, 26 LOY. L.A. L. REV. 811, 815 (1993).

eliminated the potential of liability under the rule of the *Evra Bank* case, (2) the providers agreed to the “money back guarantee” provision ensuring that an originator would be absolved of responsibility to its own bank if the transfer was not completed, and (3) the providers agreed to the package of rules on unauthorized transfers ultimately included in sections 4A-201 – 4A-203, including the rule that the bank bears the responsibility for an unauthorized transfer which the user proves to have been the result of external fraud.[96]

Although the official comments do not explain the basis for the extensive series of provisions prohibiting variation by agreement, the attitude toward variation by agreement is easily understood in light of the drafting process for Article 4A. On the key controversial issues of consequential damages, money-back guaranty, and liability for unauthorized transfers, the drafting process was itself a process of negotiation and compromise between providers and users.[97] Moreover, the human beings involved in that negotiated compromise were the people from their respective organizations who had the

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[96] *See* Carl Felsenfeld, *Strange Bedfellows for Electronic Funds Transfers: Proposed Article 4A of the Uniform Commercial Code and the UNCITRAL Model Law*, 42 ALA. L. REV. 723, 746-50 (1991); Carl Felsenfeld, *But the Proposed Uniform [?] Commercial Code Was Adopted*, 26 LOY. L.A. L. REV. 597, 605 (1993); Rubin, *supra* note 94, at 763-65.

[97] On the Article 4A drafting process, see Carlyle C. Ring, Jr., *The UCC Process—Consensus and Balance*, 28 LOYOLA L. A. L. REV. 287 (1994). The specific resolution of the much disputed isue of liability for unauthorized funds transfers was the result of a last minute suggestion by Donald Rapson, *see* Turner, *supra* note 85; a fact that Mr. Rapson has confirmed in private correspondence with the author. There is, of course, room for doubt about whether the precise resolution of that point should be taken to represent a carefully thought-out position, or merely the product of the inevitable quirks of the drafting process. For present purposes it suffices that the compromise position—including the important substantive principal that the providers of funds transfer services bear the liability for unpreventable outsider fraud—was a position that could command agreement from all affected parties.

greatest degree of expertise in the details of the wire transfer business and had spent extensive time and effort thinking through the problems of the business and plausible arrangements between users and providers. By contrast, the human beings involved in setting up a particular wire transfer arrangement are unlikely to have either the time or experience to write or review documentation and assess the impact of particular choices about liability rules. Thus, on the fundamental principles involved in the negotiated compromise that produced Article 4A, it is hard to see that any advantage could be produced by individual negotiation. In short, the process of negotiation that is assumed to be the basis for rules in the U.C.C. permitting widespread variation by agreement had already taken place. The drafting process was the negotiation. Little could be gained, and much could be lost, by allowing the resolution of those points to be re opened every time a funds transfer agreement is entered into.

D. Summary—Other Payment Systems.

Thus, we see for payment systems other than the check system, the law has quite uniformly recognized two basic principles: (1) That the risk of loss from unpreventable forgeries is borne by the providers of the payment system rather than by the users; and (2) that no agreement between a provider and a user will be enforceable if it seeks to place on the user the risk of loss from unpreventable. Thus, if the approach of the *Jefferson Park* case is followed we would have the anomalous situation that only the check system—the payment system that has been the subject of the longest development in caselaw and statute—would be governed by a regime of complete freedom of contract.

IV. SIGNED VERSUS AUTHORIZED

How, then, are we to reconcile two seemingly inconsistent propositions: that an agreement between a payor bank and its customer cannot be given effect to the extent that it reverses the basic principle that a payor bank cannot charge a customer’s account for an item which was not authorized by the customer; and that a facsimile signature agreement is, in general, effective to resolve the question whether a facsimile signature is to be treated as genuine. The answer may lie in a distinction, which may be insignificant with respect to manual signatures but significant with respect to facsimile signatures, between

(1) the question whether the signature on a check is genuine, or is to be treated as genuine; and

(2) the question whether the check is authorized, or is to be treated as authorized.

With respect to manually signed checks, the question whether the signature of the drawer is genuine and the question whether the item is authorized are essentially identical. If the signature is genuine, then the check is authorized. Conversely, if the signature is not genuine, then the check is not authorized. Suppose, for example, that Principal has a broken hand and cannot write. Principal authorizes agent to sign an item in the name of Principal. We decide whether check is authorized by deciding whether the mark is or is not to be treated as the signature of Principal. The question whether the mark is to be treated as the signature of Principal is resolved by deciding whether the Agent was or was not authorized to place Principal's signature on the item.

The fact that in the ordinary case of manually signed checks the questions of signature genuineness and authority are identical does not mean that those questions are identical with respect to other cases. Suppose, for example, that in lieu of the facsimile signature device, the practice had developed of permitting unsigned checks. That is really not all that far-fetched. Exactly the same practice has developed with respect to credit cards. At one time, no merchant would accept a credit card payment without obtaining the signature of the user. Today, unsigned credit card use is common, for example in telephone sales and in sales from unmanned devices such as gasoline pumps. There would be no conceptual difficulty, however, in distinguishing authorized from unauthorized use of credit cards in unsigned transactions. If a thief steals a credit card and uses it to purchase goods over the telephone or at an unmanned gasoline pump, it can easily be concluded that the use was unauthorized despite the fact that the presence or absence of a signature would play no role in that determination.[98]

Similarly, in consumer electronic funds transfer transactions, there is no difficulty in distinguishing between authorized and unauthorized electronic funds transfers despite the absence of a signature device. A nice illustration of the point is provided by a clever EFT fraud discovered in late 2002 in the Boston area. The malefactors attached a small electronic device to the front of ATM machines over the spot where the card was ordinarily inserted. An official-looking notice was attached to the machines informing users of a change and instructing them to insert their cards. The device read and recorded the account number and PIN but reported that a malfunction prevented the cash from

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[98] As it happens, the liability rules for credit cards are such that the issue would not arise in litigation. Under the federal statute governing cardholder liability, an issuer cannot charge a cardholder for a use of the card unless, among other things, "the card issuer has provided a method whereby the user of such card can be identified as the person authorized to use it." 15 U.S.C. § 1643(a)(1)(F).

being dispensed. After a few hours, the malefactors returned to the ATM machine and removed the device, having thereby trapped the information needed to use the card.[99]

If the malefactors used the information obtained by the scheme to withdraw funds from a cardholder’s account, there would be no difficulty in the analysis of whether the withdrawal was authorized or not. Under the Federal Electronic Funds Transfer Act, a consumer's liability for unauthorized electronic funds transfers is limited to $50, with a higher maximum if the consumer fails to promptly report the theft of a card. The question whether the withdrawal was authorized or not is a simple factual issue. Under the act, an "unauthorized electronic funds transfer" is a transfer initiated by a person "without actual authority" unless the transfer was initiated by a person "who was furnished with the card, code, or other means of access to such consumer's account by such consumer."[100] The question whether the withdrawal was authorized is not at all resolved by asking merely whether the correct PIN was used. Indeed, the fact that the correct PIN was used tells the bank nothing about whether a particular use of the card was authorized. The fact that the correct PIN was used is entirely consistent with many possibilities, including (1) an actual authorized use of the card and PIN by the cardholder, or (2) a use of the card and PIN by someone other than the customer who had been given actual authority by the customer to make the withdrawal, or (3) a use of the card and PIN by someone who had not been authorized by the customer, but whose use of the card was facilitated by the customer's carelessness in, for example, writing the PIN on the card, or (4) an entirely unauthorized use of the card and PIN by someone, such as

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[99] *2 Arrested In Alleged ATM Card Scam*, BOSTON GLOBE, Oct. 19, 2002, at B6.
[100] Electronic Funds Transfer Act §903(11), 15 U.S.C. §1693a(11).

the malefactors in the clever scheme, who had obtained the account number and PIN by nefarious means for which the customer bears no responsibility, or even (5) an unauthorized use of the card and PIN by an employee of the bank who misuses information obtained in the ordinary course of employment. We have no difficulty seeing that there is a difference between two issues: whether the transaction was in fact authorized by the customer and, whether the bank had any means of telling whether the transaction was in fact authorized by the customer. The fact that the correct PIN was used does not completely resolve the question whether the transfer was in fact authorized. Rather, that is a question to be determined under agency law and related principles.

In the EFT setting, then, the relationship between the question whether the PIN was used and whether the transfer was authorized is more complex than the simple notion that authorization turns solely on the use of the PIN. It is, of course, the case, that if a transaction is effected without use of the PIN, then that use would not be an authorized use for which the customer can be charged. For example, if a malefactor discovered a way to make ATM withdrawals from accounts without any use of the card or PIN, the withdrawals would obviously be unauthorized and the bank could not charge them to the customer's account. But, the fact that the correct PIN was used does not, without more, determine that the transfer was authorized. In the case of the clever EFT fraud described above, the correct PIN would have been used, but that fact does not demonstrate that the withdrawals were authorized. Rather, the question of authority turns on whether the customer in fact authorized the use of the PIN. In ordinary cases, that will turn on the customer's care and conduct in safeguarding the PIN. As the clever EFT fraud case illustrates, however, it is entirely possible that the correct PIN was used, but that the malefactor obtained the PIN by a means entirely beyond the responsibility of the customer. In that case, there would be no difficulty concluding that the use was not authorized.

The facsimile signature on checks issued pursuant to a facsimile signature arrangement might be treated in essentially the same fashion as the PIN in a consumer electronic funds transfer. The absence of any signature would, of course, demonstrate that the check was unauthorized, just as a withdrawal from an ATM machine made without the use of the PIN would be an unauthorized transfer. That, however, is a point of relatively little significance. The more important point is what consequences flow from the fact that a check does bear a facsimile signature, or a signature that resembles the facsimile signature on file with the bank. Under the common form of facsimile signature resolution, the fact that the check bears a facsimile signature, or a signature that resembles the facsimile signature, settles, without more, the question of the bank's authority to charge the amount of the check to the customer's account. By contrast, in the case of an electronic funds transfer, the fact that the correct PIN was used does not foreclose the customer from showing that the withdrawal was not in fact authorized. If facsimile signatures were treated in the same fashion as the PIN in electronic funds transfers, the fact that a check bears the correct facsimile signature, or one which resembles the correct facsimile signature, would not end the inquiry into authorization. Rather, it would remain open to the customer to show that the particular check was not authorized by the customer, nor did the facts warrant any preclusion of the customer from asserting the lack of authority. In short, rather than treating the presence or absence of a facsimile signature as the same question as that of authorization, these two questions would be treated as distinct inquiries, as is the case in other forms of payment transactions. While that approach may provide a possible solution to the problem of external fraud in facsimile signature cases, we need to consider in more detail precisely how a court confronted with an allegation of an unauthorized facsimile signature should treat the common form of facsimile signature resolution, which appears to place the risk of loss on the customer, regardless of how the authorized facsimile signature came to be placed on the check.

V. ENFORCEABILITY OF FACSIMILE SIGNATURE RESOLUTIONS

We have previously considered whether the explicit statutory limits on variation by agreement would impose significant restraints on the enforceability of a facsimile signature resolution that imposes on the customer the risk of loss for any check that appears to bear a facsimile signature. As we have seen, the only explicit limitation on variation of the statutory rules by private agreement is the section 4-103(a) rule that an agreement cannot "disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care." As we have also seen, the unresolved issue in application of the rule is the content of the principal that good faith requires observance of "reasonable commercial standards of fair dealing."[101] Specifically, the question is whether an agreement would be enforceable if it imposes on the customer the risk of loss for essentially unpreventable fraud, notwithstanding the basic principle of all payment systems that the providers, not the users, bear the risk of unpreventable loss.

[101] See TAN 23-24.

The question whether section 4-103(a) or related principles would permit agreements that vary fundamental rules of the check collection system has been discussed in the literature most extensively in connection with the Article 4 provisions on stop payment orders. Section 4-403 provides that a customer may stop payment of a check, provided that the stop payment order is delivered to the payor bank at a time and manner that permits that bank to act upon it. The text of the statute contains no explicit provision dealing with the question whether the stop-payment right may be restricted or eliminated by agreement. If the question were governed solely by the rule of section 4-103(a), then it would seem that a bank could, by agreement, eliminate the customer's right to stop payment, or, at least, absolve the bank of liability for a payment over a stop payment order in the absence of negligence by the bank. Yet the comments to section 4-403 indicate that the stop-payment right is more fundamental: "The position taken by this section is that stopping payment or closing an account is a service which depositors expect and are entitled to receive from banks notwithstanding its difficulty, inconvenience and expense. The inevitable occasional losses through failure to stop or close should be borne by the banks as a cost of the business of banking."[102] Commentators seem to agree that where the statute has so clearly stated that a certain right, such as the right to stop payment, is regarded as a fundamental part of the checking account relationship, an agreement that purports to eliminate that right would be unenforceable, even though it might be difficult to base that conclusion on the literal

[102] U.C.C. §§ 4-403 cmt. 1.

language of section 4-103.[103] As the leading commentators on the Code put it, "We believe that 4-103 incorporates the standard principle that parties may not depart from legislative statements of public policy, that section 4-403(a) is a statement of such a policy and that the forgoing Comment is an indication that the Code drafters did not intend that banks should have the right to eliminate the practice of stopping payment."[104]

To bring us somewhat closer to the specific issue of the enforceability of facsimile signature agreements, suppose that an agreement between a bank and its customer contained a provision that the bank would not be liable for payment of any check bearing a forged drawer's signature or forged indorsement, unless the bank failed to exercise ordinary care in paying the check. The Code clearly assumes that a bank is liable for wrongful payment in paying a check over a forgery of the drawers' signature or an indorsement. The comments to section 4-401 state, quite explicitly and without any qualification, that "[a]n item containing a forged drawer's signature or forged indorsement is not properly payable."[105] Is that fundamental principle subject to variation by agreement?

Though it is common to speak of a bank as incurring liability for paying a check over a forgery of the drawer's signature or an indorsement, there is a sense in which that way of phrasing the point is subtly but importantly inaccurate. Consider the precise basis of a customer's claim against its bank in connection with the bank's payment of a check

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[103] 1 CLARK & CLARK, *supra* note 1, ¶ 3.06[1][b]; 6A HAWKLAND, *supra* note 1, [Rev] §§ 4-403:1; WHITE & SUMMERS, *supra* note 1, §§ 18-2 & 18-5; Barry S. Roberts & Richard A. Mann, *A Proposal for Regulating Banks' Use of Exculpatory Clauses in Stop Payment Orders*, 84 Com. L.J. 183 (1979).

[104] WHITE & SUMMERS, *supra* note 1, § 18-2 at 653.

[105] U.C.C. § 4-401 cmt. 1.

containing a forgery of the drawer's signature or an indorsement. Suppose that Customer opens an account by a deposit of $1000 in cash. Later, Customer seeks to withdraw the $1000. Bank responds that the amount of the deposit is now zero, because Bank paid a $1000 check from the account. Customer responds that the check was not authorized. To take an extreme case, let us suppose that the facts are entirely known, that the $1000 check charged to the account was for a check drawn by Scalawag, and that Customer had absolutely no connection with the drawing of the authorized check. For example, suppose that Scalawag produced the check by using a photocopy machine so that Customer cannot even be held responsible for allowing Scalawag to get hold of a blank check. What, precisely, is the basis of the Customer's claim against the Bank?

Though it is common to speak of the bank as incurring liability for paying a check that was not properly payable, that is not really an accurate way of describing the situation. When Customer opened the account with a $1000 cash deposit, a debtor-creditor relationship was established. Bank was the debtor, having incurred a liability to Customer for $1000. Customer's claim against the Bank is simply a claim to enforce that debt. Customer asserts that Bank owes it $1000. Either Customer is right or wrong, but Customer's claim is based in the initial deposit. The question of the $1000 check enters the story only by reason of Bank's asserted defense that the amount of the debt is not the original $1000, but is now zero because the Bank has already repaid the debt by following Customer's instruction embodied in the $1000 check. If that check was not authorized by Customer, then Bank has failed to prove that the original $1000 debt has been diminished. Customer's claim that it is entitled to recover $1000 from Bank is not a liability based on negligence concepts on any related notions arising out of Bank's payment of the $1000 check. Rather Customer's claim is based on the original $1000 deposit. Bank's payment of the forged check enters the story only by way of an effort by Bank to defend the action on its $1000 debt obligation by asserting that it has already paid the debt.

If we are more careful in describing the basis of a customer's claim against its bank arising out of payment of an assertedly unauthorized check, it becomes quite clear why the customer's claim is not based on any assertion that the bank was negligent. Consider a simple case in an ordinary debtor-creditor relationship where the debtor repays the debt to someone that the debtor reasonably, but erroneously, believes to be the creditor or a representative of the creditor. The creditor then brings suit on the debt and the debtor seeks to defend on the grounds that it paid someone else under an honest mistake as to the identity or authority of the person receiving the payment. The only appropriate response would be laughter. There can be no doubt that payment made by mistake to wrong party does not discharge debt.[106] The response would be little different

[106] 70 C.J.S. *Payment* § 5 (1987); 60 AM. JUR. 2d *Payment* § 59 (2003); Lake v. Wilson, 35 S.W.2d 597 (Ark. 1931); Wagshal v. Selig, 403 A.2d 338 (D.C. 1979); Taylor v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 245 A.2d 426, (D.C.App.1968); Columbus Min. Co. v. Combs, 26 S.W.2d 26 (Ky. 1930); Fuge v. Quincy Co-op. Bank, 15 N.E.2d 199 (Mass.1938); Levine v. British Overseas Airways Corp., 322 N.Y.S.2d 119 (N.Y.City Civ.Ct. 1971); Eaton v. Calig, 446 N.E.2d 218 (Ohio Ct. App. 1982); Oklahoma Pub. Co. v. Video Independent Theatres, Inc., 522 P.2d 1029 (Okla. 1974); Gilliland v. Jones, 265 S.E.2d 263 (S.C. 1980). The question whether the mistaken payor can recover from the person to whom payment was made is a difficult issue in the law of restitution. *See generally* 3 GEORGE E. PALMER, THE LAW OF RESTITUTION §§ 14.1-14.28 (1978). That issue would be of no consequence if the mistaken payment itself discharged the debt, for the mistaken party would then have no concern in the matter. Indeed in the case commonly regarded as the starting place of the law of restitution permitting recovery of payment made by mistake, the fact that the mistaken payment cannot discharge the obligation to the actual creditor was regarded as too obvious to require any citation or discussion. Bonnel v. Foulke, 82 Eng. Rep. 1224 (K.B. 1657)

if we found, buried in the fine print of a promissory note, language that might be read to say that the debtor's liability would be discharged by the debtor's payment to any person that the debtor honestly believed was the creditor. Such a provision is fundamentally inconsistent with the basic concept of a debtor-creditor relationship. The debtor's liability is not based on fault, but on the simple fact of the making of the loan and non-payment thereof. Indeed, if an assertion that "something happened that made it much harder for me to repay the debt" were a defense to an action on a debt, there would be no need for a law of bankruptcy.

These considerations indicate that a provision in an account agreement that sought to eliminate the bank's basic liability for the debt would be unenforceable. So too, an attempt to place the customer's claim against the bank on something akin to a negligence basisshould be held unenforceable on the grounds that any such provision is inconsistent with the basic legal nature of the debtor-creditor relationship created by the opening of a bank account. The fact that the Code provision on variation by agreement speaks only in terms of limiting a bank's effort to disclaim responsibility for lack of good faith or ordinary care should be regarded as relevant primarily to those settings in which the concepts of ordinary care and good faith have some appropriate role to play. Indeed, the precise language used in section 4-103 is entirely understandable when it is recalled that Article 4 had its origin in the American Bankers Association Bank Collection Code,[107]

("And if I pay money in satisfaction of a debt, and he to whom it is paid has no title to receive it, *and so the duty is not satisfied*, he to whom the money is paid is thereby indebted to me ….")(emphasis added).

[107] The fullest account of the tortured history of Article 4 in the U.C.C. drafting process can be found in Allen R. Kamp, *Downtown Code: A History of the Uniform Commercial Code 1949-1954*, 49 BUFFALO L. REV. 360, 448-64 (2001).

which addressed only the relationship between a depositor and the collecting bank as agent for the depositor in attempting to collect the check.[108] In that setting, the basic obligation of the bank to the customer is an obligation to exercise care in attempting to collect the deposited item. By contrast, in the setting of the bank's liability to its customer for the amount of a collected deposit, and the bank's contention that the liability is diminished by a prior repayment, concepts of good faith and ordinary care have no role to play.

Thus, we come to the question of how a court should react if confronted by a case of an assertion by a customer of an unauthorized check paid from an account governed by a facsimile signature agreement and a response by the bank that the agreement places on the customer all responsibility for unauthorized payments. Specifically, suppose that the facts are it appears may well have been involved in the *Jefferson Park* case, to wit, an unauthorized charge is made and the customer is prepared to introduce evidence showing that the unauthorized facsimile check was not produced by any person who gained access to blank facsimile checks or the facsimile machine from the customer, but produced the bogus check by some form of desktop publishing technology. In the *Jefferson Park* case, a grant of summary judgment for the bank was affirmed, on the grounds that no factual issue was raised by the customer's contention that no evidence could be produced that the customer was in any way negligent. That ruling is correct only if a facsimile signature agreement is enforceable even if it places on the customer the risk of loss from wholly unpreventable forgeries that occur through means not involving any fault on the part of

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[108] The text of the A.B.A. Bank Collection Code can be found in 3 THOMAS B. PATON, PATON'S DIGEST §27 (1942).

the customer or any use of the customer's facilities. Yet, as we have seen, an agreement placing on the customer the risk of loss for wholly unpreventable forgeries is fundamentally inconsistent with the law of all payment systems, as well as with the basic debtor-creditor nature of the bank-customer relationship. Accordingly, insofar as it appears to say that no relevant fact issue was raised by the customer's contention that the unauthorized facsimile check was produced by means not involving any negligence by the customer, the *Jefferson Park* opinion is erroneous and should not be followed.

A somewhat more difficult question is presented by the circumstance that the customary form of facsimile signature agreement appears on its face to place the risk of loss on the customer regardless of the circumstances that resulted in the drawing of the unauthorized check. One can imagine many circumstances in which a check bearing a facsimile signature is produced as a result of some lack of care by the customer in safeguarding the facsimile signature machine or blank checks on the account. In the circumstances involved in many of the cases concerning facsimile checks, it appears that the customer bore some responsibility for a lack of care in safeguarding the machine or checks. In those cases, there seems to be little doubt that an agreement placing responsibility for the loss on the customer should be enforceable, for the only effect of the agreement is to particularize the general rule that would govern the case in any event, to wit that the customer is precluded from denying the authenticity of a signature if the customer's lack of care substantially contributed to the making of the unauthorized signature.[109]

[109] U.C.C. § 3-406(a).

One approach that a court might take is to rule that a facsimile signature agreement is simply unenforceable if it is drafted so broadly that it would impose the risk of loss on the customer even if the customer's conduct is entirely uninvolved. There is substantial support for that approach as a general issue of contract interpretation. Section 184 of the Restatement (Second) of Contracts provides that:

> (1) If less than all of an agreement is unenforceable [as contrary to public policy] a court may nevertheless enforce the rest of the agreement in favor of a party who did not engage in serious misconduct if the performance as to which the agreement is unenforceable is not an essential part of the agreed exchange.
>
> (2) A court may treat only part of a term an unenforceable under the rule stated in Subsection (1) if the party who seeks to enforce the term obtained it in good faith and in accordance with reasonable standards of fair dealing.

The commentary to this section provides some support for a contention that a court should decline to engage in an effort to reconstruct the typical form of facsimile signature agreement to separate the enforceable from the unenforceable:

> Sometimes a term is unenforceable on grounds of public policy because it is too broad, even though a narrower term would be enforceable. In such a situation, under Subsection (2), the court may refuse to enforce only part of the term, while enforcing the other part of the term as well as the rest of the agreement. The court's power in such a case is not a power of reformation, however, and it will not, in the course of determining what part of the term to enforce, add to the scope of the term in any way. A court will not exercise this discretion in favor of a party unless it appears that he made the agreement in good faith and in accordance with reasonable standards of fair dealing. … For example, a court will not aid a party who has taken advantage of his dominant bargaining power to extract from the other party a promise that is clearly so broad as to offend public policy by redrafting the agreement so as to make a part of the promise enforceable. The fact that the term is contained in a standard form supplied by the dominant party argues against aiding him in this request.[110]

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[110] RESTATEMENT (SECOND) OF CONTRACTS § 184 cmt. B (1979)

A ruling that the facsimile agreement is unenforceable as an overbroad agreement would not, of course, leave the bank with liability for all unauthorized facsimile signature checks. Rather, a ruling that the agreement is unenforceable as overbroad would mean only that the question whether the bank can charge the customer's account for the check is governed by the usual statutory rules. The customer would begin with an assertion that the signature was not genuine. The bank could respond with the usual statutory rule that the customer can be precluded from denying authenticity if the customer's "failure to exercise ordinary care substantially contributes … to the making of a forged signature."[111]

It is, however, somewhat difficult to square that approach with the many cases on facsimile signatures. There appears to be little variation in the wording of the facsimile signature agreements involved in the cases. All could, on their face, be read to impose on the customer to risk of loss even in a case in which the customer's conduct in no way contributed to the making of the unauthorized signature.[112] Yet, there are many cases in which facsimile signature agreement have been enforced in circumstances where it appears that the wrongdoer was an employee of the customer or in some fashion did gain access to the facsimile checks or machine from the customer.[113] To be sure, the

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[111] U.C.C. § 3-406(a).

[112] For example, the resolution in the *Perini* case authorized the payor banks to "honor all checks … when bearing or purporting to bear the single facsimile signature … regardless of by whom or by what means the actual or purported facsimile signature thereon may have been affixed thereto, if such facsimile signature resembles the facsimile specimen from time to time filed with said banks."

[113] See TAN 6-23.

contention that the usual form of facsimile signature resolution is fatally overbroad was not raised in the cases upholding the application of such resolutions to ordinary cases of insider fraud, so it is possible that a court could rule that the issue remains open. It does, however, seems more consistent with the many years of cases on facsimile signatures to forge an approach under which the resolutions could be upheld and applied in the ordinary insider fraud cases, yet leave it open to the customer to show that in a particular case its conduct in no way contributed to the making of the unauthorized signature.

At the very minimum, a court confronted with the issue should forge an approach consistent with the rules recently developed in Article 4A for electronic funds transfers. As has been noted above, under the Article 4A rules an electronic funds transfer can be charged to the customer's account provided that the charge was made in accordance with a commercially reasonable security procedure, but the customer can shift the loss to the bank

> if the customer proves that the order was not caused, directly or indirectly, by a person (i) entrusted at any time with duties to act for the customer with respect to payment orders or the security procedure, or (ii) who obtained access to transmitting facilities of the customer or who obtained, from a source controlled by the customer and without authority of the receiving bank, information facilitating breach of the security procedure, regardless of how the information was obtained or whether the customer was at fault[114]

The use of facsimile signatures on checks is so common that there should be no issue of whether an arrangement for payment of checks with facsimile signatures is a "commercially reasonable security procedure." Thus, the ordinary form of facsimile signature agreement would be given effect insofar as it places on the customer the initial

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[114] U.C.C. § 4A-203

risk of loss for any check that bears a signature that "resembles" the authorized facsimile signature. Yet, drawing on the Article 4A rule, that initial allocation of the burden of proof would not preclude a showing by the customer that in the particular case the unauthorized facsimile signature was made by an outsider who was not assisted in the fraud by anyone from the customer's enterprise. For example, the customer would be permitted to show that the facsimile signature was made by someone who simply got hold of a genuine check and used desktop publishing facilities to use it as a model for checks that appeared to be genuine but were produced by means entirely unconnected with the customer's operations.

A court might, however, reasonably conclude that the allocation of burden of proof adopted in Article 4A is not necessarily appropriate for cases involving ordinary checks. The expected case of wholesale wire transfer fraud is likely to involve significant sums of money. The comments to Article 4A indicate that the allocation of burden of proof in that context was based on the assumption that in criminal investigation of wire transfer fraud was likely and would ordinarily produce significant evidence about the causes of the fraud that could be used by the customer in any dispute with the bank.[115]

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[115] U.C.C. § 4A-203 cmt. 5:

> Because of bank regulation requirements, in this kind of case there will always be a criminal investigation as well as an internal investigation of the bank to determine the probable explanation for the breach of security. Because a funds transfer fraud usually will involve a very large amount of money, both the criminal investigation and the internal investigation are likely to be thorough. In some cases there may be an investigation by bank examiners as well. Frequently, these investigations will develop evidence of who is at fault and the cause of the loss. The customer will have access to evidence developed in these investigations and that evidence can be used by the customer in meeting its burden of proof.

A check fraud case might involve an amount of money that might be modest from the standpoint of the bank or public authorities—though not from the standpoint of the customer. Accordingly, it may be thought more problematic to adopt an allocation of burden of proof that relies on the assumption of a significant public investigation. Rather a court might place on the bank the burden of proving that the fraud was, more likely than not, attributable to someone within the organization of the customer.

VI. CONCLUSION

The problem of the enforceability of facsimile signature agreements thus raises important questions both about the basic principles of the check payment system and the role of courts in policing agreements concerning checking accounts. As we have seen, the only explicit textual basis for judicial policing of such agreements is the rule in § 4-103(a) that an agreement cannot "disclaim a bank's responsibility for its own lack of good faith;" where good faith is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[116] Although the definition of "good faith" appears to establish a unitary standard applicable throughout the Code, further examination reveals that judicial policing of agreements under the good faith standard must take account of the very different approaches to agreements taken in different articles of the Code. If the statute itself has established clear limits on the extent to which agreements can vary statutory rules, as in the case of the many provisions in Article 4A

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[116] U.C.C. § 4-102© & 3-103(a)(4).

that cannot be varied by agreement,[117] then it may be appropriate to give a relatively limited role to the concept of good faith as a policing tool. On the other hand, if the statute has not itself undertaken the task of establishing limits on variation by agreement, as in the case of Article 4, then the courts must inevitably be open to more serious consideration of contentions that in a particular case an agreement would alter fundamental rules on which the Article 4 structure is based, and thus cannot be enforceable.

[117] *See* TAN 88-92.