

How to Use This Manual

BACKGROUND

Notwithstanding the growth of alternative payment systems such as credit cards, check cards, debit cards, stored value cards, and electronic fund transfers, checks remain one of the most dominant noncash means of payment. A 2007 Federal Reserve Payments Study concluded that in 2006, 30.6 billion checks were paid in retail transactions, with a value of 41.7 trillion dollars.¹ Although this represented a 6.4 percent decrease in the absolute number of checks written from 2003, checks remained the single largest noncash payment system. In addition, the average amount for which a check was written increased to \$1,280. Many checks, however, are converted electronically before they are paid. As a result, only 30.6 billion checks were paid, and the average amount for which they were paid was \$1,366. Unfortunately, the high volume of check use means that check fraud is also rampant. In its most recent survey of deposit account fraud, the American Bankers Association (ABA) found that the total amount of attempted check fraud against bank deposit accounts exceeded \$12 billion in 2006. Many of these attempts were detected prior to the materialization of any loss, but 80 percent of banks surveyed nevertheless incurred check fraud losses.²

Unfortunately, the burden of most of the losses that are associated with check fraud falls on firms. Firms that are victims of check fraud may ultimately be able to shift these losses to other parties, such as banks or individuals, as a result of the legal principles that we discuss in the *Corporate Check Fraud Protection Manual: Compliance, Liability, Positive Pay*. Even where loss shifting is possible, however, the process is time consuming and can generate adversarial relationships with the firm's bank, customers, or employees. Clearly, the most desirable way to deal with check fraud is to prevent its occurrence.

A review of some of the myriad ways in which wrongdoers can deal with checks fraudulently reveals how firms can become implicated. Consider, for instance, the following situations that have resulted in the fraudulent use of a firm's checks:

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1. The 2007 Federal Reserve Payments Study: Noncash Payments Trends in the United States: 2003-3006, available at http://www.fbsservices.org/files/communications/pdf/research/2007_payments_study.pdf.
 2. See American Bankers Association, Deposit Account Fraud Survey Report (2007).

- A wrongdoer pays a firm's employee to allow the wrongdoer to scan the employee's payroll check. The wrongdoer scans the check, downloads the data from the scanner into a computer, and produces a replica of the check — including the authorized corporate signature — through a desktop publishing program. The wrongdoer then changes the name of the employee of the check, prints it, and obtains payment of the check from the firm's bank.
- A dishonest employee within the firm obtains blank check forms of the firm and the check writing machine used by the firm. The employee imprints a check on the check writing machine, which produces an authorized signature of the firm.
- A dishonest employee of the recipient of the check sent by the firm steals the check, alters the amount, indorses it in the name of the recipient, and cashes the check at the firm's bank.
- A dishonest employee within the accounting department of the firm provides a firm official who is authorized to sign checks for the firm with a check made payable to a fictitious employee. The employee informs the official that the check is to be used to pay for services provided by the payee, even though no such services have been rendered. The official signs the check and the employee cashes it at the firm's bank.
- An employee who is authorized to open checking accounts on behalf of the firm opens accounts at two local banks. The employee deposits a check from first account into the second account to prevent the bank from dishonoring checks drawn on that account. The second account, however, does not contain sufficient funds to support the check that the employee drew. Thus, the employee also draws a check on the second account and deposits it in the first account to prevent the bank from dishonoring checks drawn on that account. The procedure, discussed in Chapter 7, is known as "check kiting."
- A dishonest employee of the recipient uses a stamp with the recipient's name on it to indorse the back of the check after it has been received. The employee then steals the check and obtains payment of it from the firm's bank. The recipient requests another check from the firm, claiming that the recipient never received payment for the goods or services for which you sent the first check.

These situations indicate the wide range of fraudulent schemes that are commonly practiced. The result has been a dramatic increase in check fraud amounting to tens of millions of dollars annually. Some of this fraud is facilitated by federal requirements that funds represented by checks be made available to depositors within relatively short periods of time after deposit. The limited time for

which banks can place “holds” on deposits permits less time for banks to investigate suspicious checks and allows wrongdoers to withdraw funds against those checks before a fraudulent scheme has been uncovered. These time limits also restrict the period within which a firm can effectively report suspicious activity to its bank prior to the time that the underlying check has been paid.

Regardless of the reasons for check fraud and the increased difficulties created by new technologies, firms may frequently be in a better position to detect or deter fraud than banks or other parties to the check. For instance, where check fraud is perpetrated by a firm’s employee, it may be easier for the firm to prevent the fraud through careful hiring and monitoring of employees than for a bank to detect a fraudulently created check. As a result, legal doctrine frequently places the loss that arises from fraud on firms that may view themselves as victims of disloyal employees. (Of course, in other instances, legal doctrine may allow a firm to recover any losses from other parties to the check.) In this way, legal principles induce firms to take advantage of their relative ability to detect fraud, insure against its occurrence, and develop or employ better means of fraud deterrence.

Because legal principles often place the risk of fraud on firms, it is essential that officials of the firm not only be aware of mechanisms for minimizing fraud, but also understand how their legal responsibilities relate to their ability to reduce opportunities for others to misuse checks. Both industry and government sources seem to agree that the most effective preventive measure against check fraud is employee training with respect to both incoming checks and outgoing checks. A significant amount of fraud can be detected or avoided simply by knowing the sources of misconduct by employees and strangers, being able to identify circumstances in which fraud is more likely, and determining what features of a check are most vulnerable to fraudulent manipulation.

THE OBJECTIVES OF THE MANUAL

The *Corporate Check Fraud Protection Manual: Compliance, Liability, Positive Pay* helps firms understand the legal principles governing negotiable instruments and provides practical guidance to help firms detect and deter check fraud. We’ve designed the manual with the following objectives in mind:

- Recommend procedures that facilitate detection of fraudulent checks and thus reduce a firm’s losses from check fraud.

- Provide firms that handle checks with an understanding of the legal principles that allocate losses from check fraud.
- Offer examples of how courts have applied those principles either to impose losses on firms or to exonerate them from liability for fraud.
- Help firms train personnel in detecting and deterring check fraud.
- Provide a convenient reference source of regulations and laws that govern check fraud.

Note on Terminology

The *Corporate Check Fraud Protection Manual: Compliance, Liability, Positive Pay* refers to all institutions that offer demand deposit accounts as “banks” since the legal rules that allocate losses and the preventive measures that can be taken apply regardless of whether institutions are structured as commercial banks, savings and loan associations, or credit unions or are organized in some other form.

ORGANIZATION OF THE MANUAL

In each chapter of the *Corporate Check Fraud Protection Manual: Compliance, Liability, Positive Pay*, we provide review exercises and discussion points for the review exercises to help firms and their staffs understand the important legal, regulatory, and practical issues that pertain to check fraud. We also provide procedures for firms to implement to help detect and deter fraud in their institutions. The manual is organized as follows:

- *Chapter 1, Understanding Checks and Check Fraud*, explains the legal mechanics of checks and the processes by which financial institutions deal with them.
- *Chapter 2, Forgery of Drawer’s Signature*, focuses on the legal rules governing the allocation of losses in cases where the drawer’s signature has been forged. This chapter explains the role of firms and financial institutions in avoiding this type of fraud and indicates what they must do to avoid incurring ultimate liability for the fraud that does occur.
- *Chapter 3, Forged Indorsements*, covers the legal rules concerning the allocation of losses from forged indorsements, which are more complicated than those concerning a forged drawer’s signature. This chapter describes how firms can reduce these costs by explaining

the legal rules and presenting guidance to help minimize the risk that a check presented for deposit or payment bears a forged indorsement.

- *Chapter 4, Alteration of the Check*, discusses the types of alterations that can be made to an instrument and legal rules that govern altered checks. It presents example scenarios to illustrate the rules and presents guidance for personnel to detect check alterations.
- *Chapter 5, Notice of Breach of Fiduciary Duty*, and *Chapter 6, Payment Over a Restrictive Indorsement*, both look at fraud involving properly completed checks. Chapter 5 explains important concepts, such as holder in due course, as they relate to fiduciaries and examines the circumstances under which the law holds a firm or financial institution liable for a breach of fiduciary duty. Chapter 6 explains the different types of indorsements and the liability issues involved if a firm or financial institution does not comply with a valid restrictive indorsement. It also provides guidance on identifying fraud related to restrictive indorsements.
- *Chapter 7, Check Kiting*, and *Chapter 7A, Fraud Involving Cashier's Checks, Teller's Checks, and Certified Checks*, cover multibank fraud schemes. Chapter 7 explains what a check kiting scheme is, discusses law and regulation that come into play when a check kite occurs, and presents guidance to help firms and financial institutions detect and deter this type of fraud. Chapter 7A covers the allocation of fraud losses involving these instruments.
- In *Chapter 8, Positive Pay*, we provide guidance in using positive pay agreements to help firms reduce fraud. We indicate the areas in which positive pay may restrict exposure to fraud and explain the limits of positive pay agreements. In addition, we provide information concerning the interaction between positive pay agreements and other relationships between a firm and its bank, such as the ability to issue stop payment orders and the possibility that a check will be wrongfully dishonored. A positive pay checklist is included to help firms identify important issues for implementing positive pay agreements.

In addition, the book includes four appendixes:

Appendix A: Checklists

Appendix B: UCC Articles 3 and 4 (Revised)

Appendix C: Check Fraud: A Guide to Avoiding Losses, February 1999

Appendix D: Regulation CC