TOOTHLESS TIGERS: POSITIVE AND REVERSE-POSITIVE PAY AND THE ILLUSION OF CUSTOMER-LOSS ALLOCATION FOR CHECK FRAUD

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The author proposes three steps for institutions to take with respect to their positive and reverse-positive pay systems, potentially shifting the loss of check fraud to their customers when their customers fail to implement these services or inexplicably remove these services when their accounts have already been compromised or are particularly susceptible to fraud.

Despite the increasing use of electronic financial transactions, traditional check fraud remains a significant financial crime. To combat modern forms of check fraud, financial institutions created and marketed positive and reverse-positive pay fraud-prevention services, both of which provide customers and institutions with an extra layer of fraud protection when a purportedly legitimate check is presented to the institution for payment. Positive and reverse-positive pay, however, suffer from three primary limitations.

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First, they do not detect all forms of check fraud.

Second, their low use rate and lack of standardization hamper their systematic effectiveness.

Finally, there is little incentive for a rational customer to implement such services because the Uniform Commercial Code's default loss-allocation rules generally shift liability for check fraud to the paying or depositary institutions.

This article proposes three proactive approaches for institutions to put some teeth into their positive and reverse-positive pay systems, and, potentially in certain cases, to shift the loss of check fraud to their customers when their customers fail to implement these services or inexplicably remove these services when their accounts have already been compromised or are particularly susceptible to fraud. First, institutions can insist that certain customers implement the services, and concomitantly insist on an indemnification agreement that shifts liability to the customer for any check fraud that slips through the system while the service is active. Although probably not "manifestly unreasonable" under the U.C.C., this approach has practical drawbacks. It is unlikely that a rational customer will agree to assume unilaterally the risk for check fraud even with positive or reverse-positive pay protection because a fee is usually charged by the institution for the services, and the customer presumably can take his business elsewhere where there are no such requirements. Institutions also could encourage their customers to use positive and reverse-positive pay, and, if the customers refuse, could later argue that the customers' failure to implement the services showed a lack of ordinary care that substantially contributed to any subsequent check fraud. Although at least one court has suggested that this argument is probably without merit, it remains an unsettled question of U.C.C. law. Finally, institutions' best argument to shift liability for check fraud to their customers arises where a customer initially implements positive or reverse-positive pay, there is attempted and/or successful check fraud on the protected account, and the customer then inexplicably decides to remove the services, which results in subsequent fraud on the account. Under these circumstances, institutions have a strong argument that the customer showed a lack ordinary care, by removing the services from the account, which substantially contributed to the subsequent forgery, and that the loss should properly be allocated to the customer, not the paying or depositary institution.

POSITIVE AND REVERSE-POSITIVE PAY

Electronic financial transactions have increased significantly over the past few decades; however, the use of paper checks to accomplish business-to-business transactions still comprises the payment method for more than 75 percent of such transactions.[1] Check fraud, therefore, remains one of the most common and significant financial crimes (in 2000, losses exceeded $20 billion), with the American Bankers Association projecting it to continue to increase at a rate of 25 percent per year.[2]

To combat modern forms of check fraud, financial institutions have created and marketed to their customers various check-fraud prevention measures, two of which are positive and reverse-positive pay.[3] Positive pay requires a customer (typically a business with high check volume, those issuing checks with large amounts payable, or those otherwise particularly prone to check fraud) to transmit to its institution an electronic file of the checks it issued during that particular day.[4] When a person (or other institution) presents a check purportedly issued by the customer for payment, the customer's institution electronically compares the presented check against the list of checks in the customer's electronic file. Before the presenter of the check receives the amount payable, the institution must match the account and check number, date, and amount payable against the customer's list of preauthorized checks.[5] If any of these variables do not match the list of the customer's issued checks, the institution will not pay the presented check.[6] Reverse-positive pay is slightly different: the institution transmits to its customer, through the Federal Reserve clearinghouse system or otherwise, an electronic file identifying the checks presented to it that day for payment. The customer, in response, notifies the institution of the presented checks matching its approved list of checks legitimately issued.[7] If there are any discrepancies under either fraud-prevention system, the presented check is not immediately paid, and the checks are flagged as exception items for further review by the institution and customer.

Positive pay and reverse-positive pay primarily are not customer-protection devices; rather, they seek to protect the "Achilles Heel" of an institution's[8] check-processing system: its practical inability, on the presentment of a check, to detect a forged drawer's (customer's) signature, a forged payee

endorsement, or both ("double forgery"), or a counterfeit or altered check.[9] In the case of such forgeries, the U.C.C. generally holds the institution strictly liable to its customer for paying on the forgery because it is not "properly payable."[10] The institution is able, however, in the case of a pure forged endorsement or alteration,[11] to shift the loss "upstream" to the depositary institution (the person who takes the forgery in the first instance) through a claim for breach of presentment warranty,[12] provided that the paying institution, on presentment, paid the check in "good faith."[13] An institution, however, is not able to shift the loss to the depositary institution in the case of a forged drawer's signature, a "double forgery," or a counterfeit check, because, in these cases, the U.C.C. deems the paying institution, not the depositary institution, to be in the best position to detect these types of forgeries. In the case of a forged drawer's signature, a double forgery, or a counterfeit check, the loss generally falls on the paying institution, absent some showing that its customer failed to exercise ordinary care and that its lack of ordinary care substantially contributed to the forged drawer's signature, the double forgery, or the counterfeit check.[14]

LIMITATIONS OF POSITIVE AND REVERSE-POSITIVE PAY

The purpose of positive pay and reverse-positive pay is twofold: (1) it protects the paying institution from liability for paying on a forgery by identifying potential forgeries on presentment, allowing the institution to refuse payment on such checks; and (2) if coupled with a concomitant positive pay indemnification agreement,[15] it potentially can shift the loss for any forgery that is undetectable or otherwise slips through the system to the customer while the service is active. Although positive pay and reverse-positive pay seek to reduce the paying institution's exposure to check fraud, both services suffer from three primary limitations. First, these fraud-prevention measures do not detect all forms of check fraud. Second, the institutions' lack of uniformity and high implementation costs prevent or discourage many small to medium-sized business customers from using the services. Finally, paying and depositary institutions have been to date unsuccessful in arguing that the loss from a forgery should be properly allocated from the institution to the customer in the case where prudent implementation of positive pay or

reverse-positive pay clearly would have detected the forgery.

As an initial matter, though effective in detecting counterfeit checks, unauthorized checks,[16] and checks where the amount payable is subsequently altered after the check is issued, many positive and reverse-positive pay systems cannot detect altered payee names or forged drawer's signatures.[17] As such, even if these services are implemented, the loss from such forgeries will generally fall on the paying or depositary institutions under the U.C.C.'s default loss-allocation rules.

Second, positive and reverse-positive pay is only marginally effective in preventing check fraud because they are not widely marketed to and used by customers.[18] In 1997, only two percent of community banks (less than $500 million in assets), 6.5 percent of mid-sized banks ($500 to $4,999 million in assets), and 54.5 percent of large banks ($5 billion or more in assets) said that they affirmatively marketed positive pay to their corporate customers.[19] This low rate of use has not significantly increased since that time. For example, given the high implementation costs, "only a small percentage of small and mid-size businesses have been able to adopt a positive pay system."[20] As such, the low rate of use, in addition to the lack of standardization between such systems across the financial industry (i.e., a hodgepodge of file-transmission requirements based on individual bank specifications, and the inability to seamlessly transmit files between institutions' and their customers' varied accounting systems), has contributed to the lack of use of and uniformity of these fraud-prevention systems.[21]

Finally, few institutions have the leverage to insist, when opening an account, that the customer implement positive or reverse-positive pay. For one, there usually is a monthly fee assessed by institutions for the services. Further, many positive and reverse-positive pay agreements contain contract provisions relieving the institution for losses for checks paid according to the procedures specified in the agreements.[22] Taken together, a rational customer will not agree to pay a fee for a fraud-prevention service that ultimately shifts all liability for check fraud to the customer instead of the institution. Believing that they are generally insulated from liability for check fraud under the U.C.C.'s default loss-allocation rules, it is entirely rational for such customers to take their chances against the risk of check fraud. The only real-world consequence of this calculated risk-taking may be that the customer

would have to close its account if it is compromised by fraud.

The limitations of positive and reverse-positive pay in insulating institutions from check-fraud losses were recently exposed in *J. Walter Thompson, U.S.A., Inc. v. First Bank Americano*.[23] In *J. Walter Thompson*, a customer issued a check to a legitimate vendor-payee.[24] A thief intercepted the check, altered the name of the payee, endorsed the check in the name of the altered payee, and deposited the check into a bank account at First Bank Americano.[25] The altered check was ultimately presented to Bank of America (the customer's bank), which debited the customer's checking account in the amount of the altered check. The customer later realized the check had been altered, and requested that Bank of America credit its account in the amount of the altered check. Bank of America refused to credit the account, but also sought reimbursement from First Bank Americano (the depositary institution), which refused the request. During the check-fraud incident, the customer subscribed to Bank of America's positive-pay service.[26]

Bank of America and First Bank Americano believed that they should be relieved of all liability for the altered check. They argued that the customer failed to exercise ordinary care and "substantially contributed" to the forgery by failing to adopt certain additional check-fraud-prevention measures after the customer experienced at least ten instances of actual and attempted fraudulent activity on the account.[27] In particular, they argued that, after the fraudulent activity, the customer should have closed the account and/or instituted a higher-level payee-matching system to detect future fraud.[28]

The *J. Walter Thompson* court held that the customer did not substantially contribute to the alteration of the check because the standard of ordinary care in the U.C.C did not compel the customer to adopt certain check-fraud-prevention measures.[29] The court also concluded that the customer had reasonably relied on its existing positive-pay service, and the technological limitations that existed at the time, which did not include a higher-level payee-matching system.[30] Most importantly for this Article, the court pointed out that the lack of a payee-matching system (and presumably the preexisting positive-pay service itself) could not have "substantially contributed" to the alteration because the payee-matching system would have detected the alteration only *after the fact*.[31]

PUTTING SOME TEETH IN POSITIVE & REVERSE POSITIVE PAY

It is in the interest of institutions (to avoid general U.C.C. strict liability for check fraud) and customers (to minimize the disruption of its business operations attendant to closing an account after fraud occurs) that check fraud never occur. As discussed above, however, a customer has little incentive to implement positive or reverse-positive pay because the default U.C.C. loss-allocation rules generally shift liability for a fraudulent or counterfeit check to the paying or depositary institutions, absent some showing that the customer failed to exercise ordinary care substantially contributing to the forgery. To put some teeth into positive and reverse-positive pay check-fraud prevention, institutions can take one of three alternative, proactive approaches when marketing and implementing positive and reverse-positive pay. Under these approaches, institutions can both protect themselves against liability for check fraud by catching the fraud on presentment, and also potentially shift liability to their customers when the customers fail to implement or discontinue the use of such services.

First, institutions could choose to insist when they open an account that customers particularly susceptible to check fraud (such as title-insurance companies or other high-check-volume businesses) subscribe to positive or reverse-positive pay. If necessary, institutions could waive the monthly service fee for these customers on a case-by-case basis. In any such positive or reverse-positive pay arrangement, the institution also could insist on an agreement that includes contract provisions shifting the liability for any fraudulent-check activity to the customer while the service is active. Although such provisions would seek to modify the U.C.C.'s general loss-allocation rules, they would likely be reasonable under U.C.C. § 4-103, which provides that "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," provided that the agreement does not completely disclaim the standard of good faith and the institution's general duty of care. This two-pronged approach, however, has a practical drawback: if other peer institutions do not insist on similar fraud-prevention requirements, insisting that a customer implement positive pay or reverse-positive

pay when opening an account may be self-defeating, as new customers could easily take their business elsewhere.

Second, institutions can encourage the use of positive or reverse-positive pay when opening new accounts and reevaluating existing accounts particularly susceptible to check fraud. If customers choose not to subscribe to the services, institutions could request that the customers execute an indemnification agreement. If an institution cannot procure the customer's agreement, the institution may argue that, if fraud does occur, that the customer's failure to implement positive or reverse-positive pay showed a lack of ordinary care on the part of the customer, which substantially contributed to the fraud on the unprotected account. Although at least one court[32] has suggested that a customer does not fail to exercise ordinary care or substantially contribute to a forgery merely by failing to implement positive pay, it remains a relatively unsettled question of U.C.C. law.

Finally, institutions could request an indemnification agreement from its customer where (1) there has been prior successful and/or attempted fraud on an account; and (2) after such successful or attempted fraud, the customer inexplicably chooses to remove positive- or reverse-positive-pay protection from the account. Under these factual circumstances, an indemnification agreement purporting to shift to the customer liability for any future fraudulent-check activity after the services are removed from the account would not be "manifestly unreasonable." If a customer does not agree to an indemnification agreement under these circumstances, institutions could either (1) unilaterally close the account; or (2) argue later that removing positive or reverse-positive pay from an account with known successful or attempted instances of check fraud constituted a lack of ordinary care by the customer substantially contributing to the subsequent fraud on the unprotected account. To date, no court has addressed this particular factual scenario, but it would provide a stronger argument for institutions attempting to shift the loss for check fraud to its customers than the case where a customer fails to implement positive or reverse-positive pay from the outset.

Institutions have at their disposal many options to put some teeth into their positive and reverse-positive pay fraud-prevention systems. Although the law remains unsettled, courts will probably continue to conclude that a customer's mere failure to implement positive or reverse-positive pay (even

for a high-check-volume business) when opening an account does not constitute a lack of ordinary care on the part of the customer substantially contributing to any forgery. Institutions, however, have an important role to play in the evolution of positive-pay and reverse-positive-pay law. As the use of positive-pay and reserve-positive-pay services becomes more widespread, courts may consider that factor as persuasive when determining whether a customer substantially contributed to a forgery by choosing not to implement the services. Nonetheless, a customer's decision to (1) initially implement positive or reverse-positive pay, and, then, (2) inexplicably remove those services after actual and/or attempted fraudulent activity on the account probably constitutes a lack of ordinary care by the customer substantially contributing to any subsequent fraud on the unprotected account. If a court agrees, positive and reverse-positive pay will start to have some teeth, and the result will be an initial step towards common-sense customer loss-allocation for check fraud under the Uniform Commercial Code.

NOTES

[1] StopCheckFraud.com, *Information about Check Fraud: Basic Check Fraud Statistics*, http://www.stopcheckfraud.com/statistics.html (last visited Aug. 12, 2008).

[2] Technology, in particular, makes it easier for criminals to defraud financial institutions with fabricated but realistic counterfeit checks. *Check Fraud: A Guide to Avoiding Losses*, at 1, http://www.occ.treas.gov/chckfrd/chckfrd.pdf (last visited Aug. 12, 2008); PostivePay.net, Why Positive Pay?, http://www.positivepay.net/why.htm (last visited Aug. 11, 2008).

[3] Report, Subcommittee on Payments, *Deterring Check Fraud: The Model Positive Pay Services Agreement & Commentary*, 54 Bus. Law. 637 (1999); James J. White, *"UCC Proposals Concerning Consumer Transactions," The Emerged and Emerging New Uniform Commercial Code*, SC36 ALI-ABA 77, 253-66 (1997).

[4] PostivePay.net, *Overview of Positive Pay*, http://www.positivepay.net/index.htm (last visited Aug. 11, 2008).

[5] *Id.*

[6] *Wachovia Bank, N.A. v. Federal Reserve Bank of Richmond*, 338 F.3d 318, 320 (4th Cir. 2003) ("Positive Pay allows a paying bank to verify check numbers and amounts by comparing them to checks issued by the drawer. In this way, the paying bank can

detect counterfeit and unauthorized checks before making payment."); *Kaiser Aluminum & Chemical Corp. v. Mellon Bank, N.A.*, No. 96-399, 1997 WL 361354, at *2 n.4 (W.D. Pa. June 24, 1997) (allowing customer through positive-pay service to electronically provide bank with the customer's check issuance information on a daily basis, which the bank could then compare checks presented for payment).

[7] *Check Fraud: A Guide to Avoiding Losses*, at 15-16, http://www.occ.treas.gov/chckfrd/chckfrd.pdf (last visited Aug. 12, 2008).

[8] This article intentionally uses the term "institution" broadly, as the U.C.C.'s default loss-allocation rules apply to more than just accounts maintained at licensed banks. *Nisenzon v. Morgan Stanley DW, Inc.*, 546 F. Supp. 2d 213 (E.D. Pa. 2008) (U.C.C.'s loss-allocation rules applied to brokerage firm that provided its customers with check-writing privileges).

[9] The Federal Reserve clearinghouse system (in particular, the U.C.C.'s midnight deadline) generally does not allow for manual sight verification of an endorsement, verification of the payee, or whether the check is a counterfeit, and even if an institution electronically maintains a customer's signature to electronically compare it with the drawer's signature on a presented check, a sophisticated forgery will usually defeat such customer-signature-verification attempts.

[10] U.C.C. § 4-401.

[11] A paying institution (the "drawee" and/or "payor bank") is able to shift the loss for an alteration upstream, to the depositary institution, *Bank One Dearborn, N.A. v. Wachovia Bank, N.A.*, No. 03-6575, at *2-3 (E.D. Pa. Jan. 11, 2005), but must absorb the loss from a counterfeit check because the paying institution is in the best position to discover this type of forgery. *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*, 208 Fed. Appx. 232, 2006 WL 3522503, at *3 (4th Cir. Dec. 6, 2006).

[12] U.C.C. § 4-208; *Bank One Dearborn, N.A. v. Wachovia Bank, N.A.*, No. 03-6575, at *2-3 (E.D. Pa. Jan. 11, 2005).

[13] U.C.C. §§ 4-208; 3-417; *Wachovia Bank, N.A. v. Federal Reserve Bank of Richmond*, 338 F.3d 318, 321-22 (4th Cir. 2003); White & Summers, Uniform Commercial Code § 18-7 (4th ed. 1995).

[14] U.C.C. § 3-406 (2002).

[15] For a model positive-pay agreement, see Report, *supra* note 3.

[16] Report, *supra* note 3 at 645 n.39 ("Positive pay is generally effective in identifying counterfeit or unauthorized checks provided that the counterfeiter is not involved in implementing the positive pay scheme."); *see also* Peggy Lunt, *What truly deters check fraud?*, 2/1/95 ABABKJ 74, 1995 WLNR 4035821 (1995).

[17] James J. White, *supra* note 3; *see also Wachovia Bank, N.A.*, 338 F.3d at 321-22 ("Although Positive Pay prevents several types of fraud, it cannot detect alterations of payee names."); *Chevy Chase Bank, F.S.B.*, 208 Fed. Appx. 232, 2006 WL 3522503,

at **3 (stating that fraud by payee alteration is "known to be the common form of fraud used to circumvent the 'positive-pay' type of arrangement").

[18] StopCheckFraud.com, *Fighting Corporate Check Fraud: Can Positive Pay Stem the Rising Tide?*, http://www.stopcheckfraud.com/articles/fightingcheckfraud.html (last visited Aug. 12, 2008).

[19] James J. White, *supra* note 3; *Lunt*, *supra* note 16.

[20] StopCheckFraud, *supra* note 18.

[21] *Id.*

[22] James J. White, *supra* note 3 (emphasis added); UCC § 4-401 (2002). Although the U.C.C. prohibits an institution from disclaiming its responsibility (or limiting its damages) for its lack of good faith or for failing to exercise ordinary care, it does not prevent parties from agreeing to shift more liability from the institution to the customer. StopCheckFraud, *supra* note 18.

[23] 518 F.3d 128 (2nd Cir. 2008).

[24] *Id.* at 134-35.

[25] *Id.* at 135.

[26] *Id.*

[27] *Id.* at 138.

[28] *Id.* at 137.

[29] *Id.* at 138.

[30] *Id.*

[31] *Id.* at 137; *see also Wachovia Bank, N.A.*, 338 F.3d at 324 (altered payee; holding that Wal-Mart's positive pay system with Wachovia was enough protection to prevent it from being a substantial contributor to the altered check); Thomas Simpson, *Second Circuit Rules on "Positive Payee" Program*, 04-08 Clark's Bank Dep. & Paymt. Monthly 4, April 2008, at 1.

[32] *Kaiser Aluminum & Chemical Corp.*, 1997 WL 361354, at *2 n.4 (noting that the customer's failure to implement a positive-pay system "did not 'substantially contribute' to the making of the forged checks, but rather, arguably, only [went] to the payment of the instruments" but noting that the bank never advised the customer that it would have liability for forged checks "if it did not adopt or fully utilize these services").

AN INTELLECTUAL PROPERTY LAWYER'S READING OF UCC 2-312

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The Uniform Commercial Code imposes a non-infringement warranty on both a seller and a buyer of goods. Because there is virtually no case law interpreting the relevant non-infringement warranty sections of the Uniform Commercial Code, the author interprets some of the odd language of the relevant UCC sections and highlights their ambiguities, concluding that written agreements about the scope of the non-infringement warranty, and the seller's duties to defend, indemnify, and hold harmless, are strongly recommended.

Uniform Commercial Code, Article 2, Section 2-312 deals with the title and patent obligations of a seller and a buyer of goods. The section was written basically by commercial attorneys, not necessarily those with a deep patent background. Moreover, it was written in the 1950s and both commercial law and patent law have evolved significantly since then. The purpose of this article is to try to interpret the words of Section 2-312, from the viewpoint of an intellectual property attorney.

By way of note, this article uses the National Conference of Commissioners on Uniform State Laws/American Law Institute (NCCUSL/ALI) 1996 version of Article 2. In 2003, NCCUSL/ALI promulgated a proposed revised version of Article 2. That proposed revised version has generated significant opposition and has not been passed by any state.

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