

Who's Liable to Whom? A Brief Primer on Altered, Fraudulent, and Forged Checks for the In-House Bank Lawyer

By Daniel K. Wiig

The New York version of Articles 3 and 4 of the Uniform Commercial Code (the UCC or the "Code") outline specific responsibilities for customers and financial institutions when a third-party "wrongdoer" intercepts the check clearing process or manufactures one on behalf of the customer. While the wrongdoer is ultimately liable for her/his bad acts under applicable law, the UCC allocates burden among the customer/Drawer,¹ Drawee Bank,² and Depository Bank,³ the parties to the check clearing process, premised on a combination of negligence and who-was-in-the-best-position to avert the wrong. The party deemed responsible by the UCC can then pursue appropriate remedies against the wrongdoer.

Financial institutions can charge items against a customer's account only if these items are "properly payable,"⁴ meaning the charge is wholly authorized by the Drawer. However, if the face of the check is altered, the Drawer's signature forged, or if someone other than the intended Payee endorses the check, the item is not properly payable, consequently prohibiting the financial institution from clearing the check for payment.⁵ The problem arises when, despite the fact that an alteration or forgery occurred, the Drawee Bank nevertheless proceeds with payment. A complex set of rules follow to determine whether the Drawee Bank bears liability for its act, or if said liability is instead harnessed on the Drawer or Depository Bank.

Altered Check

An alteration is any change to the check made without the authority of the Drawer that amends the obligation(s) of the Drawer. Examples of this would be raising the amount of the check from \$1,000 to \$10,000 or manipulating the name of the payee on the face of the check (e.g., "Jane Smith" to "Jane Jones").

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Under UCC § 4-406(4), a customer has one (1) year from the date the Drawee Bank makes her/his account statement available to notify the Drawee Bank of any



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alterations, and consequently recoup her/his losses.⁶ "Making the account statement available" includes any method by which the Drawer Bank notifies its customer of the latter's account balance, including mail, email, or online posting.⁷ The customer's failure to alert the Drawee Bank within the one (1) year period is a complete bar to recovery.⁸

However, the UCC may preclude the customer from recovery even if she/he alerts the Drawee Bank within one (1) year. UCC §§ 4-406(1) and (2)(a) provide if a customer does not "promptly" notify the Drawee Bank of an alteration, the customer is precluded from making a claim if the Drawee Bank can demonstrate it suffered a loss by reason of the customer's failure to "promptly" notify it.⁹ The UCC does not define the term "promptly," but New York courts have allowed financial institutions to establish periods within their account agreements.¹⁰ Nor is the Code clear as to what would constitute a loss to the Drawee Bank.¹¹

"In the event the Drawer prevails as between it and the Drawee Bank, the latter is liable to the Depository Bank for the Drawer's loss pursuant to UCC § 4-207 (1)."

Repeated wrongdoing from the same wrongdoer can also bar a customer from recovery. Pursuant to UCC § 4-406(2)(b), a customer who fails to notify the Drawee Bank within fourteen (14) days of receiving the account statement is precluded from seeking recovery of any subsequent alterations made by the same wrongdoer.¹²

UCC § 4-406(3) provides the preclusions noted above do not apply if the customer can establish the Drawee Bank lacked "ordinary care" in paying these items.¹³ "Ordinary care" refers to procedures that adhere to normal, reasonable banking standards. For example, a Drawee Bank who accepted a clearly altered check could reflect conduct falling outside of the normal standard of care.¹⁴

A customer's negligence precludes claims for alteration under UCC § 3-406.¹⁵ This section does not enumerate specific examples of the customer's negligence.¹⁶ To be sure, this can be very fact intensive, conjuring scenarios

such as the customer leaving ample space on the face of the instrument to allow a wrongdoer to alter the item.¹⁷

Assuming defenses are unavailable and the Drawee Bank is liable to its customer, the Drawee Bank can make a breach of warranty claim against the Depository Bank, the institution that accepted the proceeds of the check for deposit into its customer—the wrongdoer’s—account. Under UCC § 4-207 (2), the Depository Bank warrants the check is authentic and free of alterations to the Drawee Bank. Consequently, the loss is on the Depository Bank because it is in the best position to uncover the alteration and stop the clearing process.¹⁸ Under UCC § 4-207 (4), a Drawer Bank must make the warranty claim “within a reasonable time” after learning from the Drawer about the alteration.¹⁹ The Code does not define reasonable.

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Harkening back to UCC §§ 4-406(1) and (2)(a), it is here where the Drawee Bank’s loss may justify denial of a tardy customer’s claim. Ironically, the Drawee Bank’s own tardiness precipitates this possibility, as it would appear that only the Drawee Bank’s failure to timely make a claim on the Depository Bank would result in a “loss” to the Drawee Bank.

Fraudulent/Forged Check

This refers to the situation when the Drawer’s signature is forged, typically the result of a stolen, blank check(s). The identical analysis as with alterations between the Drawer and Drawee Bank apply. *See* UCC §§ 4-406(4), 4-406(1) and (2)(a), 4-406(2)(b), § 4-406(3) and § 3-406.

In the event the Drawer prevails as between it and the Drawee Bank, the latter is liable to the Depository Bank for the Drawer’s loss pursuant to U.C.C § 4-207 (1).²⁰ The Drawee Bank warrants to the Depository Bank, when the former accepts the check, that the Drawer’s signature is authentic. The theory behind this rule is the Drawee Bank is in the best position to uncover this fraud, as it should have a record of the signature of its customer. Pursuant to UCC § 4-207 (4), a Depository Bank making a breach of warranty claim against a Drawer Bank must do so “within a reasonable time” after learning from the Drawer about the forgery.²¹ Again, the Code is silent as to what constitutes “reasonable.”

However, Clearing House Rule 9 (“Rule 9”) upends this rule, on a limited basis, and imposes liability on the

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Depository Bank rather than the Drawer Bank. Under Rule 9, the Depository Bank adds a warranty that the check is not fraudulent, essentially providing a warranty that the Drawer’s signature is authentic.²² The genesis of the rule is that, with increased technology and the lack of human intervention in processing checks, it is becoming much easier for counterfeit and forged checks to get through the system without the Drawer Bank’s detection. In order for Rule 9 to be applicable, both the Depository and Drawer Banks must belong either to the same clearinghouse that has adopted this rule or to clearing houses that have both adopted this role and agree to reciprocity of coverage between the two clearinghouses.²³

The Rule 9 warranty, however, is limited. The Drawer must make a claim to the Drawer Bank within sixty (60) days after the Drawer deposits the check and the Drawer Bank must file a claim with the Depository Bank within fifteen (15) days of receiving the Drawer’s claim. If the Drawee Bank does not follow this, the Depository Bank can deny the warranty. Liability then falls on the Drawer Bank as under the UCC. Assuming the time frames are met, the Depository Bank can still deny the warranty claim if (i) the amount of the claim exceeds the amount of funds on deposit; (ii) the account was closed; or (iii) the Depository Bank was not the first bank to which the check was transferred. If any of these exceptions exist, liability remains on the Drawee Bank.

Forged Endorsements

This is the situation where the endorsement on the check is not that of the intended Payee, but that of a forger. Here, the intended Payee never receives the check, as a wrongdoer stole the check, forged the intended Payee’s endorsement, and deposited the check into the wrongdoer’s account.

Under UCC § 4-406(4), a member has three years from the date the Drawee Bank makes her/his account statement available to notify it of a forged endorsement(s).²⁴ The customer’s failure to alert the institution within the three-year period is a complete bar from recovering any loss. The customer’s negligence could also bar recovery.

As between institutions, the Depository Bank is liable to the Drawee Bank pursuant to UCC § 4-207 (2).²⁵

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The theory behind this rule is that the Depository Bank is in the best position to uncover a forged endorsement. UCC § 4-207 (4) requires a Drawer Bank to make breach of warranty claim against a Depository Bank “within a reasonable time” after learning from the Drawer about the forgery. As noted earlier, the UCC does not provide a clear definition of “reasonableness.”

The drafters of the UCC designed it with the intent to address all possible scenarios, although finding such clear answers can be difficult in this dense statute, even for the most seasoned lawyer. The guiding principle for the in-house banking lawyer in search of a resolution is that, at bottom, the UCC intends to hold the person or entity in the best position to prevent the wrongdoing liable.

Endnotes

1. Defined as the person who wrote the check, from whose account the funds are drawn.
2. Defined as the financial institution where the Drawer holds the account from which the funds are drawn. Also referred to as the “payor bank” or “drawer bank.”
3. Defined as the financial institution where the check is presented for deposit. This is also known as “the bank of first deposit” or the “collecting bank.”
4. See UCC § 401.
5. There are other scenarios, outside the scope of this article, when an item is not properly payable.
6. UCC § 4-406(4).
7. See 48 NY Prac., Com. Lit. in New York State Courts § 76:29.
8. *Id.*
9. UCC §§ 4-406(1) and (2)(a).
10. See *Simcoe & Erie General Insurance Co v. Chemical Bank*, 770 F. Supp. 149 (SDNY 1992).
11. See discussion, *infra*, on when the institution’s loss becomes could become relevant.
12. See UCC § 4-406(2)(b).
13. See UCC § 4-406(3).
14. See *Putnam Rolling Ladder Co, Inc. v. Manufacturers Hanover Trust Company*, 74 NY 2d 340 (1989); see also *Monreal v. Fleet Bank*, 85 NY 2d 204 (2000).
15. See UCC § 3-406.
16. See 48 NY Prac., Com. Lit. in New York State Courts § 76:31.
17. See 81 N.Y. Jur. 2d Negotiable Instruments, § 623.
18. See UCC § 4-207 (2).
19. See UCC § 4-207 (4).
20. See UCC § 4-207 (1).
21. See UCC § 4-207 (4).
22. See The Electronic Check Clearing House Organization, Clearing House Rule 9.
23. See http://www.umacha.org/aws/UMACH/asset_manager/get_file/94260/rule_9_at_a_glance_final.pdf.
24. See UCC § 4-406(4).
25. See UCC § 4-207 (2).