



11-1-1991

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Recommended Citation

Nan S. Ellis & Steven B. Dow, *Banks and Their Customers under the Revisions to Uniform Commercial Code Articles 3 and 4: Allocation of Losses Resulting from Forged Drawers' Signatures*, 25 Loy. L.A. L. Rev. 57 (1991).

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BANKS AND THEIR CUSTOMERS UNDER THE REVISIONS TO UNIFORM COMMERCIAL CODE ARTICLES 3 AND 4: ALLOCATION OF LOSSES RESULTING FROM FORGED DRAWERS' SIGNATURES

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Steven B. Dow**

I. INTRODUCTION: OVERVIEW OF THE PROBLEM

Articles 3 and 4 of the Uniform Commercial Code (UCC or Code) address how losses resulting from forged drawers' signatures on checks and other items should be allocated.¹ The UCC's loss allocation scheme for forged drawers' signatures affects two different relationships. The first relationship is between the payor bank² and its checking account customer.³ Generally, if the bank pays a check or other item bearing a

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1. U.C.C. arts. 3-4 (1990). Articles 3 and 4 govern negotiable instruments, check collections and certain banking practices. For a table listing states that have adopted the UCC and the state codifications, see UNIF. COMMERCIAL CODE, 1 U.L.A. 1-2 (Supp. 1989).

2. A "bank" is "any person engaged in the business of banking." U.C.C. § 1-201(4) (1990). A "payor bank" is "a bank that is the drawee of a draft." *Id.* § 4-105(3). The "drawee" is the "person ordered in a draft to make payment." *Id.* § 4-104(a)(8). For a discussion of the problematic nature of these definitions, see Steven B. Dow, *Determining Bank Status in Article Four Check Collections*, 49 U. PITT. L. REV. 43, 50-60 (1987); see also ROBERT BRAUCHER & ROBERT A. RIEGERT, *INTRODUCTION TO COMMERCIAL TRANSACTIONS* 64 (1977) (discussing these definitions with examples of presentment and payment of checks); DOUGLAS J. WHALEY, *PROBLEMS & MATERIALS ON NEGOTIABLE INSTRUMENTS* 2-3 (2d ed. 1988) (giving examples using these terms).

3. The "customer" is "a person having an account with a bank or for whom a bank has agreed to collect items." U.C.C. § 4-104(a)(5) (1990). Typically this is the person who signs the check or other item as drawer. A check can, however, be signed by a customer's agent. *Id.* § 3-402; see BRAUCHER & RIEGERT, *supra* note 2, at 64; WHALEY, *supra* note 2, at 2-3.

A "check" is defined as a "draft . . . payable on demand and drawn on a bank." U.C.C. § 3-104(f)(i). A "draft" is defined both as an instrument that is an order, *id.* § 3-104(e), and "an item . . . that is an order," *id.* § 4-104(a)(7). An "instrument" is defined as "an unconditional promise or order to pay a fixed amount of money." *Id.* § 3-104(a), (b). An "item" is defined as "an instrument or a promise or order to pay money handled by a bank for collection or payment." *Id.* § 4-104(a). The "payee" is the person to whom the drawer ordered the

forged drawer's signature, it must recredit its customer's account for the check amount unless the bank establishes a defense.⁴ The second relationship concerns loss allocation between banks ("interbank"), but this arises only if the payor bank either voluntarily or involuntarily recredits its customer's account.

The National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) recently revised Article 3 of the Code and correspondingly amended Articles 1 and 4.⁵ These Code revisions (RUCC) have already been adopted in nine states and are presently being considered by the legislatures in twelve other states, including New York and California.⁶ This Article argues that the changes under the RUCC relating to loss allocation between the payor bank and

drawee (payor bank) to pay. BRAUCHER & RIEGERT, *supra* note 2, at 63; WHALEY, *supra* note 2, at 2-3. A drawer is "a person who signs or is identified in a draft as a person ordering payment." U.C.C. § 3-103(a)(3). The collection process involves the transmittal of the order to the drawee (or payor bank) so that the order may be carried out. *See id.* § 4-204.

4. For a discussion of the negligence defense, see *infra* notes 22-32 and accompanying text. For a discussion of the basis of the customer's action against the bank to recredit, see *infra* notes 15-20 and accompanying text.

5. U.C.C. arts. 1, 3, 4 (1990). The Code revisions attempt to delineate the effect of final payment on the payor bank's restitutionary rights, as well as to accommodate electronic check processing methods. *See* Robert G. Ballen et al., *Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 45 BUS. LAW. 2341 (1990). *See generally id.* at 2355-57 (discussing project to revise Article 4); Robert G. Ballen et al., *Commercial Paper, Bank Deposits and Collections, and Other Payment Systems*, 44 BUS. LAW. 1515, 1538-51 (1989) (discussing project to revise Articles 3 and 4); Fred H. Miller & William B. Davenport, *Introduction to the Special Issue on the Uniform Commercial Code*, 45 BUS. LAW. 1389 (1990) (discussing related revision projects).

6. This Article generally distinguishes between the former UCC and the revised UCC, and between current law and proposed law. Although the revised UCC (RUCC) has been adopted by nine states and is, therefore, current law in these states, the former UCC continues to be the current law in most states. Since this Article addresses itself to the 41 states that have not adopted the RUCC, the Article refers to the RUCC as "proposed" law and to the former UCC as "current" law. Although the Uniform Commercial Code, as drafted by the NCCUSL and the ALI, contains the revisions to Article 3 and the corresponding amendments to Articles 1 and 4, this Article refers to the former Code as the UCC and to the revised Code as the RUCC.

As of the date of this publication, the nine states that have adopted the RUCC include Arkansas, Connecticut, Hawaii, Kansas, Montana, Nebraska, North Dakota, Oklahoma and Wyoming. ARK. CODE ANN. §§ 4-1-101 to -208, 4-3-101 to -605, 4-4-101 to -504 (Michie Supp. 1991); Act effective Oct. 1, 1991, P.A. No. 91-304, 1991 Conn. Legis. Serv. 602-58 (West); Act effective Jan. 1, 1992, ch. 490 (Hawaii); Act effective Feb. 1, 1992, ch. 296 (Kansas); Act approved Apr. 10, 1991, ch. 410 (Montana); Act operative Jan. 1, 1992, L.B. 161 (Nebraska); Act effective Jul. 1, 1993, ch. 448 (North Dakota); Act effective Jan. 1, 1992, ch. 117, 1991 Okla. Sess. Law Serv. 370 (West); WYO. STAT. §§ 34.1-3-101 to -905 (1991).

The RUCC has been introduced to the legislatures of the following twelve states: Arizona, California, Colorado, Illinois, Michigan, New Mexico, New York, Pennsylvania, Utah, Vermont, Washington and West Virginia. Telephone interview with Katie Robinson, Legislative Assistant, National Conference of Commissioners on Uniform State Laws (Sept. 5, 1991).

its checking account customer will make it much more likely than under the UCC that the losses resulting from forged drawers' signatures will fall on the customer. As a result, the payor bank will rarely have any need to recover payment from other banks, making the RUCC changes in interbank loss allocation rules relatively unimportant.

This Article focuses on forged drawers' signatures under the RUCC and how the proposed changes affect loss allocation between the payor bank and its checking account customer. The Article will (1) briefly review the law under the UCC relating to forged drawers' signatures,⁷ (2) identify the relevant changes within the RUCC,⁸ and (3) discuss and evaluate these changes.⁹ The Article concludes that the changes are unsound and that state legislatures should not adopt them.¹⁰ The Article proposes that a two-tier loss allocation scheme is a preferable alternative to both the UCC and the RUCC, and that by adopting this scheme, states can both increase incentives to minimize forgery losses and implement an equitable system for allocating losses.¹¹

II. ALLOCATION OF LOSSES UNDER THE UCC

A. General Rule

The UCC rule currently used by most states regarding forged drawers' signatures provides that if the payor bank pays the item, it bears the loss.¹² This rule applies both in disputes between the payor bank and its customer,¹³ and in disputes between the payor bank and prior collecting banks.¹⁴ The RUCC, however, changes this loss allocation scheme by making it easier for the payor bank to shift the loss to its customer. Under the UCC, if the payor bank pays¹⁵ a forged item and charges its

7. See *infra* notes 12-40 and accompanying text.

8. See *infra* notes 43-56 and accompanying text.

9. See *infra* notes 57-93 and accompanying text.

10. See *infra* notes 105-08 and accompanying text.

11. See *infra* notes 94-105 and accompanying text.

12. This rule stems from several UCC sections including § 3-418 (payment final in favor of a holder in due course), § 4-302 (payor bank accountable), § 3-417 and § 4-207 (warranties) and § 4-401 (properly payable); see *infra* notes 17, 38 and accompanying text.

13. See, e.g., *Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank*, 85 Cal. App. 3d 797, 831, 149 Cal. Rptr. 883, 905-06 (1978). See *infra* note 22 and accompanying text for a discussion of available defenses.

14. *Northern Trust Co. v. Chase Manhattan Bank*, 784 F.2d 803, 804 (2d Cir. 1984) (*per curiam*) (final payment rule bars restitution, negligence, conversion and warranty actions by payor in cases of forged drawers' signatures); see *infra* note 38.

15. The term "pays" is used here to connote final payment. Methods of paying an item are governed by U.C.C. § 4-213. U.C.C. § 4-213 (1989) (superseded by § 4-215 (1990)). See Steven B. Dow & Nan S. Ellis, *The Payor Bank's Right to Recover Mistaken Payments: Sur-*

customer's account, the customer can demand that the payor bank recredit his or her account for the amount of the item.¹⁶ This demand is based upon the fact that the payor bank may only charge its customer's account for an item which is properly payable.¹⁷ Although the UCC does not say so directly,¹⁸ a check bearing a forged drawer's signature is not properly payable.¹⁹ Consequently, the payor bank must recredit its

vival of Common Law Restitution Under Proposed Revisions to Uniform Commercial Code Articles 3 and 4, 65 IND. L.J. 779, 802-04 (1990), for a discussion of the final payment concept.

16. The customer typically becomes aware of the forgery upon receipt of the bank statement revealing payment of the unauthorized check. *See, e.g.*, *Dean v. Centerre Bank*, 684 S.W.2d 373, 374-75 (Mo. Ct. App. 1984); *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 188 (Tex. Ct. App. 1989). The customer might also become aware of the forgery when the payment of a forged item has depleted the funds in the customer's account, resulting in the payor bank dishonoring the customer's check for insufficient funds.

17. U.C.C. § 4-401(1) states: "As against its customer, a bank may charge against his account any item which is otherwise properly payable from that account . . ." U.C.C. § 4-401(1) (1989) (superseded by § 4-401(a) (1990)). Thus, by implication the payor bank may not charge its customer's account unless the item is properly payable. *See, e.g.*, *National Credit Union Admin. v. Michigan Nat'l Bank*, 771 F.2d 154, 156 (6th Cir. 1985) (noting general rule that "bank is liable for paying an item with a missing indorsement because the item is not 'properly payable'"); *Cumis Ins. Soc'y, Inc. v. Girard Bank*, 522 F. Supp. 414, 418 (E.D. Pa. 1981) (bank deemed to have used own money in honoring forged check); *Danning v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 151 Cal. App. 3d 961, 969, 199 Cal. Rptr. 163, 168 (1984) (stating that "a check with an unauthorized signature is not properly payable"), *overruled on other grounds by Arceneaux v. Arceneaux*, 51 Cal. 3d 1130, 275 Cal. Rptr. 797 (1990); *Fireman's Fund Ins. Co. v. Security Pac. Nat'l Bank*, 85 Cal. App. 3d 797, 805 n.7, 149 Cal. Rptr. 883, 889 n.7 (1978) ("[B]ank is not entitled to debit depositor's accounts upon payments not made by his [or her] order or direction."); *Isaac v. American Heritage Bank & Trust Co.*, 675 P.2d 742, 744 (Colo. 1984) (bank may not charge against account item not properly payable); *Taylor v. Equitable Trust Co.*, 304 A.2d 838, 842-43 (Md. 1973) (UCC codifies underlying contract implied between bank and its customer that bank will charge any item properly payable against depositor's account only on order of depositor or depositor's agent); *North Carolina Nat'l Bank v. Hammond*, 260 S.E.2d 617, 622 n.1 (N.C. 1979) ("[D]rawee bank cannot debit its drawer customer's account for an improperly paid item . . . of which payments of a forged check is presumably one species."); *Bank of the West v. Wes-Con Dev. Co.*, 548 P.2d 563, 566 (Wash. Ct. App. 1976) ("A drawee bank may not debit a drawer's account after paying a check with a forged payee's indorsement.").

18. U.C.C. § 4-104(i) (1989) (subsection withdrawn 1990) ("[P]roperly payable' includes the availability of funds for payment at the time of decision to pay or dishonor.").

19. Under the UCC, "Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it." *Id.* § 3-404(1) (superseded by U.C.C. § 3-403 (1990)). Inasmuch as the customer in the case of a forged drawer's signature has not directed the payor bank to pay the item and to charge his account, courts and commentators agree that the item is not "properly payable." *National Credit Union Admin.*, 771 F.2d at 157; *Cumis Ins. Soc'y*, 522 F. Supp. at 418; *Danning*, 151 Cal. App. 3d at 969, 199 Cal. Rptr. at 168; *Fireman's Fund Ins. Co.*, 85 Cal. App. 3d at 804-05 nn.5 & 7, 149 Cal. Rptr. at 889 nn.5 & 7; BARKLEY CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS* § 6.2 (rev. ed. 1981); *Dow, supra* note 2, at 77 n.221; Carolyn Edwards, *Recovery of Final Payments Under the Uniform Commercial Code*, 6 OHIO N.U. L. REV. 341, 342 (1979); John D. O'Malley, *The Code and Double Forgeries*, 19 SYRACUSE L. REV. 36, 37 (1967); John D. Colombo, Comment, *Commercial Paper and Forgery*:

customer's account for the amount of the item²⁰ unless the bank can assert a defense.

B. Payor Bank's Defenses

The payor bank can assert several defenses in response to its customer's demand for recredit.²¹ This Article addresses customer negligence.

1. Customer negligence

Customer negligence is the payor bank's defense most affected by the changes to the UCC.²² Under present law in most jurisdictions, the customer is precluded from asserting that the check was unauthorized if his or her negligence "substantially contribute[d]" to the forgery.²³ Neither the UCC nor its comments, however, clarify the intended meaning of "substantially contributes." While the phrase is obviously meant to impose a causation requirement, it is unclear whether such a requirement encompasses a proximate cause test and, if so, which proximate cause test.²⁴ The extent to which the "substantially contributes" clause

Broader Liability for Banks?, 1980 U. ILL. L. REV. 813, 819; Michael J. Morse, Note, *Uniform Commercial Code—Articles 3 and 4—Bank Required to Disburse Funds After Final Payment*, 64 MARQ. L. REV. 408, 410 (1980).

20. *G & R Corp. v. American Sec. & Trust Co.*, 523 F.2d 1164, 1168 (D.C. Cir. 1975); *Issac v. American Heritage Bank & Trust Co.*, 675 P.2d 742, 744 (Colo. 1984), *aff'g* 635 P.2d 1296 (1981) (stating customer's right to demand that bank recredit account may be implied from § 4-401). Under UCC §§ 3-406 and 4-406, if the customer is negligent and precluded from asserting the forgery, the item is technically properly payable. U.C.C. § 3-406 (1989); *id.* § 4-406 (amended 1990); see *Fireman's Fund Ins. Co.*, 85 Cal. App. 3d at 804 n.5, 149 Cal. Rptr. at 889 n.5 (1978).

21. See *infra* note 22.

22. Failure to report a forgery promptly is one of the types of customer negligence discussed in this Article, at least where there are subsequent forgeries by the same wrongdoer. U.C.C. § 4-406(c) (1989) (amended 1990) (bank statement rule). Other defenses exist, such as when the customer through some act ratifies the forgery, *id.* § 3-404(2) & cmt. 3 (superseded by § 3-403(a) & cmt. 3 (1990)). Additionally, the payor bank can assert the statute of limitations as a defense to the customer's demand to recredit. *Id.* § 4-406(4) (superseded by § 4-406(f)(1990)). The customer has one year to "discover and report his [or her] unauthorized signature." *Id.* If the customer fails to do so within this time he or she will be precluded from asserting the forgery against the bank. *Id.*

23. *Id.* § 3-406 (amended 1990) (customer "who by his [or her] negligence substantially contributes to . . . the making of an unauthorized signature is precluded from asserting [forgery]"). *Id.* Signatures are presumed to be genuine unless specifically denied in the pleadings, "except where the action is to enforce the obligation of a purported signer who has died or become incompetent before proof is required." *Id.* § 3-307(1)(b) (superseded by § 3-308(a) (1990)).

24. Proximate cause tests such as the "but-for" test, the "substantial factor" test, and the "causation in fact" test are all commonly used in the law of negligence. See, e.g., *Douppnik v. General Motors Corp.*, 225 Cal. App. 3d 849, 857, 275 Cal. Rptr. 715, 719 (1990) (applying

requires inquiry into a customer's duty of care is also unclear.²⁵

Courts have found the customer's conduct sufficiently negligent to trigger the contributory negligence preclusion where the customer (1) failed to look after a signature stamp;²⁶ (2) failed to exercise reasonable care in hiring and supervising employees who handled checks;²⁷ and (3) failed to take reasonable action after discovering an irregularity with respect to a first forged check.²⁸ This preclusion allows the payor bank to avoid recrediting the customer's account, thus placing the entire amount of the forged check loss upon the negligent customer.²⁹

"substantial factor" test); *People v. Pike*, 197 Cal. App. 3d 732, 744, 243 Cal. Rptr. 54, 62-63 (1988) (applying "but-for" test); *Maupin v. Widling*, 192 Cal. App. 3d 568, 573, 237 Cal. Rptr. 521, 524 (1987) (explaining "causation in fact" test); see W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* §§ 41-42, at 263-79 (5th ed. 1984) [hereinafter *PROSSER & KEETON*].

25. *Compare* *Thompson Maple Prods., Inc. v. Citizens Nat'l Bank*, 234 A.2d 32 (Pa. Super. Ct. 1967) (negligence in allowing access to blank delivery slips and issuance of instruments substantially contributed to forgery) with *Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 491 F.2d 192 (8th Cir. 1974) (negligence in issuance of checks did not substantially contribute to forgery). For a discussion of inadequacies in the Code's treatment of this concept, see Douglas J. Whaley, *Negligence and Negotiable Instruments*, 53 N.C. L. REV. 1 (1974). Professor Whaley discusses the difficulties inherent in the application of negligence principles to negotiable instruments law, particularly in questions of causation. *Id.* at 22-29. He concludes that courts should substitute a cause-in-fact test for the legal or proximate cause test. *Id.* at 26, 42. For a discussion of how the RUCC fails to adequately resolve this confusion, see *infra* notes 65-91 and accompanying text.

26. The Code drafters explain that "[t]he most obvious case is that of the drawer who makes use of a signature stamp or other automatic signing device and is negligent in looking after it. The section extends, however, to cases where the party has notice that forgeries of his signature have occurred and is negligent in failing to prevent further forgeries by the same person." U.C.C. § 3-406 cmt. 7 (1989) (amended 1990); see *First Am. Nat'l Bank v. Christian Found. Life Ins. Co.*, 420 S.W.2d 912, 915 (Ark. 1967) (failure to adequately supervise use of facsimile signature). See generally Whaley, *supra* note 25, at 33-34 (obviously negligent to keep signature stamp or other automatic device without proper safeguarding to prevent unauthorized use).

27. See Whaley, *supra* note 25, at 35-38. Professor Whaley states: "No court . . . should hold that an employer may hire a paroled ex-forgery, place him in charge of check disbursements, and fail to supervise his activities." *Id.* at 36.

The employer's duty to question its employees varies with the circumstances. For example, suspicious circumstances will increase the employer's duty, including where there are missing records, as in *Westport Bank & Trust Co. v. Lodge*, 325 A.2d 222 (Conn. 1973), or the employee is unexplainedly living beyond his means, as in *Scott v. First National Bank*, 119 S.W.2d 929 (Mo. 1938). In such cases, the employer would be negligent to ignore the possibility of employee forgery.

28. *Vending Chattanooga, Inc. v. American Nat'l Bank & Trust Co.*, 730 S.W.2d 624, 627 (Tenn. 1987); *Kaley v. Union Planters Nat'l Bank*, 775 S.W.2d 607, 610 (Tenn. Ct. App. 1988); see U.C.C. § 4-406 (1989) (amended 1990). See generally JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 16-7, at 712-15 (3d ed. 1988) (customer is contributorily negligent when put on notice of forgery by irregularities in account).

29. U.C.C. § 3-406 (1989) (amended 1990); *id.* § 3-307(1) (superseded by § 3-308(a) (1990)).

Section 3-406 of the Code, however, only grants the customer negligence preclusion to a payor bank who paid the instrument "in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business."³⁰ The section thus places the entire amount of the forged check loss upon the payor bank when *both* the customer *and* the payor bank are negligent. However, except for section 4-103(3),³¹ the Code offers no guidance in determining whether the conduct of the payor bank falls below the standard of ordinary care. Although courts are divided on this issue, many courts and commentators interpret the Code as requiring payor banks to compare the drawer's signature on an item with the customer's signature on file before paying an item and charging its customer's account.³²

30. Section 3-406 of the Code states:

Any person who by his [or her] negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.

Id. § 3-406 (amended 1990).

In a similar manner, § 4-406 provides that the preclusion is inapplicable if the "customer establishes lack of ordinary care on the part of the [payor] bank in paying the item(s)." *Id.* § 4-406(3) (subsection withdrawn 1990). The dilatory customer was precluded from asserting forgery with respect to subsequent forgeries by the same wrongdoer. *Id.* § 4-406(2)(b). See *infra* notes 33-35 and accompanying text for a discussion of the bank statement duty.

31. Under § 4-103(3), following Federal Reserve regulations, operating letters, clearing house rules and "general banking usage" is evidence of the exercise of ordinary care. U.C.C. § 4-103(3) (1989) (amended 1990). Pursuant to these provisions payor banks must establish and observe certain routine practices before paying an item.

32. See, e.g., *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 527 N.E.2d 354 (Ill. App. Ct. 1988) (although examination of signature cards may not be practical commercial practice, nevertheless bank not relieved from bearing loss from paying forged checks); *First Nat'l Bank & Trust v. Cutright*, 205 N.W.2d 542, 545 (Neb. 1973) (bank failing to compare rubber stamped signature on check with pen signature on signature card was enough evidence to show lack of ordinary care); *Mortimer Agency, Inc. v. Underwriters Trust Co.*, 341 N.Y.S.2d 75, 78 (Civ. Ct. 1973) (considering signature together with suspicious nature of spelling amount and accompanying letter); *Medford Irrigation Dist. v. Western Bank*, 676 P.2d 329 (Or. Ct. App. 1984) (automated check processing without comparing of signatures of checks below certain amount did not reasonably relate to detection of unauthorized signatures); *Federal Ins. Co. v. Bank of New York*, 2 U.C.C. Rep. Serv. 2d (Callaghan) 580 (N.Y. Civ. Ct. 1986) (bank cannot assert contributory negligence of customer as defense where bank has failed to compare check's signature to signature card of customer); *Jackson v. First Nat'l Bank*, 403 S.W.2d 109 (Tenn. Ct. App. 1966) (bank is negligent for automatically processing checks without verifying signature where circumstances should have put bank on notice of forgery); *Whaley*, *supra* note 25, at 15-17. *But see Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291 (1st Cir. 1988) (bank's practice of examining all signatures on checks for more than \$1000, examining signatures on checks between \$100 and \$1000 if bank had reason to suspect problem, and examining randomly chosen one percent of all other checks is one of ordinary care and standard commercial banking practices); *Vending Chatta-*

2. Bank statement duty

Section 4-406 of the Code imposes another duty upon the payor bank's customer, to "exercise reasonable care and promptness to examine the statement and items to discover his [or her] unauthorized signature . . . and [to] notify the bank promptly after discovery thereof."³³ If the customer fails to fulfill this duty, the customer may be precluded from asserting the forgery under certain circumstances.³⁴ Where these circumstances exist, the customer will bear the entire loss because the bank statement rule gives the payor bank another complete defense to the customer's recredit claim. As with customer negligence, if the customer can establish lack of ordinary care on the part of the bank in paying the item, the entire amount of the loss reverts back to the bank.³⁵

3. Impact of payor bank's defenses

The UCC, as currently codified in the majority of states, requires the payor bank to assert any defense that it might have against the customer³⁶ if it wishes to proceed against collecting banks on a forgery claim.³⁷ This provision coupled with the lack of other alternatives³⁸

nooga, Inc. v. American Nat'l Bank & Trust Co., 730 S.W.2d 624 (Tenn. 1987) (bank not required as matter of law to closely examine each check with signature card but must conform to reasonable commercial standards).

33. U.C.C. § 4-406(1) (1989) (amended 1990). This is the so-called bank statement duty.

34. The customer will be precluded from asserting the forgery, first, where the bank suffers a loss as a result of the customer's failure. *Id.* § 4-406(2)(a) (amended 1990). Second, the customer will be precluded from asserting the forgery with respect to subsequent forgeries by the same wrongdoer. *Id.* § 4-406(2)(b) (amended 1990).

35. *Id.* § 4-406(3) (amended 1990).

36. Such defenses would be asserted against the customer's claim to recredit the account. In addition to customer negligence, the payor bank might be able to assert the statute of limitations as a defense to the demand for recredit. This statute of limitations operates without regard to the negligence of either party. *Id.* § 4-406(4) (superseded by § 4-406(f) (1990)). In other words, while ordinarily the bank's negligence will excuse the negligence of the customer, the bank's negligence will not excuse or toll the running of the statute. Under these circumstances the customer probably will be precluded from proceeding against collecting banks and other prior good faith transferors. The customer will presumably still have a valid cause of action against the forger, at least until the corollary state statute of limitations expires.

37. Subsection 5 of section 4-406 states:

If under this section a payor bank has a valid defense against a claim of a customer upon or resulting from payment of an item and waives or fails upon request to assert the defense the bank may not assert against any collecting bank or other prior party presenting or transferring the item a claim based upon the unauthorized signature or alteration giving rise to the customer's claim.

Id. § 4-406(5) (1989) (subsection withdrawn 1990).

38. If the payor bank has paid the item and has been forced to recredit its customer's account, it will generally be unsuccessful in shifting this loss to prior collecting banks. The doctrine of *Price v. Neal*, 97 Eng. Rep. 871 (K.B. 1762), as codified in the final payment provisions of U.C.C. §§ 3-418, 4-213 (1989) (superseded by § 4-215 (1990) and § 4-302 (1989)

causes the payor bank routinely to assert customer negligence as a defense.³⁹ The frequency with which payor banks assert customer negligence may cause the customer, rather than the payor bank, to bear the loss from the forgery because many customers cannot afford to litigate the issue of negligence.⁴⁰ This is, of course, more likely where the amount of the forged item is small because it is not cost effective for the customer to litigate the question of negligence in such cases. Thus, the customer, even when not negligent, often bears the loss on small items. Where the amount of the forged item is large, on the other hand, it be-

(amended 1990)), is the major obstacle to the payor bank's attempt to recover "up the chain." The payor bank will be unable to shift the loss using UCC warranty theory because, except for the rare instance where the presenter actually knows that the drawer's signature is forged, no presentment warranty will be breached. *Dozier v. First Alabama Bank*, 363 So. 2d 781, 784 (Ala. Civ. App. 1978) (presenter warrants under subsection (1)(b) of each warranty that he or she has no knowledge of forged drawer's signature); *Payroll Check Cashing v. New Palestine Bank*, 401 N.E.2d 752, 754, 756 (Ind. Ct. App. 1980) (warranty of good title breached only by forged indorsement, not by forged drawer's signature); *Manufacturers & Traders Trust Co. v. County Trust Region*, 398 N.Y.S.2d 298, 298 (App. Div. 1977); *North Carolina Nat'l Bank v. Hammond*, 260 S.E.2d 617, 621 (N.C. 1979) (payor bank cannot assert breach of transfer warranty under subsection (2) of each warranty provision because the payor is not transferee).

The payor bank will be similarly unsuccessful if it bases its action upon the Article 3 indorser's contract under 3-414(1). *See, e.g., Dozier*, 363 So. 2d at 783; *Kirby v. First & Merchants Nat'l Bank*, 168 S.E.2d 273, 276 (Va. 1969). The payor bank may also attempt to sue for common law restitution under § 1-103 of the Code. That section provides for the use of principles of law and equity to supplement the UCC, unless displaced by the act. U.C.C. § 1-103 (1989). The payor's right to restitution is, however, limited by UCC § 3-418 which provides that payment is final in favor of a holder in due course. *Id.* § 3-418; *id.* § 3-418 (1990). The extent to which these rights are limited by the accountability provisions of the Code is also open to question. *Id.* § 4-213 (1989) (superseded by § 4-215 (1990)); *id.* § 4-302 (amended 1990); *see, e.g., Dow & Ellis, supra* note 15, at 808-23 (conflict between sections cannot be reconciled); *Columbo, supra* note 19, at 831-32 (commentators split as to whether banks are prohibited from recovering funds paid out).

39. This assertion is based mainly on the paucity of cases in which the payor bank did not assert customer negligence as a defense. Of course, to some extent this may be attributable to the willingness of banks to voluntarily recredit their customers' accounts upon being notified of a forgery. Daniel E. Murray, *Price v. Neal in the Electronic Age: An Empirical Survey*, 87 BANK. L.J. 686, 702-03 (1970). As the amount of the forgery (and thus the loss to the payor bank) increases, however, the bank undoubtedly becomes less willing to voluntarily recredit its customer's account.

According to the findings of Professor Murray, it also is not unusual for the payor bank simply to recredit its customer's account, either absorbing the loss or collecting under its forgery insurance policy. *Id.* at 701-05, 713-15.

40. In an earlier revision project, entitled the Uniform New Payments Code (NPC), the drafters made this point in support of their proposed two-tier loss allocation scheme. *See UNIFORM NEW PAYMENTS CODE* § 200 purpose cmt. 2 (P.E.B. Draft No. 3, 1983). *See infra* notes 94-96 and accompanying text, where a similar two-tier scheme is proposed. For background on the NPC, see Steven B. Dow & Nan S. Ellis, *The Proposed Uniform New Payments Code: Allocation of Losses Resulting From Forged Drawers' Signatures*, 22 HARV. J. ON LEGIS. 399 (1985); Hal S. Scott, *Corporate Wire Transfers and the Uniform New Payments Code*, 83 COLUM. L. REV. 1664 (1983).

comes more cost effective to litigate the question of negligence. Therefore, with large items it is more likely that the customer will litigate and avoid bearing the loss.

III. ALLOCATION OF LOSSES UNDER THE RUCC

The RUCC revisions substantially alter the UCC's basic loss allocation scheme. Although the revisions are presumably intended to improve the Code, they contain significant inequities in allocating forged check losses. Although nine states have adopted the RUCC,⁴¹ states currently considering adopting the revisions⁴² and states that have yet to address the changes should consider these inequitable results before adopting the RUCC.

A. Proposed Changes Under the Revised Article 3

Superficially, revised Article 3 retains the Code's basic loss allocation scheme between payor banks and their customers by keeping the concept of "properly payable" and the relationship between the concepts of properly payable and customer negligence.⁴³ Thus, in the case of check forgery, the customer can still demand that his or her account be recredited for the amount of the forged check.⁴⁴ Furthermore, the bank is still able to assert the usual defenses to this demand, including customer negligence, because the revisions retain the basic rule that customer negligence which "substantially contributes" to the forgery precludes the customer from successfully demanding recredit.⁴⁵

There are, however, several important changes in the revised Article 3 which, when combined, significantly shift the allocation of forgery losses from the payor bank to its customer.⁴⁶ First, where present law completely excuses the customer's negligence if the payor bank is also negligent,⁴⁷ section 3-406 of the revisions calls for the loss to be allocated using a comparative negligence scheme.⁴⁸ Thus, if both the customer

41. See *supra* note 6.

42. *Id.*

43. U.C.C. § 4-401 (1990). The only major change in § 4-401 is in subsection (c). This subsection permits the bank to charge its customer's account for postdated checks unless the customer has notified the bank of such check prior to its presentment. *Id.* § 4-401(c).

44. See *id.* § 4-401 cmt. 1.

45. U.C.C. § 3-406(a) (1990) (customer "whose failure to exercise ordinary care substantially contributes to . . . the making of a forged signature" is precluded from asserting forgery). Compare *id.* § 3-406 (1989) (amended 1990) with *id.* § 3-406 (1990).

46. See *infra* notes 57-93 and accompanying text.

47. U.C.C. § 3-406 (1989) (amended 1990); see *supra* notes 30-31 and accompanying text.

48. U.C.C. § 3-406(b) (1990).

and the payor bank have failed to exercise ordinary care, the loss is divided between them "according to the extent to which the failure of each to exercise ordinary care contributed to the loss."⁴⁹

The second change governing loss allocation is contained in section 4-406.⁵⁰ Although this section continues to provide that failure to examine a bank statement and to promptly report any forgeries constitutes customer negligence and remains a defense to a customer's claim to recredit his or her account,⁵¹ this duty arises whether or not the items were actually returned to the customer.⁵² To accommodate the increasing use of check truncation,⁵³ the revisions require only that the bank send or make available a statement of account, and do not require the bank to return the items to the customer unless the customer requests them.⁵⁴ In addition, section 4-406 provides for a comparative negligence scheme similar to that proposed in section 3-406.⁵⁵

The third, and perhaps most significant change provides that the failure of the payor bank to examine computer processed items for forged signatures will not constitute bank negligence *per se* if the bank's procedures do not require examining the items, and if the bank's procedures are not unreasonable in comparison with those of other banks.⁵⁶ This

49. *Id.*

50. *Id.* § 4-406.

51. *Compare id.* § 4-406 (1989) (amended 1990) with *id.* § 4-406 (1990).

52. Section 4-406 of the RUCC states in pertinent part: "A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return [the items] or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid." *Id.* § 4-406(a) (1990). Furthermore, the official comment states: "Whether the bank returns to the customer the items paid is a matter for bank-customer agreements." *Id.* § 4-406 cmt. 1. The bank can comply with the general standard of providing information "sufficient to allow the customer reasonably to identify the items paid" in three ways. First, it can provide the item. *Id.* Second, it can provide the customer with an image of the item. *Id.* Finally, it can describe the item by item number, amount and date of payment. *Id.*

53. Check truncation refers to the process of check collection whereby items are not physically returned to the payor from the collecting bank. See DONALD I. BAKER & ROLAND E. BRANDEL, *THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS* § 2.02, at 2-13 to 2-30 (1988) (explanation of various forms of check truncation).

54. U.C.C. § 4-406(b) (1990). Where the items are not returned, the bank retaining the item (depository or payor) would be required to "maintain the capacity to furnish legible copies of the items" for seven years. *Id.*

55. *Id.* § 4-406(d)-(e). Under revised § 4-406, however, if the customer proves that the bank did not pay the item in good faith, the comparative negligence rule would be inapplicable and the customer would be permitted to assert the forgery. *Id.* § 4-406(e). Curiously, a similar provision is not found in § 3-406. *Id.* § 3-406.

56. Section 3-103(a)(7) of the RUCC provides:

"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

standard would, in effect, relieve payor banks of any duty to examine items for forgery.

B. Analysis of RUCC Loss Allocation

The proposed changes are flawed in several significant respects, and should not be adopted. First, the RUCC retains the basic customer negligence terminology of the Code, passing up an excellent opportunity to resolve the confusion that exists with respect to the present wording. Second, the RUCC effectively relieves the payor bank of any duty to examine items for forgery. Inasmuch as failure to examine items for forgery is virtually the only way in which a payor bank can be negligent in this context, the negligent customer will bear the loss much more frequently under the RUCC than under the Code. As a result, it is more likely under the RUCC than under the Code that both negligent and non-negligent customers will choose to bear the loss rather than to litigate the question of negligence, even in the case of large items. Third, adopting a system of comparative negligence creates a further disincentive for the customer to litigate the negligence question. Taken as a whole, these proposed changes substantially shift loss allocation from the payor bank to the customer. The magnitude of this shift is only apparent through a closer examination of each individual change.

1. Negligence

The revisions retain the common negligence terminology,⁵⁷ thereby prolonging the confusion surrounding it.⁵⁸ In an apparent effort to eliminate this uncertainty, the revision to section 3-406 substitutes the phrase "failure to exercise ordinary care" for the term "negligence." The term "negligence," however, was never problematic. The issues of proximate causation and the applicable standard of conduct are the source of problems.⁵⁹ Thus, merely modifying the verbiage without addressing these issues offers no significant improvement.⁶⁰

bank that takes an instrument . . . 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.

Id. § 3-103(a)(7).

57. Compare *id.* § 3-406 (1989) (amended 1990) with *id.* § 3-406 (1990).

58. See PROSSER & KEETON, *supra* note 24, at 263-80; Whaley, *supra* note 25, at 26-29; *infra* notes 63, 66, 69 and accompanying text.

59. See *infra* notes 66, 69-70 and accompanying text.

60. Furthermore, UCC § 4-406 used the phrase "lack of ordinary care" even before the 1990 amendments. Compare U.C.C. § 4-406(3) (1989) (amended 1990) with *id.* § 4-406(3) (1990). This change, therefore, is not significant.

The definition of "ordinary care" in the revised section 3-103(a)(7), however, is significant. In the case of a person engaged in business, ordinary care is defined as "observance of reasonable commercial standards, prevailing in the area in which that person is located, with respect to the business in which that person is engaged."⁶¹ The definition, however, only addresses the standards of care for the bank and the business customer; it does not outline the non-business customer's standard of care.

In addition, the revisions provide no guidance as to what *particular* conduct might constitute a failure to exercise ordinary care in the banking context.⁶² This issue has been the source of conflict in the courts under present law⁶³ and should, therefore, have been addressed. Furthermore, the fact that proposed section 3-103 of the RUCC effectively relieves the bank from the responsibility of examining items for forgeries or other wrongdoing merely compounds the confusion. As a result it is unclear what type of conduct on the part of the payor might constitute lack of ordinary care.⁶⁴

The revisions also fail in two significant ways to resolve causation problems. First, a comment to the RUCC provides that conduct "substantially contributes" to the loss if it is "a contributing cause of the alteration or [forged] signature and a substantial factor in bringing it about."⁶⁵ Assuming the drafters proposed this definition as a response to the confusion under the UCC,⁶⁶ they should have provided a statutory definition rather than relegating the language to the comments.

Second, the drafters adopted the "substantial factor" test from tort law and rejected the more stringent "direct and proximate cause" test⁶⁷ in order to make it easier for the bank to avoid recrediting the customer's

61. U.C.C. § 3-103(a)(7) (1990).

62. The drafters of the RUCC expressly refused to define the particular conduct that would constitute failure to exercise ordinary care. "The question is [instead] left to the court or the jury for decision in the light of the circumstances in the particular case including reasonable commercial standards that may apply." *Id.* § 3-406 cmt. 1 (1990).

63. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 189 (Tex. Ct. App. 1989) (noting significant authority split on standard of care required for examining checks for forgeries); *see supra* notes 31-32 and accompanying text.

64. U.C.C. § 3-103(a)(7) (1990). *See infra* note 84 and accompanying text where it is suggested that failure to examine items is virtually the only example of payor bank conduct that could constitute bank negligence.

65. U.C.C. § 3-406 cmt. 2 (1990).

66. *See generally* Whaley, *supra* note 25, at 2-3 ("negligent *issuance* of checks not 'proximate cause' of loss; only negligence leading to *forgery* is compensable and UCC § 3-406 has no effect on this rule").

67. U.C.C. § 3-406 cmt. 2 (1990).

account.⁶⁸ It is unclear, however, that this would be the actual effect, given the substantial amount of controversy that the concept of proximate cause and its related questions generate under tort law.⁶⁹ Rather, it is more likely that incorporating the "substantial factor" test from tort law into commercial law will merely invite more controversy.⁷⁰ Moreover, with a less stringent test the revisions will likely make it easier for the bank to prove customer negligence, thereby shifting the loss from the payor bank to the customer.⁷¹

2. Bank examination of items

The revisions make fundamental changes to the payor bank's duty to examine items for forgery.⁷² Although the payor bank would continue to be negligent if it failed to follow reasonable commercial standards,⁷³ revised Article 3 specifies that those reasonable commercial standards do not necessarily require the payor bank to examine any item automatically processed for payment.⁷⁴ Under the RUCC, if the item is automatically processed, the loss from any forged drawer's signature will likely remain

68. *Id.* ("Under the less stringent test the preclusion [of the assertion of a forgery as the basis for recrediting an account] should be easier to establish.")

69. *See* PROSSER & KEETON, *supra* note 24, at 263 ("There is perhaps nothing in the entire field of law which has called forth more disagreement, or upon which the opinions are in such a welter of confusion."); Whaley, *supra* note 25, at 42 ("In negotiable instruments law as elsewhere, 'proximate cause' has become a wild card doctrine and caused enormous confusion in an area where . . . certainty is a commercial necessity.")

70. *See* Whaley, *supra* note 25, at 27, 42. Professor Whaley argues that the proximate cause test should be abandoned in favor of an approach questioning whether there existed a duty to do or not to do the act, whether the duty was violated, and whether this violation was a substantial factor contributing to the forgery. *Id.* at 26-27. Professor Whaley asserts that in deciding whether or not a duty existed:

[T]he court must take into account many policy factors such as the degree of commercial awareness of the party, the financial impact of an adverse decision, the foreseeability of the harm, the ability of later parties to protect themselves from the wrongdoer, the degree of fault, and, perhaps most important, the extent to which the party's actions are out of step with those of others in similar situations.

Id. at 27.

71. This is especially true in light of the fact that it will be more difficult for the customer to prove payor bank negligence under the revisions. *See supra* note 56 and accompanying text. *See infra* notes 76-93 and accompanying text where it is suggested that the proposed shift of loss away from the payor bank to the customer is inappropriate.

72. U.C.C. § 3-103(a)(7) (1990).

73. *Id.* §§ 3-406(b), 4-406(e). Under the revisions this negligence on the part of the payor would partially offset the negligence of the customer. *Id.*

74. *Id.* § 3-103(a)(7). The NPC had a provision suggesting that failure of the payor bank to examine its customer's signature on items under a certain amount might meet reasonable commercial standards. UNIFORM NEW PAYMENTS CODE § 202 purpose cmt. 4 (P.E.B. Draft No. 3, 1983). *See supra* note 40 for a discussion of the NPC. By comparison, under the RUCC the payor bank would have no obligation to examine any items, even large items. U.C.C. § 3-103(a)(7) (1990).

on a negligent customer—even if the payor bank failed to examine the signature. While there is currently some disagreement among jurisdictions which follow the UCC, this result is generally not possible under the UCC.⁷⁵

The RUCC advocates relieving the bank of its duty to inspect for forgeries in part to encourage check truncation and to accommodate the realities of computer check processing.⁷⁶ The apparent rationale for this position rests in the impracticality of payor banks checking the validity of all signatures.⁷⁷

This justification, however, is flawed for several reasons. First, signature verification is compatible with efficient check processing. Some empirical evidence indicates that the majority of payor banks check the drawers' signature on a substantial number of checks.⁷⁸ Even banks that

75. See Whaley, *supra* note 25, at 15; *supra* note 32. The RUCC approach is arguably contrary to the common law approach. Professor Whaley submits that the basis for many commercial law negligence cases is the question of the ability of later parties to protect themselves from the negligent party's conduct. See Whaley, *supra* note 25, at 10. Under this "second chance theory," the payor bank would have the ability, by examining items for forgeries, to protect itself from the earlier negligent conduct of the customer. If it chooses not to do so, it would not be able to pass the loss back to the earlier negligent party. *Id.*

76. U.C.C. §§ 3-103(a)(7), 4-101 cmt. 2 (1990). With the type of check truncation in which the depository bank retains the items, payor banks do not receive the items in any physical form. See BAKER & BRANDEL, *supra* note 53, § 2.02. The payor bank, therefore, typically has no opportunity to verify its customer's signature. Such a system would appear to be incompatible with a loss allocation scheme like that under the old UCC, which ultimately depended on signature verification.

77. The drafters of the NPC advocated the abolition of the *Price v. Neal* doctrine by substituting the transmission liability doctrine which assigned liability to any party who transferred an unauthorized item. UNIFORM NEW PAYMENTS CODE § 204 (P.E.B. Draft No. 3, 1983). One rationale given for this proposal concerned the payor bank's inability to check the validity of signatures after the development of computer check processing. *Id.* § 204 cmt. 2. Commentators severely criticized the suggestion that the doctrine of *Price v. Neal* should be abolished and the suggestion was discarded. See, e.g., Dow & Ellis, *supra* note 40, at 424-33. The NPC proposed that because it is difficult for the payor bank to check the validity of its customers' signatures, the bank should be permitted to shift the loss up the chain to the prior collecting banks. UNIFORM NEW PAYMENTS CODE § 204 cmt. 2. The revisions propose that because it is difficult for the payor bank to check the validity of its customers' signatures, the bank should be permitted to shift the loss to its customers. This rationale is questionable, and shifting the loss in this way is wholly inappropriate.

78. Murray, *supra* note 39, at 698-701. In his 1970 survey Professor Murray reports that nearly all banks check most signatures. However, since 1970 there is evidence that contradicts the basic findings of his research. AMERICAN BANKERS ASSOCIATION, NATIONAL OPERATIONS/AUTOMATION SURVEY 119 (1986). There is additional compelling anecdotal evidence. For example, Morgan Guaranty Trust had a policy of examining signatures only on checks of \$10,000 or more. Sally S. Harwood, Note, *Commercial Transactions—Commercial Paper—Allocation of Liability for Checks Bearing Unauthorized Indorsements and Unauthorized Drawer's Signatures*, 24 WAYNE L. REV. 1077, 1090 n.90 (1978); see also John D. O'Malley, *Common Check Frauds and the Uniform Commercial Code*, 23 RUTGERS L. REV. 189, 209

no longer check signatures on all items typically check them on large items—items over some dollar amount established by the banks.⁷⁹ Such verification is both practical and cost effective because there are relatively few large-item checks presented to payor banks and because the potential losses are high. The revisions, however, do not account for this practice.⁸⁰

Even if the economic realities of modern banking justify relieving the payor bank of its duty to verify all signatures, they do not justify relieving the payor bank of a duty to verify at least some signatures. It seems reasonable, given the costs of verification and the certainty and extent of liability, that verifying the customer's signature on items over a certain amount would be economical for the payor bank.⁸¹ The RUCC, however, does not obligate the payor bank to check signatures even on large amount items.⁸² The risk of loss from forged drawers' signatures should not be shifted away from the payor bank. Even if a shift in loss is justified on an economic basis, the shift should only take place to the extent that signature verification by the payor bank is not economical.⁸³

(1969) (stating that "[i]t has been about 40 years since large banks have given up the precautionary practice of examining the signatures on each check paid."). *Oak Park Trust & Savings Bank* examined only checks greater than \$1000. *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 527 N.E.2d 354, 355 (Ill. App. Ct. 1988), *rev'd*, 522 N.E.2d 783 (Ill. 1990) (bank's machine automatically separated and paid all checks under \$1000). Similarly, *Western Bank* has a policy of examining signatures only on checks of \$5000 or more. *Medford Irrigation Dist. v. Western Bank*, 676 P.2d 329, 331 (Or. Ct. App. 1984) (bank asserted procedure consistent with methods used by most banks of its size). Moreover, in view of the very large number of items processed each day by some large banks it is difficult to believe that most banks routinely verify the signatures on all items. Corinne Cooper, *Checks Held Hostage—The Funds Availability Controversy*, 102 BANK. L.J. 532, 535 (1985) (approximately 36 billion checks are collected through Federal Reserve system each year).

79. *Wilder Binding Co.*, 527 N.E.2d at 355-56; *Medford*, 676 P.2d at 331; AMERICAN BANKERS ASSOCIATION, *supra* note 78, at 119 (1986).

80. U.C.C. § 3-103 (a)(7) (1990).

81. Computer systems are well suited to selecting items over a certain amount. These items can then be visually inspected for forgery. An operator at the depository bank encodes the amount of the check on its face using magnetic ink character recognition (MICR) symbols. A computer at the payor bank then reads these symbols and can be programmed to pick out all items over a certain amount. BAKER & BRANDEL, *supra* note 53, § 1.02[2]; CLARK, *supra* note 19, § 10.5. This practice is currently utilized by some banks. Murray, *supra* note 39, at 698-701.

82. See U.C.C. § 3-103(a)(7) (1990).

83. See *infra* notes 94-105 where the authors propose a two-tier scheme under which the payor bank is obligated to examine signatures on items over \$500. Seventy-two percent of all checks written are for under \$100. BANK ADMINISTRATION INSTITUTE, CHECKING ACCOUNT USAGE IN THE UNITED STATES 7 (1979). Only 28%, therefore, are for over \$100, and even fewer are for over \$500. Since a majority of payor banks check the drawer's signature on a substantial number of checks, they presumably find it economical to do so. See *supra* note 78. It is clearly economical, then, for banks to verify signatures on items over \$500.

Second, banks have voluntarily chosen to process their checks by computer. It is fair to assume that banks see this method as the most efficient and cost-effective way of processing checks under the UCC, and they undoubtedly made the choice with full consideration of the forgery costs they were likely to incur. If the ultimate forgery costs make computer check processing less cost-effective than the payor banks had anticipated, the banks are free to develop an alternative processing method which meets their needs for efficiency and signature verification.

Third, a rule which no longer requires payor banks to inspect items for forgeries would effectively relieve the payor bank of all forgery losses because, in the usual case, the *only* fault a payor bank *ever incurs* arises from its failure to examine an item.⁸⁴

Finally, to the extent that this change may be justified by a desire to encourage the increased use of check truncation, the justification is inadequate. Check truncation developed under the present loss allocation system in spite of the concern of payor banks over forgery liability.⁸⁵ Any argument that computer processing and check truncation cannot develop without changes in the rules of loss allocation is implausible because both of these methods have developed, and continued to develop, under the current Code. It is fair to conclude that banks which use check truncation believe it to be cost-effective under the Code.⁸⁶ In fact, many banks are currently attempting to minimize forgeries by developing the technological means to verify and transmit signatures electronically.⁸⁷

Advocates of check truncation suggest the practice as a cost reduction method for banks.⁸⁸ Such cost reductions, however, do not justify

84. Other types of fault might conceivably include if the bank examined the check but failed to discover the forgery, or if the bank was given some false signature cards and did not verify them.

85. A 1981 study found that approximately 25% of all financial institutions truncate checking services. Robert M. Garsson, *Truncation Losing Ground as Banks Concentrate on Other Matters*, AM. BANKER, June 1, 1983, at 8; see also BAKER & BRANDEL, *supra* note 53, §§ 2.01-2.03 (truncation eliminates paper checks in favor of electronically transmitting data); Linda McCormick, *European American Will Soon Test Fast Check Processing System; 'Digitized Image' Reduces Size of Paper by Three-Fourths, Allowing High-Speed Handling*, AM. BANKER, June 3, 1982, at 3.

86. Jerry McElhatton, *Check Processing: The Challenge Grows*, MAG. BANK ADMIN., June 1986, at 22, 28 (check truncation will contribute toward greater efficiency and less paper).

87. See McCormick, *supra* note 85, at 3. It is currently technologically possible for depositary banks to retain checks and to forward a digital "image" of the check to the payor bank in such a way that the payor bank can examine the drawer's signature without possessing the actual item. Raymond F. Dinan, et al., *ImagePlus High Performance Transaction System*, 29 I.B.M. Sys. J. 421, 422, 432 (1990).

88. See McCormick, *supra* note 85, at 3.

allowing check truncation to form the basis for loss allocations resulting from forgeries. If the savings derived from check truncation are not substantial enough to overcome the expenses of the correspondingly larger forgery costs, the practice does not make economic sense and should be abandoned. Banks should, therefore, devise a method of processing checks that is both economically sound and compatible with a loss allocation scheme based upon sound public policy. State legislatures should not adopt the RUCC because it would eliminate any incentive for banks to devise such an equitable method.

3. Comparative negligence

The revision's comparative negligence scheme⁸⁹ will worsen the customer's situation regardless of the amount of the forged item. On small items, the customer will have even less incentive to litigate the question of negligence because the bank's liability will be offset by the amount of the customer's negligence.⁹⁰ Further, under the revisions the payor bank ordinarily need not examine the drawer's signature;⁹¹ it then becomes extremely difficult for the customer to establish the payor bank's negligence on either small or large items. Thus, although this proportional loss scheme appears to be fair in theory, in practice it will place the entire loss on the customer.

In conclusion, the revisions to the UCC regarding loss allocation from forged drawers' signatures are flawed, and states should not adopt them as proposed. In their present form, they represent a major shift in loss allocation from the payor bank to the customer. The shift is unjustified because the customer is unlikely to have forgery insurance,⁹² and less likely to be able to avoid the loss.⁹³

89. U.C.C. §§ 3-406, 4-406 (1990).

90. Recall that under current law, the customer, even the non-negligent customer, will frequently give up and absorb the loss because litigating the question of negligence is not cost effective. UNIFORM NEW PAYMENTS CODE § 200 cmt. 2 (P.E.B. Draft No. 3, 1983); see *supra* note 40 and accompanying text. This is true even though under present law the negligent customer can shift the *entire* loss to the payor bank by showing payor bank negligence. *Supra* note 30 and accompanying text.

91. U.C.C. § 3-103(a)(7) (1990).

92. For a general discussion of this rationale, see E. Allan Farnsworth, *Insurance Against Check Forgery*, 60 COLUM. L. REV. 284, 294 (1960).

93. This argument is referred to as the "second chance" theory because the drawee bank has some chance to detect the wrongdoing and avoid the loss, even after customer negligence. It has been offered at common law to justify imposition of liability, despite customer negligence, upon the payor bank that paid forged items. See Whaley, *supra* note 25, at 10.

IV. AN ALTERNATIVE APPROACH: TWO-TIER LOSS ALLOCATION

A two-tier system of liability, recognizing the economic realities of litigating disputes over small amounts, would be a better approach than either the UCC or the RUCC.⁹⁴ Under this approach, if the amount of the forged check is less than a specified amount, for example \$500,⁹⁵ the customer would bear no loss regardless of negligence. The bank would recredit the customer's account for the item amount even if that customer's negligence contributed to the forgery. This strict liability rule for smaller items would protect the customer from the need to litigate the negligence issue because it is not cost effective to do so. Where the amount exceeds the given statutory minimum, however, the customer's negligence would become relevant. This two-tier system would allocate losses from forgeries between customers and payor banks more fairly than either the UCC or the RUCC.⁹⁶

Under the UCC, the payor bank often refuses to recredit a customer's account, asserting customer negligence.⁹⁷ When the amount of the item is relatively small, even the non-negligent customer often absorbs the loss rather than litigating the negligence question because of the high cost of litigation.⁹⁸ The revisions provide even less incentive to litigate because they lower the bank's standard of care, thus decreasing the customer's chances of recovery. If under the present law in most states (where failure on the part of the payor bank to examine items for forged signatures constitutes bank negligence) customers rarely find it cost efficient to litigate the question of negligence on small items, it will be even

94. This two-tier system was proposed by the drafters of the NPC. UNIFORM NEW PAYMENTS CODE § 200(2) (P.E.B. Draft No. 3, 1983); see Dow & Ellis, *supra* note 40, at 411-18 (authors approved of two-tier system of liability as proposed in NPC). Although the two-tier system proposed in the NPC applied only to consumers, its rationale:

should also be applied to the business customer for whom the costs of litigating the issue of negligence are just as great. For many businesses, especially small ones, these costs [would be] just as burdensome as for consumers. What is not economical for a consumer is, in this case, no more economical for a business customer.

Dow & Ellis, *supra* note 40, at 416.

95. This amount was chosen mainly because it was the amount chosen by the drafters of the NPC and the amount seems reasonable. See *supra* note 83. See also *supra* note 81 for a discussion of how banks can effectively verify checks over a certain amount.

96. The authors' approach is directly contrary to that advocated by Professors Cooter and Rubin in their article. See Robert D. Cooter & Edward L. Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63 (1987). Professors Cooter and Rubin assert that the consumer should be strictly liable for forged checks up to a certain amount, with the bank liable for the remainder. *Id.* at 128.

97. See *supra* note 39 and accompanying text.

98. See Bryan D. Hull, *Common Law Negligence and Check Fraud Loss Allocation: Has Common Law Supplemented or Supplanted the U.C.C.?*, 51 OHIO ST. L.J. 605, 612 & n.62 (1990); see also *supra* note 40 and accompanying text.

less likely for the question of negligence to be litigated under the RUCC provisions, where failure to examine such items on the part of the payor bank does not necessarily constitute bank negligence.⁹⁹

Moreover, the comparative negligence scheme further reduces the likelihood of litigation; even where the customer proves the bank's negligence, recovery may be reduced by any contributory negligence. The proposed two-tier system, however, would relieve the customer of the burden of litigating the issue of negligence where economically unfeasible. The payor bank would be able to recoup these small item losses through forgery insurance.

By comparison, the question of negligence is worth litigating where larger amounts are at stake. Accordingly, states considering this issue should combine the basic UCC approach with the proportional loss allocation scheme of the revision¹⁰⁰ for amounts over \$500. The customer should be able to claim the forged item was not properly payable and demand recredit. On these large items, the payor bank should be able to defend against the demand for recredit by proving customer negligence, and the customer should be able to rebut this with a showing of payor bank negligence. The payor bank, however, should not be relieved of the burden of examining items for forged signatures, as the revisions clearly propose. Such a rule would effectively relieve the payor bank from bearing any loss because in all but the most unusual cases the *only* sort of fault a payor *would ever have* is failing to examine an item.¹⁰¹ It is reasonable to impose a duty on the payor bank to check signatures on at least large checks.¹⁰² The RUCC fails to provide adequate incentives for the payor bank to be careful because it does not obligate the bank to check signatures on any items, even large ones.¹⁰³

For large items, the comparative or proportional negligence rule proposed by the revisions would be appropriate when both bank and customer have some degree of responsibility for the loss. Where the item is large and litigation more likely, it is inequitable to ignore the relative degrees of fault when allocating loss.¹⁰⁴ Once the trier of fact has deter-

99. See U.C.C. § 3-103(a)(7) (1990); *supra* notes 72-77 and accompanying text.

100. U.C.C. §§ 3-406, 4-406(d)-(e) (1990) (loss allocated according to extent to which failure of each party to exercise ordinary care contributed to loss).

101. See *supra* note 84 and accompanying text.

102. See *supra* note 83.

103. Some evidence shows that banks commonly check the signatures on certain large items over a specified amount. See *supra* notes 78-79 and accompanying text.

104. Writing from a law and economics perspective, Professor Julian McDonnell labels as "paternalistic" any effort by the courts to penalize payor banks for failing to visually examine drawers' signatures on items before payment. Julian B. McDonnell, *Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalist Creeds Under the Uniform*

mined that both parties are at fault, apportioning the fault follows relatively easily.¹⁰⁵

Finally, although the two-tier system of liability would protect even the negligent customer from losses on small items, it would not encourage customer negligence. In any given act of forgery, there is a considerable chance that the resulting loss will be over \$500. Because the customer cannot know whether any given forged item will be in an amount greater than \$500, the customer has a substantial incentive to be careful with all checks.

V. CONCLUSION

While the present law governing loss allocation from forged drawers' signatures needs improvement, the changes proposed in the revised Article 3 fall considerably short of the mark. The combined effect of the changes—the new negligence terminology, the comparative negligence rule, and, most importantly, effectively relieving the payor bank of its duty to examine signatures—shifts the loss onto the customer to an even greater extent than under present law and will possibly increase overall forgery losses.

This examination of the revised Article 3 reveals an underlying effort behind the proposed changes to shift the loss resulting from forged drawers' signatures away from the payor bank. The Uniform New Payments Code (NPC) drafters undertook a similar effort more than a decade ago.¹⁰⁶ Under the NPC, the loss would have been shifted away from the payor bank onto prior collecting banks.¹⁰⁷ That approach was severely criticized and eventually abandoned.¹⁰⁸ Now the new revisions shift the loss onto the payor's customers. This approach is no more justified than the previously rejected NPC approach, and should not be adopted.

Commercial Code, GEO. L.J. 1399, 1428-30 (1985). However, the suggested two-tier approach would promote the efficiencies in check processing that Professor McDonnell desires, while providing incentives to both banks and customers to prevent forgery losses. Any forgery losses that do occur would be allocated on an equitable basis.

105. On large items, the policy behind proportional negligence outweighs the policies behind the "second-chance theory." See *supra* note 75 for a discussion of the second-chance theory. The parallel trend in tort law and the shift from contributory to comparative negligence supports this position.

106. UNIFORM NEW PAYMENTS CODE § 204 (P.E.B. Draft No. 3, 1983). Preparation of the Uniform New Payments Code began in 1977. *Id.* at 1-3.

107. *Id.* § 204 cmt. 3. ("Under subsection (1), all subsequent parties to which a draw order is transmitted, including a payor account institution . . . can recover from prior parties if a draw order is unauthorized. . . . This covers forged drawer signatures.").

108. Dow & Ellis, *supra* note 40.

Promoting electronic processing of checks is a worthwhile goal. The resulting cost savings will surely benefit banks and, if these savings are passed on to check users, their customers as well. This goal, however, does not justify the revisions to Article 3. The banks developed and implemented electronic processing and check truncation with the current loss allocation scheme in place. This suggests that many bankers consider these measures to be cost effective under present law. The RUCC proposed changes will likely result in a more widespread use of these electronic methods, but they will burden the customers with the entire cost of forgeries. Current law, as codified by the majority of jurisdictions, gives banks an incentive to verify their customer's signature on items before paying them because the banks will generally bear the loss if they pay items carrying forged drawers' signatures. It also creates an incentive to develop new technologies to diminish forgery losses, such as electronic signature verification that will remain compatible with electronic processing.¹⁰⁹ Under the RUCC these important incentives would vanish.

Reducing litigation is also a worthwhile goal. The revisions will certainly have the effect of reducing litigation. Again, however, the bank's customers will bear the entire cost because it is unlikely that even non-negligent customers would litigate most cases of small forgery losses. The goal of reducing litigation should not be achieved at the expense of an equitable loss allocation scheme.

The two-tier proposal would promote electronic check processing and would reduce the amount of potential litigation, while maintaining incentives for both banks and their customers to prevent forgery. Therefore, it would reduce the overall amount of forgery losses. Under the two-tier scheme, banks would be able to use complete electronic processing on an overwhelming majority of items. Banks would continue to have an incentive to verify signatures and would likely continue to develop new technologies to reduce forgery losses even further. Customers would continue to have an incentive to be careful with their checks because of the chance that a forgery might exceed the statutory minimum.

The two-tier scheme would eliminate the need for litigation on smaller items where it is not cost effective. In cases of larger items where litigation is cost effective, the loss will be proportionately shared based on the fault of both parties. The determination of fault would contemplate the actual causes of forgeries: the payor bank's failure to examine signatures as well as the customer's carelessness. State legislatures should not

109. See *supra* note 81 for a discussion of forgery and banks' use of computers.

adopt the revised Article 3 unless the rules relating to loss allocation from forged drawers' signatures are reconsidered and substantially revised.

