

FINANCIAL FRAUD LAW REPORT

VOLUME 2

NUMBER 8

SEPTEMBER 2010

HEADNOTE: COMPREHENSIVE REFORM COMES TO THE FINANCIAL SYSTEM Steven A. Meyerowitz	673
OVERVIEW AND IMPLEMENTATION OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT Kevin L. Petrasic	675
THE IMPACT ON BANKS OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT V. Gerard Comizio and Lawrence D. Kaplan	684
PREEMPTION UNDER DODD-FRANK Michael T. Rave	700
LEGAL REASONS TO IMPLEMENT POSITIVE PAY AND HIGH SECURITY CHECKS Frank W. Abagnale	704
PRIVATE COMMERCIAL BRIBERY: THE NEXT WAVE OF ANTI-CORRUPTION ENFORCEMENT? Cheryl A. Krause and William Gibson	710
NAVIGATING STATUTES OF LIMITATIONS IN THE ENFORCEMENT CONTEXT Paul R. Berger, Bruce E. Yannett, and Orianna Yin Dutka	719
FCPA COMPLIANCE: THE VANISHING “FACILITATING PAYMENTS” EXCEPTION? Cheryl A. Krause and Elisa T. Wiygul	730
MULTILATERAL DEVELOPMENT BANKS TO CROSS-BAR IN EFFORT TO COMBAT CORRUPTION Sean Hecker, Noelle Duarte Grohmann, and Rebecca Jenkin	736
RECENT DEVELOPMENTS IMPACT THE FALSE CLAIMS ACT Peter B. Hutt II	741
WHY A PURE HEART AND EMPTY HEAD AREN'T ENOUGH: THE “GOOD FAITH” DEFENSE IN PONZI SCHEME LITIGATION Robert S. Hertzberg and Deborah Kovsky-Apap	748
RULING ON THE CONSTITUTIONALITY OF PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD LEAVES PCAOB ACTIONS, ENFORCEMENT PROCEEDINGS, AND INVESTIGATIONS UNAFFECTED Ralph V. DeMartino and Jessica N. Garvin	753
THE DUTY TO UPDATE FORWARD-LOOKING STATEMENTS: A CAUTIONARY TALE EMERGES FROM THE SECOND CIRCUIT COURT OF APPEALS F. Douglas Raymond III and Eric Marr	758
NEW YORK'S TOP COURT REJECTS SUIT BY HEDGE FUND PARTNERS AGAINST ACCOUNTING FIRM Roberta A. Kaplan and Marco V. Masotti	763

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POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. ISSN 1936-5586

Legal Reasons to Implement Positive Pay and High Security Checks

FRANK W. ABAGNALE

The author examines the implications for banks and bank customers of a recent court decision involving a check fraud loss.

In what may well become a precedent-setting case, Wachovia Bank has won a lawsuit against a customer's insurance company after the customer failed to implement Positive Pay and later suffered a \$153,856.46 check fraud loss. The bank had repeatedly recommended that the customer use Positive Pay, but the customer had declined.

BACKGROUND

As the court explained, in late 2005, Todd's Snax, Inc., d/b/a Schultz Foods Company ("Schultz Foods"), issued a check in the amount of \$153,856.46 to Amerada Hess Corporation that was drawn on Wachovia Bank. Thieves stole the check out of the mail, changed the name of the payee to "Kenneth Payton," and induced Payton (an unwitting accomplice) to endorse the check and deposit it into his account at TCF Bank. TCF presented the check for payment to Schultz Foods' bank, Wachovia Bank, and Wachovia charged the amount of the check against Schultz Foods' account. By the time Schultz Foods discovered the fraud, Payton

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had wired the funds to a bank in Singapore, and the thieves had disappeared with the money.

When the fraud came to light, Schultz Foods demanded that Wachovia re-credit its account. Schultz Foods claimed that Wachovia had to bear the loss because it had processed the altered check in violation of § 4-401(a) of the Uniform Commercial Code. Wachovia disagreed, citing the fact that Schultz Foods had declined to implement “Positive Pay,” a check-fraud deterrence program that would have identified the altered payee name and prevented the loss.

Wachovia claimed that under the terms of the deposit agreement between Schultz Foods and Wachovia, the failure of Schultz Foods to implement Positive Pay made Schultz Foods liable for the loss.

After Wachovia refused to re-credit the account, Schultz Foods filed a claim with its insurer, Cincinnati Insurance Company. Cincinnati paid the claim and then filed a subrogation action against Wachovia to recover its loss.

INSURER’S CONTENTIONS

In the lawsuit, Cincinnati contended that the altered check had not been “properly payable” under § 4-401(a) when Wachovia deducted the amount of the check from Schultz Foods’ account, and, absent an agreement to the contrary, Wachovia therefore was liable for the loss.

The problem with Cincinnati’s argument was that there *was* an agreement to the contrary — the deposit agreement signed by Schultz Foods when it opened its commercial checking account at Wachovia. Section 12 of that agreement described several methods by which a customer could safeguard its account from fraud. These methods fell into two categories:

First, Section 12 contained a bullet-pointed list of “precautions” that customers “can and should take to decrease the risk of unauthorized transactions.” The precautions included basic measures such as protecting the secrecy of passwords, promptly reviewing bank statements for unauthorized activity, and immediately reporting suspicious activity to the bank.

Second, Section 12 stated that Wachovia might make available to its customers “certain products and services that are designed to detect and/

or deter check fraud.” These products and services were developed by Wachovia or purchased from third party vendors by Wachovia and offered to customers.

Finally, Section 12 of the deposit agreement concluded with a conditional release of Wachovia’s liability:

You agree that if you fail to implement any of these products or services, or you fail to follow these and other precautions reasonable for your particular circumstances, you will be precluded from asserting any claims against [Wachovia] for paying any unauthorized, altered, counterfeit or other fraudulent item that such product, service, or precaution was designed to detect or deter, and we will not be required to re-credit your account or otherwise have any liability for paying such items.

Section 25E of the deposit agreement contained virtually identical language. That section began with the customer’s acknowledgment that Wachovia had made available “treasury services designed to reduce the likelihood that a fraudulent, unauthorized or altered check or other item will be paid.” That section continued with the customer’s acknowledgment that its failure to use such “treasury services” could “substantially increase” the likelihood of fraud. Section 25E concluded with another conditional release of Wachovia’s liability that was virtually identical to the release found in Section 12.

POSITIVE PAY

Wachovia claimed that under the terms of the deposit agreement between Schultz Foods and Wachovia, Schultz Foods’ failure to implement Positive Pay made Schultz Foods liable for the loss. Positive Pay was a “product or service” for purposes of Section 12 and a “treasury service” for purposes of Section 25E. It was “designed to detect” the type of fraud that caused the \$153,856.46 loss to Schultz Foods. Wachovia repeatedly made Positive Pay available to Schultz Foods, and Schultz Foods unwisely chose not to implement it.

Prior to this loss, Schultz Foods’ account at Wachovia has been the subject of check fraud on three separate occasions. After the first incident,

in March 2002, Wachovia recommended that Schultz Foods either close its account or implement Positive Pay. Schultz Foods closed its account but did not implement Positive Pay. After the second incident, in October 2003, Wachovia did not recommend that Schultz Foods close its account, but after the third incident, in September 2004 — which did not result in any loss to Schultz Foods — Wachovia told Schultz Foods that if its account became compromised, Schultz Foods should either close its account or implement Positive Pay. Schultz Foods closed its account but again did not implement Positive Pay.

Wachovia did not require Schultz Foods to absorb any fraud-related loss in connection with any of the three incidents, even though Schultz Foods never implemented Positive Pay. Based on these experiences, Cincinnati claimed that Schultz Foods “had an expectation that Wachovia would reimburse Schultz Foods’ account” for unauthorized charges so long as Schultz Foods took precautions such as closing its account. However, that alleged expectation was contrary to the deposit agreement. Section 43 contained the following anti-waiver provision:

WAIVER OF RIGHTS BY THE BANK. We reserve the right to waive the enforcement of any of the terms of this Agreement with respect to any transaction or series of transactions. Any such waiver will not affect our right to enforce any of our rights with respect to other customers or to enforce any of our rights with respect to later transactions with you and is not sufficient to modify the terms and conditions of this Agreement.

Although Wachovia had voluntarily protected Schultz Foods from its fraud losses in the past, Wachovia’s well written deposit agreement protected it from liability created by the illusion of a precedent.

COURT RULING

In issuing its order on July 14, 2010, in *Cincinnati Ins. Co., as Subrogee of Todd’s Snax, Inc., d/b/a Schultz Foods Co. v. Wachovia Bank, N.A.*,¹ the U.S. District Court for the District of Minnesota agreed with Wacho-

via's argument that the deposit agreement between Wachovia and Schultz Foods required Schultz Foods either to implement Positive Pay or to assume responsibility for any fraud losses caused by its failure to implement Positive Pay. The order said:

...the Court finds that, under the deposit agreement between Schultz Foods and Wachovia, Schultz Foods must bear the loss because Schultz Foods failed to implement a fraud-detection program [Positive Pay] offered by Wachovia — a program that would have prevented the loss. The Court thus grants summary judgment to Wachovia.

POINTS TO CONSIDER

There are a number of matters that banks and bank customers should consider in view of this court decision.

1. Companies should review their bank deposit agreements to understand their legal rights and responsibilities. Based upon this lawsuit, banks will be reviewing and re-writing their deposit agreements to include the kinds of provisions Wachovia Bank included in its deposit agreement.
2. Companies should speak with their insurance agents about coverage limits for check fraud and cyber crime. Many standard commercial policies cover up to \$25,000, which is entirely inadequate for most companies.
3. Companies should implement Positive Pay with payee match on all checking accounts. If a company's bank does not offer Payee Positive Pay, the company should request it in writing and send its request by Certified Mail Return Receipt Requested. One never knows when this documentation might prove important.
4. Payee Positive Pay is not foolproof. Forgers are beating it by adding a new payee name above the original payee name. The added payee check passes through undetected. Using a "secure name font" helps prevent added payee names.

5. High security checks are a critical component in check fraud prevention. When Schultz Foods' check was altered, apparently there was no visible trace of the alteration.
6. Use a 14 point font for the payee name and address, and good quality toner. A bigger font makes physical alterations more evident.

NOTE

¹ No. 08-CV-2734 (PJS/JJG) (D. Minn. July 14, 2010).