

Bank Fraud & IT Security

REPORT

Prepared by
Southeast Consulting, Inc.



Check Fraud Liability

by **Frank Abagnale, Secure Document Consultant**

Holder in Due Course (HIDC) is part of the Uniform Commercial Code (UCC) that significantly impacts an organization's liability for check fraud from the checks it issues. After learning about HIDC, prudent companies are often motivated to use high security checks and change check disbursement procedures to protect themselves. Anyone responsible for check disbursements or fraud prevention should understand this law. Accordingly, the following is a brief description of Holder in Due Course along with four instructive Federal Appellate Court rulings.

In simple terms, a Holder in Due Course is anyone who accepts a check for payment. On the face of the check there is no evidence of forgery or alteration, nor does the recipient have knowledge of any fraud related to the check. Under these conditions, the recipient is an HIDC and is entitled to be paid for the check.

The statute of limitations under the UCC for an HIDC to sue the check's maker for its face value is 10 years from the issue date, or three years from the date the check was first deposited and returned unpaid, whichever comes first. An HIDC can assign, sell, give, or otherwise transfer its rights to another party, who assumes the same legal rights as the original Holder.

The following four Federal Appellate Court cases illustrate the far-reaching power of *Holder in Due Course*.

▪ **Robert J. Triffin v. Cigna Insurance**

Issue: Placing A Stop Payment Does Not Eliminate Your Obligation To Pay A Check. In July 1993, Cigna Insurance issued James Mills a Worker's Compensation check for \$484. Mills falsely claimed he did not receive it due to an address change, and requested a replacement. Cigna placed a stop payment on the initial check and issued a new check.

Also in this Issue:

- **The Role of the Independent Auditor in Detecting Bank Fraud**
- **How Much of Your Bank's Data is in the Wild?**

Editorial Board:

Frank W. Abagnale, *Abagnale & Associates*

Rich Baich, *Principal, Deloitte & Touche LLP*

Tom Bartolomeo, *Senior Vice President, Information Security, Wachovia Corporation*

James Bauerle, Esq., *Legal and Fraud Prevention Services, Keevican, Weiss, Bauerle and Hirsch*

Dr. Bill Chu, *Chairman, Department of Software and Information Systems, University of North Carolina at Charlotte*

Robert Dinsmore, *Audit Committee Chairman, American Community Bancshares*

Steve Hasty, *Partner-in-Charge, Regional Risk Advisory Services, KPMG, LLP*

Jim Mathews, *SVP/Bank Security Officer, Fifth Third Bank*

Robert Siciliano, *President, IDTheftSecurity.com*

Ralph Summerford, *Partner-in-Charge of Forensic Accounting and Fraud Examination Services, Forensic/Strategic Solutions, PC*

A.S Pratt & Sons

2008© ALEX eSOLUTIONS. All rights reserved.
The ALEX eSOLUTIONS logo is a trademark, used herein under license.

Need more information on specific topics?

Call: 800-572-2797
E-mail: info.pratt@aspratt.com
Visit: www.aspratt.com

Mills nevertheless cashed the first check at Sun's Market (Sun). Sun then presented the check for payment through its bank. Cigna's bank dishonored the check, stamped it "Stop Payment," and returned the check to Sun's bank.

Had Sun filed an HIDC claim against Cigna as the issuer of the check, Sun would have been entitled to be paid because of its status as a Holder in Due Course. Apparently Sun either did not know about HIDC or chose not to pursue it. Sun management merely pinned the check on a bulletin board in the store, for two years.

Eventually, Robert Triffin bought the check from Sun, assumed its HIDC rights, and filed a lawsuit in August 1995, over two years after the check was returned unpaid. Remember that the statute of limitations is three years. The Court ruled in favor of Robert Triffin, and ordered Cigna to pay him \$484, plus interest.

Recommendation: Cause a check to *expire* before replacing it, or you may be held liable for both checks. This can be facilitated by printing an expiration statement on the check face such as, "THIS CHECK EXPIRES AND IS VOID 20 DAYS FROM ISSUE DATE." If a check is lost, wait 20 + 2 days from the initial issue date before reissuing. Many companies print "VOID AFTER 90 DAYS" but cannot reasonably wait that long before re-issuing a check. A party that accepts an expired check has no legal basis to sue as an HIDC if the check is returned unpaid.

Superior Court of New Jersey, Appellate Division, A-163-00T5. <http://lawlibrary.rutgers.edu/courts/appellate/a0163-00.opn.html>

After learning about HIDC, prudent companies are often motivated to use high security checks and change check disbursement procedures to protect themselves.

▪ **Robert J. Triffin v. Somerset Valley Bank and Hauser Contracting Co.**

Issue: *You May Be Held Responsible For Checks You Did Not Issue or Authorize.* Hauser Contracting Co. used ADP for payroll services. A thief obtained check stock that looked identical to ADP's checks and created 80 counterfeit payroll checks totaling nearly \$25,000. These counterfeit checks were identical to Hauser Contracting Co.'s.

A retailer who knew Mr. Hauser became suspicious and called him. Somerset Valley Bank also called. Mr. Hauser reviewed the in-clearing checks, which looked just like his, and confirmed the checks were unauthorized and the payees were not his employees. The bank returned the checks marked as "Stolen Check - Do Not Present Again."

Mr. Triffin bought 18 of these checks totaling \$8800 from four check cashing agencies, claimed HIDC status, and sued both Mr. Hauser and his bank for negligence for not safeguarding the payroll checks and facsimile stamp. Because the counterfeit and authentic checks

looked identical, the lower court ruled for Triffin. Hauser appealed, but the Federal Appellate Court upheld the lower court. The Court said the counterfeit check met the definition of a negotiable instrument, and because the check and signature were identical to an authentic check, the check cashing agency could not have known it was not authentic.

Recommendation: Use a controlled check stock, which means using checks that are uniquely designed or customized for your organization and are not available blank to others. SAFEChecks and the SuperBusinessCheck are controlled check stocks. Superior Court of New Jersey, Appellate Division, A-163-00T5.

<http://lawlibrary.rutgers.edu/courts/appellate/a0163-00.opn.html>

▪ **Robert J. Triffin v. Pomerantz Staffing Services, LLC**

Issue: *High Security Checks May Protect You From Some Holder in Due Course Claims.* Pomerantz Staffing Services used high security checks that included heat sensitive thermo chromatic ink on the back and a warning banner on the face that said, "THE BACK OF THIS CHECK HAS HEAT SENSITIVE INK TO CONFIRM AUTHENTICITY." Someone made copies of Pomerantz's checks, but without the thermo ink on the back. They cashed 18 checks totaling \$7000 at Friendly Check Cashing Company. Friendly's cashiers failed to heed the warning on the check face, and did not look for the thermo ink. All 18 checks were returned unpaid, likely caught by Positive Pay.

Mr. Triffin bought the checks, claimed Holder in Due Course status, and sued Pomerantz. Pomerantz countersued and won. The judge correctly asserted that if Friendly had looked for the thermo ink as instructed, they could have determined that the checks were counterfeit. Because they were provided a means to verify authenticity and failed to do so, they were not an HIDC and had no rights to transfer to Mr. Triffin.

This case illustrates the value of check security features, a properly worded warning band, and a controlled check stock. Pomerantz was protected by his checks.

Recommendation: Use high security checks with overt and covert security features, including explicitly worded warning bands. Such security features will also help prevent other kinds of check fraud. The SuperBusinessCheck is a properly designed high security check with 16 security features.

<http://lawlibrary.rutgers.edu/courts/appellate/a2002-02.opn.html>

▪ **Arkwright Mutual Insurance v. Nationsbank**

Issue: *Facsimile Signatures May Invite Fraud Losses* In another victory for banks, the Florida 11th Circuit Court of Appeals upheld NationsBank's, now Bank of America, interpretation of its carefully worded Deposit Agreement. This agreement effectively shifted the burden of responsibility from the bank to its customer in cases of forgery. The phrase "purporting to bear the facsimile signature" saved NationsBank over \$4 million in losses resulting from forged checks.

Florida Power and Light (FP&L), a customer of NationsBank, used a facsimile machine to sign most of its corporate checks. FP&L's check volume totaled nearly 20,000 each month. Unfortunately, in the mid-1990s, 27 fake checks were cashed over a two month period totaling \$4,387,057. These counterfeit checks bore exact replicas of the FP&L facsimile signature and used actual serial numbers from real FP&L checks that had been voided or cancelled.

Because all of the counterfeit checks were over the

Banks are bound by the regulations of the UCC, which has historically placed the responsibility for detecting forgery on the bank. However, the UCC also specifically allows a bank and its customers to alter, through contractual agreement, the liability for fraud losses.

\$25,000 sight review threshold established by NationsBank, each one was sent to the Signature Control Department and visually compared with the authorized signatures. The fake checks appeared authentic and signatures were identical to the signature card, and therefore were paid *in good faith*. When FP&L discovered the counterfeits, they contacted NationsBank, which in turn contacted its upstream collecting banks. However, because the 24-hour rescission period had long since passed, NationsBank was denied its request for reimbursement. It therefore refused to credit FP&L for the loss.

Arkwright Mutual Insurance, who insured FP&L against commercial crime, reimbursed the company. It then sued NationsBank. Arkwright claimed that the checks were not *properly payable* because nothing in the contracts between the two had authorized NationsBank to pay checks with forged facsimile signatures.

NationsBank disputed this, pointing out that FP&L had agreed to a provision in its Deposit Agreement that said, "If your items are signed using any facsimile signature or non-manual form of signature, you acknowledge that it is solely for your benefit and convenience. You accept sole responsibility for maintaining security over any device affixing the signature. Such signature will be effective as your signature regardless of whether the person affixing it was authorized to do so."

As part of the Deposit Agreement contract, FP&L had passed a resolution authorizing NationsBank to pay checks for \$500,000 or less *when bearing or purporting to bear* selected facsimile signatures.

This is extremely significant. Banks are bound by the regulations of the Uniform Commercial Code, which has historically placed the responsibility for detecting forgery on the bank. However, the UCC also specifically allows a bank and its customers to alter, through contractual agreement, the liability for fraud losses.

"The effect of the provisions of this chapter (4-103) may be varied by

agreement, but the parties cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack of failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured, if those standards are not manifestly unreasonable."

In other words, the parties may set their own ground rules as long as it is not overly one-sided.

The Official Comments to Chapter 4-103 expand on this idea:

"In view of the technical complexity in the field of bank collections, the enormous number of items handled by banks, the certainty that there will be variations from the normal in each day's work in each bank, the certainty of changing conditions and the possibility of developing improved methods of collection to speed the process, it would be unwise to freeze the present methods of operation by mandatory rules. This section, therefore, permits within wide limits variation of the effects of provisions of this Article by agreement [Subsection [1]] confers blanket power to vary all provisions of this Article by agreements of the ordinary kind."

The Florida court granted summary judgment to NationsBank, agreeing that these two contractual agreements shifted the liability for the forged checks to Florida Power and Light.

Clearly, the courts are upholding the freedom-of-contract language between banks and their customers, requiring a company to abide by the agreements it has signed. These legal precedents should encourage banks to be precise when drafting documents outlining customer responsibilities with respect to fraud, and customers to read, fully understand, and agree to *the fine print*.

Conclusion: Implement fraud prevention measures such as Positive Pay and highly secure controlled check stock, which would have caught the forged checks and in this case stymied the forger.

**This reprint is made with the permission of
A.S. Pratt & Sons**