

# The relative risks of frauds and how to protect against them

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There's an old saying that if a man defrauds you one time, he's a rascal; if he defrauds you twice, you're a fool. Banks process vast amounts of monetary payments every banking day, and rascals are always waiting in the wings, scheming to steal the moving money. In a very real sense, therefore, banks are the nation's professional fraud victims. There's no escaping the occasional rascal, but commercially reasonable procedures and agreements incorporating an array of available legal rights can help banks avoid the risk of becoming the defrauded fool.

Although there is some overlap, different payment mechanisms impose fundamentally different fraud risks on banks. The overlap relates to authority [if an unauthorized rascal initiates a payment (typically to himself or his own creditor) or an authorized payment gets surreptitiously routed to an unauthorized crook, someone has been defrauded]. The victim will then look to the bank that processed the payment to cover the loss. The law provides banks with a sizable arsenal of protections to avoid risks from these sorts of claims, although the protections differ for the different types of payments. The law also contains traps for the bank that has inadequate procedures or good procedures that it doesn't follow.

Articles 3 and 4 of the Uniform Commercial Code govern checks, drafts and notes. Article 4A of the code addresses wholesale electronic funds transfers, including wires and ACH transactions. These rules are supplemented (and sometimes preempted) by federal laws and regulations (such as the Electronic Funds Transfer Act and Regulation E, covering consumer transfers; the Expedited Funds Availability Act and Regulation CC, addressing funds availability; and Regulation J, addressing wires using the Fedwire system); and Federal Reserve operating circulars on bank operations. ACHs can be electronic funds transfers under Article 4A but are also subject to a voluminous set of rules promulgated by the National Automated Clearing House Association.

To minimize loss from check frauds, banks need to have and follow commercially reasonable procedures. If a bank exercises "ordinary care," defined in most states to mean "reasonable commercial standards, prevailing in the geographic area in which the [bank] is located," the bank can avoid many types of liability under Articles 3 and 4. Likewise, a bank that does not practice the reasonable commercial standards of its local banking community runs the risk of bearing some or all of a check fraud loss.

A comparative negligence scheme appears significantly throughout Articles 3 and 4 of the code. For example, Section 3-406 of the Code initially precludes a customer from recovering damages from a bank for an alteration of or a forged signature on an instrument if the customer acted negligently. Yet if the customer can prove that the bank also acted negligently — i.e., without exercising "reasonable commercial standards" prevailing in its geographical area — the bank and the customer will share the loss based on their respective levels of fault. A customer 95 percent negligent can still sue a bank that is only 5 percent negligent, thus forcing the bank to spend the legal fees to defend the case.

Unlike Articles 3 and 4, Article 4A and Regulation J, which govern wires, do not invoke comparative negligence. If a bank processes an authorized payment order as directed, it generally will have no liability. Fraudulent payment orders can occur when a crook manipulates the security procedures to deliver a payment order that was not actually authorized by the customer. If the security procedure was commercially reasonable and the bank followed the procedure, however, it should have no liability.

NACHA rules govern transactions utilizing the ACH network. Under the NACHA rules, the Originating Depository Financial Institution warrants to the Receiving Depository Financial Institution and the ACH operator that each transmittal was properly authorized, and that the debit was for an amount due and owing. Any breach of these warranties requires the ODFI to indemnify the RDFI for all claims, including attorneys' fees and costs, resulting from breach of the warranty or the debiting or crediting of the entry to that account. No comparative negligence scheme is incorporated in the NACHA rules.

How can banks best protect themselves from payment-fraud risk? First, implement sound procedures for opening and maintaining accounts and making payments. Payment frauds always involve some level of negligence by the defrauded party. A well-documented set of commercially reasonable procedures and a paper trail to document that the bank followed those procedures will go a long way in minimizing exposure, even for comparative negligence in a check fraud case.

For wires and ACHs, be sure to have good security procedures agreed to by the customer to assure the authenticity of payment orders, and be sure to document that procedures were followed.

Banks should draft deposit agreements and funds transfer agreements with the utmost care. Under the code, banks have no liability for unauthorized checks paid more than one year after the customer was informed by its statement or otherwise of the unauthorized payment. The law generally permits banks to shorten this one-year notice period, and courts have upheld periods in deposit agreements as short as 30 days.

Banks can also include attorney fee-shifting provisions in account agreements, making the customer responsible for the bank's attorneys' fees for any litigation involving the customer's accounts. These provisions can deter customers from pursuing non-meritorious claims.

Also, banks can consider arbitration clauses for their account agreements, which require customers to bring claims in arbitration rather than litigation. Arbitration can sometimes be a more streamlined process than litigation.

With regard to electronic funds-transfer fraud, banks should have standard wire and ACH agreements that set forth commercially reasonable security procedures to confirm authority for issuing payment directions to the bank. Many agreements provide that the agreed security procedures are commercially reasonable, the customer agrees to comply with the security procedures, and the customer will be bound by any payment order whether or not the order is actually authorized. Like checking agreements, electronic funds-transfer

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agreements can also require the customer to report any unauthorized transfer to the bank within a relatively short period of time after receiving confirmation of a transfer.

Delivering quality banking products and services to customers, while efficiently avoiding fraud losses, should be among the central goals of bank policies and procedures and the drafting of customer agreements. Assuring that your policies and procedures are reasonable in your banking community and building in permitted protections to your customer agreements will go a long way toward achieving those goals. IB

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