Contracting out of the Uniform Commercial Code: Reducing Bank Liability by Shortening the One-Year Notice Period for Reporting Check Fraud

By Salvatore Scanio and Robert W. Ludwig

Introduction

The Uniform Commercial Code (UCC) allocates responsibility for check fraud losses between banks, customers, and others in the chain of collection through various rules and defenses, including a comparative negligence regime in Revised UCC Articles 3 and 4 (1990).[1] In evaluating which party should bear a loss and how much responsibility each should bear is usually fact-intensive, and often a time-consuming and costly exercise. One bright-line exception is that a customer must report check fraud to its bank within one year after the statement containing the fraudulent items is provided to the customer under the one-year "preclusion" rule in UCC Section 4-406(f). If the customer fails to give timely notice, the claim against its bank is generally barred regardless of bank negligence.[2] By shortening the UCC's one-year period in the account agreement to as little as 14 days, banks may significantly reduce their potential liability for check fraud under one of the UCC's few near-absolute rules.

Contracting out of UCC Article 4

Generally, the provisions of the UCC "may be varied by agreement,"[3] so long as "the obligations of good faith, diligence, reasonableness, and care prescribed" by the UCC are not disclaimed.[4] Specifically, UCC Section 4-103(a) "confers blanket power to vary all provisions of…Article [4] by agreements of the ordinary kind."[5] Accordingly, a bank by contract may vary the provisions of Article 4 but "cannot disclaim" its "responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure."[6] As an additional limitation, the parties may only "determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable."[7]

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Drawee/Payor Bank Liability for Check Fraud

UCC Articles 3 and 4 provide loss-allocation rules applicable to the parties in the chain of collection of negotiable instruments, namely the drawer of the check (drawer), the payee to whom the check is payable (payee), the depositary or collecting bank that cashes or accepts the check for deposit (depositary), any intermediary bank (intermediary), and the drawee or payor bank that pays the check (drawee) and returns or makes it available each month to its customer, the drawer.

The basic rule regarding the allocation of liability between a drawer and drawee or payor bank is that a drawee bank may only charge its customer's account for "properly payable" items.[8] "An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank."[9] Consequently, a drawee is considered strictly liable for items that were not "properly payable." Checks bearing alterations (for example, payee or amount), forged or unauthorized drawer signatures, or payee indorsements, are "not properly payable."[10]

A drawee bank, in defending a check fraud claim under UCC Section 4-401, has a myriad of potential defenses available under UCC Articles 3 and 4. Those include:

- the bank statement and repeater rules in UCC Section 4-406;[11]
- a trilogy of comparative negligence defenses under UCC Section 3-404 (imposters and fictitious payees), Section 3-405 (responsible employees), and Section 3-406 (general comparative negligence);
- the automated-processing defense in UCC Section 3-103(a)(7);[12]
- presentment warranties in UCC Section 3-417 and Section 4-208;[13] and
- contract defenses provided in the applicable account agreement.

One-Year Preclusion Defense

A key defense to a check fraud claim against a drawee is Article 4's one-year preclusion rule.[14] Under UCC Section 4-406(f), a customer must discover and report any unauthorized signature or alteration on a check to its bank within one year after a statement or check is made available to the customer.[15] Absent timely notice, the customer's claim against its bank is precluded regardless of bank negligence.[16] The policy behind the one-year preclusion is to impose a duty on customers to promptly examine their bank statements and in favor of a reasonable time limitation on bank liability for fraudulent checks.[17]

Reduction of the One-Year Preclusion Rule

Recently, in *Clemente Bros. Contracting Corp. v. Hafner-Milazzo*,[18] the New York Court of Appeals addressed whether a customer agreement reducing the UCC's one-year preclusion to 14 days was enforceable. (Although New York has not adopted Revised UCC Article 4 (1990), the provisions applicable here are substantially similar.) In a split 5–2 decision, New York's high court held that a bank may cut down the one-year notice by agreement as long as the modification is not manifestly unreasonable.[19] Specifically, the court held a 14-day period enforceable in cases in which the customer is "a corporate entity that either is financially sophisticated or has the resources to acquire professional guidance."[20] In this case, the court noted that the customer had numerous employees, regularly moved hundreds of thousands of dollars in and out of its accounts, had the resources to make an informed decision about opening accounts at its bank and to monitor them once a month within 14 days of each statement, and critically, had executed a corporate resolution containing the 14-day notice provision.[21] The court further observed that such an expectation was "all the more reasonable in this age, when customers can monitor their account transactions minute by minute online from around the world."[22]

In *dicta* the court qualified the holding, suggesting that a 14-day period could be manifestly unreasonable for unsophisticated customers, small family businesses, or consumers, for whom a 30- or 60-day period may be appropriate.

Such "customers may lack the time, technology, or other resources to check their account statements within such a limited period every month. They are more susceptible to unforeseen events disrupting their routines or normal business operations. And it may be that banks need less protection on these accounts because the total assets held may be less than those of larger companies."[23]

Prior to *Clemente Bros.*, one other court had upheld a reduction of the one-year preclusion in UCC Section 4-406 to 14 days.[24] Commentators, however, that have suggested such a short period is manifestly unreasonable because it can enable a bank to escape liability effectively like a prohibited disclaimer.[25] The dissent in *Clemente Bros.* raised the same concern, noting that "the overall effect of the time reduction is to eliminate plaintiff's opportunity to assert, after the 14-day period had passed (but before the one-year time period had elapsed) that [the bank] had failed to exercise ordinary care and, consequently, recover damages as a result of that negligence. The shortening of the time period works a de facto disclaimer of liability, which is prohibited under section 4-103(1)."[26]

Several other courts, however, have enforced a reduction in the preclusion period to 60 days.[27] In enforcing such contractual modifications to the UCC, courts have justified the "cut-down" on public policy grounds. As stated in *American Airlines Employees FCU v. Martin*, the "statutory scheme reflects an underlying policy decision that furthers the UCC's 'objective of promoting certainty and predictability in commercial transactions.' The UCC facilitates financial transactions, benefitting both consumers and financial institutions, by allocating responsibility among the parties according to whoever is best able to prevent a loss."[28] Similarly, in *National Title Ins. Corp. Agency v. First Union Nat'l Bank*, the court observed that UCC Section 4-406(f), a condition precedent requiring timely notice, "recognizes that a customer is in a better position than a bank to know whether a signature is authorized or an item has been altered. … A reduction in the one-year period … to 60 days encourages diligence by a customer and is 'in accord with public policy by limiting disputes in a society where millions of bank transactions occur every day.' "[29]

Conclusion

Although the recent New York decision provides authority for varying the UCC's one-year preclusion to as little as 14 days for many commercial customers, the case is also a reminder that a one-size-fits-all approach may not be appropriate, with longer reporting periods potentially required for other types of customers. Indeed, in 2001, the Uniform Law Commissioners circulated a draft amendment to UCC Section 4-406 that would have made any shortening of the one-year period to less than 90 days unenforceable against a consumer. The discussion in *Clemente Bros*. regarding whether a reduced notice is appropriate for a particular customer also runs counter to the UCC's objectives of uniformity, predictability, and litigation avoidance. Banks should bear these considerations in mind in evaluating the preclusion used for particular classes of customers.

Notes

1. This article addresses Revised UCC Articles 3 and 4, drafted in 1990, and substantially adopted in all states, except New York, which continues to apply the original 1962 versions of UCC Articles 3 and 4. Of the issues discussed here, none present any significant differences between the 1962 and 1990 Codes. A key change in the 1990 Code was the adoption of a comparative negligence loss-allocation scheme to replace the all-or-nothing contributory negligence approach in the 1962 UCC.
2. The rule, however, may be subject to a bank's good faith. Compare UCC § 1-201(20) amd 4-401(d) providing the obligation of "good faith," with § 4-406(f), the one-year preclusion that applies "[w]ithout regard to care or lack of care." The courts have reached conflicting results regarding whether bad faith affects the one-year preclusion. *See, e.g.*, Falk v. Northern Trust Co., 763 N.E.2d 380, 386-87 (Ill. App. 2001) (bad faith extends the one-year rule); Canfield v. Bank One, 51 S.W.3d 828 (Tex. App. 2001) (same); Halifax Corp. v. First Union Nat'l Bank, 546 S.E.2d 696 (Va. 2001) (bad faith does not extend the one-year rule); and *AFT v. Bullock*, 605 F. Supp. 2d 251, 259 (D.D.C. 2009) (same).
3. UCC § 1-302(a).
4. *Id.* § 1-302(b).
5. *Id.* § 4-103, cmt. 2.
6. UCC § 4-103(a); *see, e.g.*, Crescent Women's Med. Group, Inc. v. Keycorp, 806 N.E.2d 201, 205 (Ohio C.P. 2003) ("The language 'even if we are at fault,' in effect, disclaims the bank's responsibility for its own failure to exercise ordinary care … [and is invalid.]"); Herzog, Engstrom & Koplovitz P.C. v. Union Nat'l Bank, 640 N.Y.S.2d 703, 704 (N.Y. App. 1996) (parties may not by agreement "abrogate the bank's responsibility to exercise good faith and ordinary care").
7. UCC § 4-103(a).
8. UCC § 4-401(a). The allocation of liability between depositary banks and others in the chain of collection is determined under other rules under UCC Articles 3 and 4, including the comparative negligence provisions of UCC §§ 3-404, 405 and 406, liability for breach of restrictive indorsement under UCC § 3-206, conversion under UCC § 3-420, and presentment and transfer warranties under §§ 3-416, 3-417, 4-207, and 4-208. A fundamental principle of the UCC is that the loss resulting from forgery or alteration should fall on the party in the best position to prevent the fraud. For example, a depositary is often assumed to be in the best position to avoid fraud by taking steps to verify the presenter's identity, the indorsement, and visible alterations or irregularities on a check before accepting the check for deposit.
9. UCC § 4-401(a).
10. UCC § 4-401, cmt. 1 ("An item containing a forged drawer's signature or forged indorsement is not properly payable."); *e.g.*, UCC § 3-403 (unauthorized signature is generally ineffective); Monreal v. Fleet Bank, 735 N.E.2d 880 (N.Y. 2000) (forged signature); Travelers Indemnity Co. v. Good, 737 A.2d 690 (N.J. App. 1999) (forged indorsement); Castle Worldwide, Inc. v. Southtrust Bank, 579 S.E.2d 478, 482 (N.C. App. 2003) (missing payee indorsement); *but see* UCC § 4-205 (depositary may supply missing indorsement).
11. When a drawee makes available a monthly bank statement, a customer has a duty to "exercise reasonable promptness in examining the statement or items to determine whether any payment was not authorized" because of unauthorized signatures of the customer or alterations. UCC § 4-406(c). The UCC does not define "reasonable promptness" in the case of single items, but 30 days may be considered reasonable by reference to the 30-day repeater rule in Rev. UCC § 4-406(d)(2), an increase from the 14-day repeater rule of former UCC § 4-406(2)(b). Most deposit agreements establish time limits of 14 to 30 days for customers to review their statements. In the case of a single item for which the customer provides timely notice, the bank may not assert comparative negligence defenses under § 4-406, but may assert other defenses. In the event the bank proves the customer failed to provide timely notice, the bank may assert comparative negligence defenses.

Rev. UCC §§ 4-406(d)(1), 4-406(e). In the case of multiple items by the same wrongdoer, a drawee may assert the repeater rule in § 4-406(d)(2) for all items following the 30-day period after the statement containing the first item. When the rule is implicated, the customer is precluded from asserting its unauthorized signature or any alteration on such items against the drawee, *id.*, unless the customer proves that the bank failed to act with ordinary care in paying the items, in which the loss is allocated on a comparative negligence basis. UCC § 4-406(e).

12. The definition of "ordinary care" states that when a bank "takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument," provided such treatment comports with the bank's procedures and general practice. UCC § 3-103(a)(9). In other words, drawees are not required to review individual checks for forged signatures or other irregularities, though they may be expected follow fraud review procedures.

13. A drawee may shift the loss upstream to the depositary under its "presentment warranties" in the case of checks bearing (1) alterations or (2) forged or unauthorized indorsements. UCC §§ 3-417, 4-208. A depositary also gives a limited presentment warranty as to signatures, namely that it merely has "no knowledge that the signature of the purported drawer … is unauthorized." UCC §§ 3-417(a)(3), 4-208(a)(3). A drawee may recover its expenses, potentially including attorneys' fees, and interest resulting from the breach of warranty. UCC § 3-417, cmt. 5.

14. Depositary banks, subjected to direct statutory negligence actions under revised UCC Article 3, have begun asserting defenses traditionally viewed as drawee defenses, including the notice preclusions in UCC § 4-406. For example, in two federal district cases in Georgia and Alabama, depositary banks raised UCC § 4-406 as a defense to claims asserted by a non-customers, and the courts reached conflicting results. In Ownbey Enter., Inc. v. Wachovia Bank, *N.A.*, 457 F. Supp. 2d 1341, 1358 (N.D. Ga. 2006), the court ruled that § 4-406's "notice requirements apply to any bank a customer chooses to pursue." The court reasoned the "policy behind [4-406] is to place a definite duration on the ability to proceed against banks where customers do not promptly notify banks of forgeries and alterations, and where customers thereby limit the banks' ability to minimize loss." *Id*. One month earlier, a court in Alabama rejected the argument, holding that UCC § 4-406 "'governs a customer's duty to discover unauthorized signatures or alterations on items drawn on his account'" and therefore "'does not, by its terms, apply to a depositary bank.'" Continental Cas. Co. v. Compass Bank, 2006 U.S. Dist. LEXIS 12977 *5, 10 (S.D. Ala. Mar. 6, 2006) (quoting AmSouth Bank, N.A. v. Reliable Janitorial Service, Inc., 548 So.2d 1365, 1368 (Ala. 1989)).

15. The one-year preclusion does not apply to indorsements. UCC § 4-406 cmt. 5 ("4-406 imposes no duties on the drawer to look for unauthorized indorsements"). It remains an unsettled question whether the preclusion applies regardless of bad faith, as opposed to "care or lack of care" under UCC § 4-406(f). *See supra* n.2.

16. *Id*. The rule, however, may be subject to a bank's good faith. *See supra* n.2.

17. *E.g., Falk*, *supra* n.2 at 384.

18. 2014 N.Y. LEXIS 1003 (N.Y. May 8, 2014).

19. *Id*. at *16.

20. *Id*. at *17.

21. *Id*. at *16-17.

22. *Id*. at 17.

23. *Id*.

24. Borowski v. Firstar Bank Milwaukee, *N.A.*, 579 N.W.2d 247, 251-52 (Wis. App. 1998).

25. *See* 2 James J. White & Robert S. Summers, Uniform Commercial Code, § 21-2, at 357 (1995) (15-day limitation is "manifestly unreasonable" because "a short statute of limitations can serve effectively to enable the bank to escape liability as an outright disclaimer").

26. *Clemente Bros. supra* n.18, at *21.

27. *See, e.g.,* Peters v. Riggs Nat'l Bank, N.A., 942 A.2d 1163, 1168 (D.C. 2008); National Title Ins. Corp. Agency v. First Union Nat'l Bank, 559 S.E.2d 668, 672 (Va. 2002); and American Airlines Employees FCU v. Martin, 29 S.W.3d 86, 96–98 (Tex. 2000).

28. American Airlines Employees FCU, *supra* n.27 at 92 (citations omitted).

29. National Title Ins., *supra* n.27 at 672 (citations omitted).