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Editor, *The Texas Bank Lawyer* and *The American Bank Lawyer* (1985-present) (Both are publications of the Texas Association of Bank Counsel)

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FORGERIES, COUNTERFEITS, AND ARTICLES 3 & 4 OF THE UNIFORM COMMERCIAL CODE

DUPED WA ATTORNEY FEARS LOSING HOME FROM COUNTERFEIT CHECK SCAM

A so-called delinquent debtor had delivered a cashier's check for his so-called manufacturing client in Japan. The check was for $386,500. * * *

The attorney cashed the check, deposited his 35% "commission" then as instructed by his "client," sent the payment overseas.* * *

But when the check was processed, it turned out to be bogus. U.S. Bank went after the attorney's accounts, taking more than $4,000. The attorney was hit with a flood of bounced check and overdraft fees.

Then, the bank went after him for the rest of the money -- nearly $245,000.

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COUNTERFEIT CHECK IN ATTORNEY E-MAIL SCAM LOOKS PERSUASIVE

Having never seen one before, and thinking readers have not as well, I was delighted when a fellow attorney showed me a counterfeit check used in an attempt to deceive a law firm in an attorney e-mail scam. Gracious thanks to Utah attorney Randy Birch - - who was not deceived. The Secret Service informed him that it was indeed counterfeit, but looked very much like the real thing.

Aside from the detail, attorneys will note that the check is made out to the law firm's IOLTA account. This should give warning that the people on the other side of the scam are quite knowledgeable about our business. Beware!

COUNTERFEIT CASHIER'S CHECK SCAM
(Texas Attorney General)
Sunday, February 1, 2004

The Internet is a wonderful tool that allows us access to all kinds of goods and services at the touch of a button. Unfortunately, the Internet has also created unique opportunities for new kinds of criminal activity and fraud. Unscrupulous individuals can now target people on a global scale that was impossible prior to the explosion of the World Wide Web.

One cyber scam that our office receives frequent complaints about is the so-called Nigerian Fraud, also known as Advance Fee Fraud and 419 Fraud. As you may know, in this particular scheme you receive an e-mail purporting to be from a government official in Nigeria, claiming to be in possession of a large sum of money. The person claims to need your help in accessing the funds, and that the only way to do this is by first depositing the money in a bank account in the United States - yours. The writer offers to pay you a certain percentage for assisting with the transfer and deposit of the funds. He then asks for your personal financial information, so he can transfer the money to your bank account. The truth is, your account is likely to be drained if you give him your personal financial information.

There are numerous variations on this theme. Sometimes the writer is a woman claiming to be the widow of a deposed president. Or the writer may be from a country other than Nigeria. The tip-off is that you are going to allow your account to be used to facilitate the transfer of a huge sum of money. Supposedly, you'll get a percentage as a fee. But you won't. This fraud actually does originate in foreign countries, well beyond the reach of Texas law and law enforcement.

The Attorney General's Office wants to alert you to a new variation of this fraud, where the criminal uses counterfeit cashier's checks to defraud consumers and banks. In this fraud, a person selling a relatively expensive item over the Internet is approached by an individual, usually from a foreign country, who wants to buy the item and pay with a cashier's check. The buyer sends a cashier's check in an amount far
these new crimes. Most of these criminals reside in
create new methods to protect the public and minimize
defraud citizens, law enforcement must also evolve and
As criminals continue to devise new ways to
puppies have been approached with this scheme.
These criminals have targeted sellers
indiscriminately. Citizens selling cars, boats and even
have to pay the money back.
indisputable, she sent the buyer a check for the
leared the check and deposited it in her account. She was
to the aforementioned offer, accepted the inflated cashier's
check and deposited it in her account. She was
suspicious, so she waited for the cashier's check to
taken in by the check, assured the customer that it was
good, and only discovered the counterfeit after the
swindle was complete.
Unfortunately, this scam can harm innocent
citizens twice. Under Texas law, the bank may be
considered the actual victim of the crime, while the
citizen may be viewed as the perpetrator for passing
the counterfeit check. Victims of this crime may
actually face civil and criminal liability in addition to
losing the amount of the refund check they have sent.
In a couple of cases we have heard about, the bank was
taken in by the check, assured the customer that it was
good, and only discovered the counterfeit after the
counterfeit check seems to be covered.
This is a very serious type of crime because even
cautious consumers can be victimized. We received a
complaint from a woman who was selling horses on
the Internet. She was approached with the
described as the tell-tale sign of a
Nigerian fraud. The counterfeit cashier's check scam
has found a way to disguise this red flag. The
consumer is offered a large sum to deposit (as in the
original form of the Nigerian fraud), so the refund
check seems to be covered.

Adding further to the deviousness of the scheme is
that the criminal does not ask for an advance fee. More
and more people are savvy enough to recognize the
request for an advance fee as the tell-tale sign of a
Nigerian fraud. The counterfeit cashier's check scam
has found a way to disguise this red flag. The
consumer is offered a large sum to deposit (as in the
original form of the Nigerian fraud), so the refund
check seems to be covered.

This is a very serious type of crime because even
cautious consumers can be victimized. We received a
complaint from a woman who was selling horses on
the Internet. She was approached with the
\(\text{for the overage.}\)

foreign countries, making prosecution nearly
impossible. The most effective way to combat these
kinds of fraud is through the cooperation of law
enforcement agencies and the dissemination of timely
information. As always, thank you for your service to
the State of Texas.

Greg Abbott
Attorney General of Texas
5&type=3

SOME PROTECTIVE STEPS FOR
DEPOSITARY BANKS IN DEALING WITH
CASHIER'S CHECKS, CERTIFIED CHECKS,
OR TELLER'S CHECKS

Because of the funds availability rules in Reg. CC,
depositary banks have a special difficulty in dealing
with cashier's checks, certified checks, or teller's checks. 12 C.F.R. § 229.10(c)(v) requires a depositary
bank to make funds deposited in an account with these
instruments to be made available no later than the next
business day following the banking day on which the
instruments are deposited. This puts the depositary
bank in a precarious position if the instrument turns out
to be counterfeit and the funds are withdrawn from the
account before the fraud is discovered. (There is a
similar risk, of course, when a provisional credit is
entered for an ordinary check but the risk is somewhat
lessened because the funds availability rules in Reg.
CC allow longer periods of time before full credit must
be made available to the customer. See, e.g., 12 C.F.R.
description of the problems facing depositary banks as
well as some suggested approaches for managing the
risks posed by counterfeit checks. Part of the Bulletin
appears below with some additional comments in bold
print added by the author in brackets:

OCC BULLETIN 2007-2

** * * Regulation CC contains several exceptions
that allow banks to delay making funds available. If a
customer deposits more than $5,000 in any one day, for
example, the bank may place a hold on the amount
over $5,000. For purposes of this exception, the bank
may aggregate all checks deposited into all accounts
held in the customer's name, either as sole or joint
holder.

** * * The bank also may delay making the funds
available if it has reasonable cause to believe that the
check is uncollectible from the paying bank. For
purposes of Regulation CC, there is reasonable cause if
facts exist that would cause a reasonable person to have a well-grounded belief that the check is uncollectible. However, the bank may not base its reasonable cause determination on the fact that a check is of a particular class or has been deposited by a particular class of persons. Therefore, a bank may not, for example, place a hold on all cashier's checks.

If the facts support imposing such a delay, the bank may delay availability only for a reasonable period of time. Regulation CC also provides a safe harbor for determining a reasonable period of time for this purpose: the bank generally may withhold funds for a total of seven business days for local cashier's checks, and for a total of 11 business days for nonlocal cashier's checks. If the bank holds a check for longer than the applicable safe harbor, the bank must establish that the longer period is reasonable.

* * * The Uniform Commercial Code (UCC) addresses the ability of a bank to charge back items returned to it, including fraudulent cashier's checks. Depositary banks generally may charge back to their customers the amount of checks that are later returned by the paying bank. § 4-214(a). The bank's right to charge back may not apply if the issuing bank fails to return an item to the bank by midnight of the banking day following the day on which the issuer received the item.] In addition, a [depositary] bank may provide in its deposit agreement for the right to charge back any item regardless of when the item is returned to it. The fact that a depositary bank has made funds represented by the returned item available to the depositor - even if the depositor has made use of such funds - does not affect the bank's right under the UCC or its deposit agreement to charge back the item or otherwise obtain a refund from its customer. Similarly, if a paying bank mistakenly pays a fraudulent cashier's check, the UCC generally allows the bank to recover the amount paid. [On this point, the Bulletin cites § 3-418(a) & (b), however, in the author's opinion, this overstates the value of this section as a means of recovering payment by the issuing bank.]

RISKS FOR DEPOSITARY BANKS

Customer deposits of fraudulent cashier's checks create a number of risks for depositary banks. For a variety of reasons, the customer may believe that the depositary bank bears some responsibility for his or her loss. For example, the customer may argue that the bank should not have credited the account before the check cleared, or should have followed different procedures to detect the fraud. [See, e.g., Holcomb v. Wells Fargo Bank, 66 Cal. Rptr. 3d 142 (Cal. Ct. App. 2007) (depositary bank could be liable for misrepresenting that check was good); City Check Cashing, Inc. v. Manufacturers Hanover Trust Co., 764 A.2d 411 (N.J. 2001) (misrepresentation claim against drawee bank possible but not on facts presented in case at bar); Gossels v. Fleet National Bank, 876 N.E.2d 872 (Mass. App. Ct. 2007) review granted 884 N.E. 2d 522 (Mass. 2008) (collecting bank held liable for negligent misrepresentation and conversion of funds when it failed to indicate an endorsement of a check was required and that a foreign check payable in euros would be paid at a conversion rate in dollars with an associated fee; bank also held liable for unfair and deceptive trade practice under state consumer protection law).] Alternatively, the customer may claim that he or she was led to believe that the check had cleared by statements made by a bank employee, such as, that funds were available. [See Valley Bank of Ronan v. Hughes, 147 P.3d 185 (Mont. 2006) (collecting bank could be found liable for negligent misrepresentation regarding check collection process even absent breach of its obligation of ordinary care under § 4-202 in the actual collection of the check; customer alleged teller said the check was “good” and it turned out of be a counterfeit check issued as part of a Nigerian check fraud) and Avanta Federal Credit Union v. Shupak, ___ P.3d ___. 2009 WL 5160002 (Mont., Dec. 31, 2009) (bank not estopped from exercising right of charge back under § 4-214, but was liable for negligent misrepresentation that funds from cashier's check were “secure” and could be drawn upon.)] The customer may also believe that the bank should not reverse a credit after making the funds available. [This is unlikely to be a successful argument. See Drew v. Commerce Bank, N.A., 2007 WL 1468683, 62 UCC Rept. Serv.2d 814 (N.J. Super., May 22, 2007) (Not reported in A.2d) (after being told several times that funds were “available,” money order turned out to be counterfeit but bank had statutory right to reverse provisional credit.)]

Customer dissatisfaction raises reputation concerns for a bank. In addition to the immediate customer relations impact, a bank could face broader reputational risk, including that resulting from possible litigation by the customer.

Depositary banks may also face credit risks in these situations. Reversing the deposit may cause the depositor's account to become overdrawn, and thereby create what is, in effect, a loan to the depositor. In that event, the customer may be unable - or unwilling - to repay the overdraft.

* * * Paying banks also experience risks related to fraudulent cashier's checks. Paying banks that fail to identify fraudulent cashier's checks may pay the checks erroneously. Even if they identify the checks as fraudulent, they may find themselves liable for the amount of those checks if they do not return the checks in a timely manner.
RECOMMENDATIONS

National banks should take actions to address the risks to the bank and its customers posed by fraudulent cashier's check schemes:

- Depositary banks should have appropriate procedures for processing and cashing cashier's checks that include methods of identifying potentially suspicious items and criteria for placing holds on deposits.¹

- Depositary banks should consider training or other steps to ensure that relevant personnel are aware of the increasing incidence of fraudulent cashier's checks. At a minimum, bank employees who handle deposits should be aware of the bank's procedures for identifying and handling suspicious cashier's checks. In addition, bank tellers could be trained to examine large-dollar checks more closely to identify suspicious cashier's checks, and to ask appropriate questions when customers deposit such cashier's checks.²

[Banks might consider having specific persons with special training to whom customers should be referred if there is even a slight doubt about a cashier’s or similar bank instrument.]

- Depositary banks should review their deposit agreements to ensure that the agreements appropriately address returned items and mitigate the risks related to fraudulent cashier's checks. [On this point, see Lema v. Bank of America, 826 A.2d 504 (Md. 2003) (if deposit agreement clearly allows charge back even if check is returned after the issuing bank’s midnight deadline this is a permissible variation of § 4-214 under the “variation by agreement” provisions in § 4-103). To similar effect, see also Donovan v. Bank of America, 2008 WL 4061073 (D. Me. 2008). In Donovan, the critical provision in the deposit agreement said, “[I]f an item deposited in your account has been paid by the financial institution on which it is drawn and that institution later returns the item to us claiming that it was altered, forged, or unauthorized or should not have been paid for any other reason, we may debit your account for the amount of the item.”]

- Depositary banks should be aware of the need to explain the status of deposits to its customers clearly and accurately, particularly in light of the potential for customer confusion. For example, without such information, customers may conclude that a check has cleared solely because the funds are available in the depositor's account. Tellers and other relevant personnel should receive appropriate training or other information to accomplish these objectives.

- Depositary banks should consider methods of working cooperatively with deposit customers that become victims of cashier's check fraud. In addition to providing assistance to the customer in connection with their claims or other actions against perpetrators, it may be appropriate in some circumstances to convert a resulting overdraft into a more formal loan that the customer can repay over time, instead of demanding that the overdraft be repaid immediately.

[A useful website to obtain information about current alerts and listing of known counterfeit cashier’s checks is http://www.occ.treas.gov/fraudresources.htm. This website also contains links to several sites dealing with other fraudulent activities, including identity theft.]

* * * *

Some Protective Steps for Payor Banks in Dealing with Cashier’s Checks, Certified Checks, or Teller’s Checks

As the issuing bank for cashier’s checks or as the certifying bank for certified checks, the payor bank has some ability to protect itself by maintaining accurate records for instruments that have been accepted or certified. In the case of teller’s checks, a positive pay agreement between the issuing bank and the payor bank can provide similar protection. This is not to say, however, that a bank that is induced to issue or certify a check by a fraud perpetrated by the remitter will be protected since the instrument could end up in the hands of a holder in due course or other protected person. However, issues presented in these situations are different than the counterfeit check and forged check issues that are the subject of this outline.

If the payor bank detects a counterfeit or a forgery before its midnight deadline, the solution is simple: dishonor and return the check as permitted by § 4-301. The real problem arises if the payor bank pays the check in error or fails to make a timely return. In these

¹ Banks should be advised, however, that these procedures must comply with all applicable laws. For example, as noted above, because Regulation CC expressly prohibits basing doubts concerning collectability on the fact that a check is of a particular class, national banks cannot institute a policy of placing holds on all cashier's checks. [Footnote has been renumbered from original in Bulletin.]

² Designating a particular person to whom customers should be referred when a cashier's check exceeds a particular amount may also be a useful approach. [Footnote has been renumbered from original in Bulletin.]
cases, the right to return the check may be very limited, if not impossible, because the payor receives only a warranty that the person presenting the check is a person entitled to enforce the instrument. See §§ 3.417(d) and 4-208(d). If the check is a non-ordinary check or a teller’s check, the warranties are somewhat broader and permit return for a forged indorsement, but the warranty against a forged drawer’s signature is limited to a warranty that the presenter (or any prior party) has no knowledge that the signature of the drawer is unauthorized. If an ordinary check or a teller’s check bears a forged drawer’s signature, proving that anyone other than the wrongdoer had knowledge of the forgery may well be impossible.

A complicating factor also arises in the case of electronic presentment where only an image of the instrument is presented to the payor. This problem was nicely illustrated in Wachovia Bank, N.A. v. Foster Bancshares, Inc. 457 F.3d 619 (7th Cir. 2006) and Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A. 208 Fed. Appx. 232 (4th Cir. 2006). In the former case, the original check had been destroyed and the court held that where it could not be determined from the image presented to the drawee whether the check was altered or counterfeit, it would be presumed the check was an alteration and recovery was allowed for breach of the presentment warranty against alteration. In the latter case, the check had also been destroyed, but the court held the check was not an alteration, but a counterfeit.

To address the problem of limited warranties given by a presenting bank, two clearinghouse associations have adopted rules under which a presenting bank warrants that the signature of the drawer is not forged or unauthorized and that the check is not a counterfeit. See Rule XIX(O) of the Electronic Check Clearing House Organization at https://www.eccho.org/cc/rules/RulesSummary-Feb2009.pdf and Rule 9 of the National Automated Clearinghouse Association at http://www.nacha.org/default.htm. Local or regional clearinghouse associations such as the Southwestern Automated Clearinghouse Association are members of one of the national associations and adhere to their respective rules. Under § 4-103 clearinghouse rules have the effect of agreements that are binding on all parties interested in an item or items being handled, whether or not those parties have specifically assented to the agreements. See, e.g., City Check Cashing, Inc. v. Manufacturers Hanover Trust Co., 166 N.J. 49, 764 A.2d 411 (2001) (check cashing service bound by time periods stated in clearinghouse agreement). Such agreements cannot, however, disclaim a bank’s responsibility for the lack of good faith or the failure to exercise ordinary care or limit the measure of damages for such lack or failure.

Dealing with Ordinary Forgeries on a Customer’s Account

In the case of an ordinary forgery on a customer’s account, the check is not properly payable and the general rule is that the loss falls on the payor bank. However, this general rule is subject to some significant exceptions, most importantly §§ 4-406 and 3-406. The Texas version of these two sections appear immediately below. They differ somewhat from the Official Text and the changes in the Texas version are indicated by the included strikeouts and insertions.

SECTION 3-406. NEGLIGENCE CONTRIBUTING TO FORGED SIGNATURE OR ALTERATION OF INSTRUMENT.

(a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

(b) Under Subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

(c) Under Subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under Subsection (b), the

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3 In Southwest Bank v. Information Support Concepts, Inc., 149 S.W.3d 104 (Tex. 2004) the Texas Supreme Court addressed the question of whether the proportionate responsibility rules in the Texas Civil Practice and Remedies Code applied to the comparative fault provisions in the UCC. Finding no Texas cases in point, the court discussed, with approval, the decision in John Hancock Financial Services, Inc. v. Old Kent Bank, 346 F.3d 727 (6th Cir. 2003), where the court held that the Michigan Tort Reform Act did not apply to a conversion claim brought under UCC sec. 3-406. Emphasizing that the underlying purposes and policies of the UCC include a directive “to make uniform the law among the various jurisdictions,” the court stated, “Were we to impose Texas's proportionate responsibility scheme on Revised Article 3, parties litigating UCC-based conversion claims in Texas would face a unique liability scheme, overriding the UCC's express purpose of furthering uniformity among the states.” The court noted that its ruling applied to the comparative fault provisions in §§ 3.404, 3.405 and 4.406 as well as to § 3.406.
burden of proving failure to exercise ordinary care is on the person precluded.

SECTION 4-406. CUSTOMER'S DUTY TO DISCOVER AND REPORT UNAUTHORIZED SIGNATURE OR ALTERATION.

(a) A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount, and date of payment. [If the bank does not return the items, it shall provide in the statement of account the telephone number that the customer may call to request an item or a legible copy of the items pursuant to Subsection (b).]

(b) If the items are not returned to the customer, the person retaining the items shall either retain the items or, if the items are destroyed, maintain the capacity to furnish legible copies of the items until the expiration of seven years after receipt of the items. A customer may request an item from the bank that paid the item, and that bank must provide in a reasonable time either the item or, if the item has been destroyed or is not otherwise obtainable, a legible copy of the item. [A bank shall provide, on request and without charge to the customer, at least two items or a legible copy of the items with respect to each statement of account sent to the customer.]

(c) If a bank sends or makes available a statement of account or items pursuant to Subsection (a), the customer must exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the customer must promptly notify the bank of the relevant facts.

(d) If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by Subsection (c), the customer is precluded from asserting against the bank:

(1) the customer's unauthorized signature or any alteration on the item, if the bank also proves that it suffered a loss by reason of the failure; and

(2) the customer's unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank.

(e) If Subsection (d) applies and the customer proves that the bank failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss, the loss is allocated between the customer precluded and the bank asserting the preclusion according to the extent to which the failure of the customer to comply with Subsection (c) and the failure of the bank to exercise ordinary care contributed to the loss. If the customer proves that the bank did not pay the item in good faith, the preclusion under Subsection (d) does not apply. 4

(f) Without regard to care or lack of care of either the customer or the bank, a customer who does not within one year after the statement or items are made available to the customer (Subsection (a)) discover and report the customer's unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or alteration. If there is a preclusion under this subsection, the payor bank may not recover for breach of warranty under Section 4-208 with respect to the unauthorized signature or alteration to which the preclusion applies.

Several points about these two sections are worthy of note. First, in regard to § 4.406, note there is no specific time period stated in the case of a single forgery on, or alteration of, a check drawn on a customer’s account during a single statement period. The 30 day time period stated in subsection (d)(2) applies to multiple forgeries by the same wrongdoer that span more than one account period (the so-called “repeater rule.”) This makes it incumbent upon the bank to include a provision in the deposit agreement specifying a time limit for the examination of account

4 See note 3, supra.


statements. The question then becomes how short can the time limit be? In Union Planters Bank, N.A. v. Rogers, 912 So. 2d 116 (Miss. 2005), the court upheld a time period of 15 days. There seems to be no Texas case clearly addressing this issue but tacit approval of a 60 day time limit was mentioned in American Airlines Employees Federal Credit Union v. Martin, 29 S.W.3d 86 (Tex. 2000). A related issue is whether the one year time limit in subsection (f) can also be reduced. On this question, see, e.g., In re Estate of Ray, 24 Misc. 3d 285, 874 N.Y.S.2d 891, (N.Y.Sur. 2009) (60 day limit upheld); Peters v. Riggs National Bank, N.A., 942 A.2d 1163 (D.C. 2008) (60 day period approved); Freese v. Regions Bank, N.A., 644 S.E.2d 549 (Ga. Ct. App. 2007) (30 day period approved); National Title Insurance Corp. v. First Union National Bank, 559 S.E.2d 668 (Va. 2002) (60 day period approved); Stowell v. Cloquet Co-op Credit Union, 557 N.W.2d 567 (Minn. 1997) (20 day period approved). In Canfield v. Ban One, Texas, N.A., 51 S.W.3d 828 (Tex. App.—Texarkana 2001, no pet.), the court approved a 90 day limitation.

Even with a stated limit on the time available for a customer to examine statements, a bank faces a difficult proof issue. Subsection (d)(1) requires the bank to prove that it suffered a loss because of the customer’s failure to review and report an unauthorized signature or alteration. As noted in Clean Water Systems, Inc., 159 B.R. 941 (Bankr. D. Kan. 1993), such a loss could result if the bank could have recovered the funds from the forger or from another bank, obviously a difficult burden to meet. See, e.g., Schoenfelder v. Arizona Bank, 796 P.2d 881 (Ariz. 1990) (despite three month delay by customer in reporting forgeries, bank produced no evidence showing loss); Commercial Cotton Co., Inc. v. United California Bank, 163 Cal. App.3d 511 (1985) (bank failed to show loss even though customer delayed for eighteen months in discovering and reporting forgeries); Fundacion Museo de Arte Contemporaneo de Caracas—Soﬁa Imber v. CBI-TDB Union Bancaire Privee, 996 F.Supp. 277 (S.D.N.Y. 1998), aff’d 160 F.3d 146 (2d Cir. 1998) (even if customer failed duty of examination, bank failed to show a loss resulting from such failure).

Although a bank may have difﬁculty in showing a resulting loss from a forgery or forgeries shown in a single bank statement, in the case of repeated forgeries, by the same wrongdoer extending over a period of time (i.e., during more than one statement period), the “repeater rule” in subsection (d)(2) generally protects the bank against the subsequent forgeries. Such a rule makes good sense since knowledge of earlier forgeries gives the bank an opportunity to identify subsequent forgeries on the same account. See, e.g., Hatcher Cleaning Co. v. Comerica Bank—Texas, 995 S.W.2d 933 (Tex. App.—Fort Worth 1999, no pet.) (failure to adequately report forgeries extending over a period of several months precluded customer’s recovery for series of forgeries); Space Distributors, Inc. v. Flagship Bank of Melbourne, 402 So.2d 586 (Fla. App. 1981) (customer precluded from recovery for forgeries that extended over a two year period); Spacemakers of America, Inc. v. SunTrust Bank, 609 S.E.2d 683 (Ga. App. 2005) (failure to report first forgery barred recovery for twelve additional checks forged by same wrongdoer).

It must be noted, however, that even if a customer fails to report a forgery shown on an account statement, the bank may still have difficulties in avoiding liability for subsequent forgeries by the same wrongdoer if the bank itself fails to exercise ordinary care in paying the items. Subsection (e) states a comparative fault rule allocating loss between the customer and the bank if both fail to exercise ordinary care. Note that the Texas version of this subsection, like that contained in § 3.406(b), varies from the Official Text by reducing the burden placed on the customer as compared to the burden placed on the bank. A good discussion and application of the comparative fault provisions appears in Bank of Texas v. VR Electric, Inc., 276 S.W.3d 671 (Tex. App.—Houston [1st Dist. 2008, pet. denied] (failure of both customer and bank to exercise ordinary care resulted in allocation of loss between both). See also Grassi Design Group, Inc. v. Bank of America, N.A., 908 N.E.2d 393 (Mass. App. 2009) (bank exercised

5 The State Bar Committee Comment discussing the reason for this change appears as a comment to § 3-404. That comment states, “Subsection (d) has been revised from the Official Text to delete the word "substantially" located before the words "contributes to the loss resulting from payment of the instrument". Deletion of the word "substantially" eliminates an additional fact question of the degree of negligence for a trier of fact. A person contributing to the loss resulting from payment of the instrument by failing to exercise ordinary care in paying the instrument or taking it for value or for collection must pay the person bearing the loss to the extent his failure to exercise ordinary care contributed to the loss. The definition of "ordinary care" in section 3.103 has been expanded for banks to permit them not to examine each instrument in check processing. This change plus the retention of a "substantial contribution" standard would shift the balance of proof too far in favor of banks from a policy standpoint. As a consequence, in the interest of maintaining a more appropriate balance between banks and their customers, the deletion of the word "substantially" was made. This change conforms to a similar change made by the California legislature in adopting its version of UCC Articles 3 and 4.” As to the relationship between the comparative fault rule in §§ 3.404, 3.405, 3.406 & 4.406 and the Texas proportionate responsibility provisions in the Texas Civil Practice & Remedies Code, see note 3, supra.
ordinary care in processing checks and thus customer could not recover on statutory or contract claims).

While § 4.406 does not explicitly require notice of forgery to be given in writing, it is common practice for a deposit agreement to require written notice. However, even if written notice is required, it must be remembered that a deposit agreement is merely a particular type of contract and a court might find a customer has substantially complied with the notice requirement even though the form of notice differs from that specified in the deposit agreement. See ADC Rig Services, Inc. v. JPMorgan Chase Bank, N.A., 641 F.Supp.2d 617 (S.D.Tex. 2009), where the court held, inter alia, that an issue of fact existed as to whether the account holders substantially complied with the terms of their deposit agreements by giving oral notice to the bank and attempting unsuccessfully to have the bank provide the forms required by the deposit agreements to give formal written notice. Other doctrines of general contract law, such as waiver or estoppels, may also affect a bank’s ability to enforce the written terms of a deposit agreement. See § 1-103.

For customers who issue large numbers of checks, a positive pay program may be desirable. Under a positive pay agreement, a customer electronically provides its bank with a list of issued checks. If a check that is not on the list is presented for payment, the check is automatically suspect and the bank is entitled to dishonor it without incurring the risk of liability for wrongful dishonor. A good example of a of a positive pay agreement appears in "Model Positive Pay Services Agreement & Commentary," 54 Bus.Law. 637 (ABA 1999). A direct deposit program is another alternative if customers would like to revise their payment system to avoid the risks associated with issuing paper checks.

Conclusion

It has now been twenty years since the Official Text of Articles 3 and 4 were extensively revised. During that time technological changes have had a major impact on banking and it is apparent that laws designed in large part to deal with a paper based system are inadequate in an electronic world. Stop-gap measures based on contract or piece-meal federal legislation such as Reg. CC and Check 21 create a confusing patchwork for the present-day banking system. To address such concerns, the Uniform Law Commission and the American Law Institute have formed a Payment Systems Study Committee to review issues that have emerged during the last twenty years. Reports of the issues under consideration may be found at http://www.nccusl.org/Update/CommitteeSearchResult.aspx?committee=327.

APPENDIX

A BIRD'S EYE VIEW OF ARTICLE 4

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Article 4 of the Uniform Commercial Code was enacted as Chapter 4 of the Texas Business & Commerce Code in 1967. A substantial revision of the Official Text approved by the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1990 was adopted in Texas in 1995. A few amendments were made to Chapter 4 in the 2005 Texas legislative session, primarily to promote electronic collection of checks and the use of electronic records for the giving of notice and the like.

There are two main facets to the coverage of Chapter 4. First, there is the relationship between the bank and its customers (an area of interest to both a general practitioner and to a bank attorney). Second, there is the relationship among banks involved in the collection process, an area that involves, primarily, counsel for banks. The relationship between the bank and its customers is covered, principally, in the seven sections comprising Subchapter D of Chapter 4. These sections address the propriety of charges to the customer's account, wrongful dishonor of checks, stop payment orders, stale checks, death or incompetency of a customer, customer duties to discover and report unauthorized signatures and alterations, and a payor bank's right of subrogation after improper payment.

The other four subchapters in Chapter 4 deal with collection and payment functions involving both cash and non-cash items. Cash items include checks and "payable through" drafts. Non-cash or collection items include documentary drafts, debt-type securities (although these are covered, in many cases, by Chapter 8), and previously-dishonored cash items that are represented, concerning which payment is less certain and that are paid once and for all only upon collection.

issues (debit card matters are the subject of the EFTA). Other state law may also affect payment methods, particularly in the relatively new field of payments made through stored value cards, "smart cards," or internet payment systems like PayPal. As of July 1, 2007, Reg. E was amended to cover payroll cards that allow employees to transfer or access funds placed in an account by an employer, but the law governing the other forms of payment is undeveloped and often based on the contract between the customer and the card issuer or payment system provider.


Scope of Chapter 4

The possibility of conflict exists between provisions of Chapter 4 and other chapters of the UCC, particularly Chapter 3 on Negotiable Instruments and Chapter 8 on Investment Securities. In the event of conflict, the provisions of Chapter 4 override those of Chapter 3, but yield to those of Chapter 8. § 4.102(a).

Chapter 4 codifies banking practices that had long been established, but not previously recognized by statute (for example, cutoff hours after which deposits are deemed to have been made on the following business day). See § 4.108. It also attempts to anticipate future development of banking practices by facilitating rapid processing of items. A primary illustration is § 4.206, which permits a bank to transfer an item with its transit number alone. A few amendments were made to Chapter 4 in 1996, primarily as modifications or elaborations of rules or procedures designed to simplify the collection process, a bulk handling operation requiring all possible simplification. Some new provisions were added, however, and these are emphasized in the ensuing discussion.

Terminology

Chapter 4 applies special terminology derived from business usage. Some definitions are incorporated by reference to Chapter 3.

An instrument is a "draft" if it is an order (this definition is necessary to differentiate drafts from notes, which are "promises"). A check is a draft drawn on a bank and includes cashier's checks and teller's checks. § 3.104(f). An instrument may be a check even though it is described on its face by another term, such as "money order." A "cashier's check" is a draft on which the drawer and drawee are the same bank or branches of the same bank. § 3.104(g). A "teller's check" is a draft drawn by a bank on another bank or payable at or through a bank. § 3.104(h). Traveler's checks are defined in § 3.104(i). One should also note that Chapter 4 treats a certificate of deposit as a species of note rather than a draft. See § 3.104(j).

An "item" is an instrument or a promise or order to pay money handled by a bank for collection or payment. § 4.104(a)(1). This term does not include a payment order governed by Chapter 4A on funds transfers or a credit or debit card slip. While checks make up the great majority of items collected by banks, banks also collect promissory notes, bills of exchange, bonds, coupons, and some other kinds of instruments. In this chapter, the term, "check" is used as a rough synonym for the Code term, "item," with the understanding that the same rules apply to collection of all items, unless a different rule is indicated in the discussion.

A "bank" is a "person" (including business entities, obviously) engaged in the business of banking, including a savings bank, savings and loan association, credit union, or trust company. § 4.105(1).

A "depositary bank" is the first bank to take an item (even though it is also the payor bank), unless the item is presented for immediate payment over the counter. § 4.105(2).

"Payor bank" means the bank that is the drawee of a draft. § 4.105(3). The "drawee" is the person ordered in a draft to make payment. § 4.104(a)(8).

"Intermediary bank" means a bank to which an item is transferred in the course of collection, except the depositary or payor bank. § 4.105(4).

A "collecting bank" is a bank handling an item for collection, other than the payor bank. § 4.105(5).

"Presenting bank" means a bank presenting an item for payment, except a payor bank. § 4.105(6). "Presentment" is a demand by or on behalf of a person entitled to enforce an instrument to pay the instrument made to the drawee or a party obliged to pay the instrument (or, in the case of a note or accepted draft payable at a bank, to the bank) or to accept a draft made to the drawee. § 3.501 (a). In the case of electronic presentment (to which party banks must agree or be subject to under clearing house rules, federal reserve regulations, or operating circulars), a "presentment notice" in the form of transmission of an image of an item or information describing the item suffices as presentment in lieu of the item itself. See § 4.110.

The standards of "good faith" and "ordinary care," defined in § 1.201(a)(20) and § 3.104(a)(9),
respectively, are also applicable in Chapter 4. §§ 4.104(c) & (d). Good faith" means honesty in fact and observance of reasonable commercial standards of fair dealing. "Ordinary care," in the case of a person engaged in business, means observance of reasonable commercial standards prevailing in the area where the person is located with respect to the business in which the person is engaged."

A "customer" is a person having an account with a bank or for whom a bank has agreed to collect items, including a bank maintaining an account at another bank. § 4.104(a)(5).

Other definitions, primarily from Chapter 3, also apply to Chapter 4. Examples are "check" and "holder in due course." A comprehensive list appears in § 4.104(c).

One should particularly note the exclusion of "payor bank" from the definition of "collecting bank." While a collecting bank is held to a standard of ordinary care in the collection process, a payor bank may be absolutely liable for failure to respond correctly and in a timely manner upon presentment of a check for payment. § 4.302.

Collecting Banks and Agency Status

When a check is indorsed and deposited in a collecting bank, a "transfer" takes place. Chapter 4 presumes that an agency for collection purposes is created unless the parties clearly manifest an intention for sale of the check to have occurred. § 4.201(a). Consequently, the depositor remains the "owner" of the check and the bank is only a provisional debtor of the depositor. All credits given in the chain of collection remain provisional until final payment is made. As a check moves along the chain of collection, each collecting bank becomes a holder and an agent of the bank from which it received the item, as well as a sub-agent of the depositor.

In the exceptional case where an intent to sell is manifested, the check becomes the absolute property of the bank, which is then a debtor of the depositor. Code provisions for presentment, payment, and collection remain applicable. § 4.201(a). Note that, after an item has been indorsed with the words, "Pay any bank" or the like, only a bank may acquire rights of a holder of the item until it has been either returned to the customer initiating collection or specially indorsed by a bank to a person who is not a bank. § 4.201(b).

Collecting Bank's Duty of Care

A bank handling a check for collection owes specified duties to the depositor (or owner) and is liable for failure to fulfill them. The applicable standard is "ordinary care." A collecting bank must exercise ordinary care in presenting a check or forwarding it for presentment, sending notice of dishonor or nonpayment or returning an item (other than a documentary draft) to the bank's transferor after learning that the item has not been paid or accepted, settling for an item when receiving final settlement, and notifying its transferor of any loss or delay in transit within a reasonable time after discovering the fact. § 4.202(a).

A collecting bank is considered to have exercised ordinary care by taking proper action in response to the above matters before its "midnight deadline" (see the discussion of this term below) following receipt of an item, notice, or settlement. Taking action within a reasonably longer time may also be considered exercise of ordinary care, but, in such instances, the bank bears the burden of establishing timeliness. § 4.202(b). Subject to subsection 4.202(a)(1), a collecting bank is not liable for the insolvency, neglect, misconduct, mistake, or default of another bank or person or for loss or destruction of an item in the possession of others or in transit. § 4.402(c).

Neither a collecting bank, nor a payor bank, can disclaim by agreement its responsibility for lack of good faith or failure to exercise ordinary care and the measure of damages for such lack or failure cannot be limited. Note that acting pursuant to federal reserve regulations or operating circulars constitutes exercise of ordinary care and, in absence of special instructions, action consistent with clearing house rules and the like, or with a general banking usage not disapproved by Chapter 4, is prima facie evidence of the exercise of ordinary care. § 4.103(c).

Parties may, however, determine the standards by which a bank's responsibility is to be measured, if the standards set are not "manifestly unreasonable."

When a check is transferred to a bank for collection, it must honor any instructions given by the transferor, but needs not follow those of any other person. This is so even if the depositor notifies the collecting bank that it has revoked the authority of the depositary bank.

Collecting Bank as a "Payable Through" or "Payable At" Bank

If an item states that it is "payable through" a bank identified in the item, this designates the bank as a collecting bank, but does not, by itself, authorize the bank to pay the item. The item may be presented for payment only by or through that bank. § 4.106(a). If an item is designated as being "payable at" a particular bank, it is equivalent to a draft drawn on that bank. § 4.106(b).

If a draft names a non-bank drawee, and it is unclear whether a bank named in the draft is a co-drawee or a collecting bank, the bank is a collecting bank. § 4.106(c).
The Midnight Deadline

Chapter 4 sets a "midnight deadline" for a bank to take action on received items. This deadline is midnight on the bank's next banking day following the banking day on which it receives an item or notice or for the time for taking action commences to run, whichever is later. § 4.104(a)(10). A "banking day" is the part of a day on which a bank is open to the public for carrying on substantially all of its banking functions, but, for the purpose of determining the bank's midnight deadline, it does not include Saturday, Sunday, or any holiday on which the federal reserve banks are not performing check clearing functions. §4.104(a)(3).

Generally speaking, a collecting bank has until midnight of the banking day following the banking day it receives a check to present, forward, or return the check. § 4.202(b). Taking proper action within a reasonably longer time may constitute exercise of ordinary care, but the bank then has the burden of proving timeliness. A payor bank has until its midnight deadline to dishonor a check for which it made provisional payment when the bank received the check. § 4.301.

In applying the midnight deadline rules, it is necessary to determine when an item is "received." Checks delivered to the bank after banking hours (for example, those placed in an after-hours depository) are treated as received at the opening of the next banking day. § 4.108(b). A bank may also establish a cutoff time of two p.m. or later for the handling of items and the making of entries on the bank's books. § 4.108(a).

There are several situations where the midnight deadline rules are relaxed. The liability of a bank missing a midnight deadline is subject, for example, to a defense that the person seeking enforcement presented or transferred the item for the purpose of defrauding the payor bank. § 4.302(b). A collecting bank acting beyond its midnight deadline in handling an item does not lose its right of charge-back, but it is responsible for any resulting loss. §§ 4.202 & 4.214. Failure of equipment or interruption of computer facilities (as well as other circumstances) may excuse delay with respect to the midnight deadline (or other deadlines), but a bank must still exercise such diligence as the circumstances dictate. § 4.109(b). A two-banking-day waiver is also permitted for a collecting bank, but only with regard to items drawn on a payor other than a bank. § 4.109(a).

Provisional and Final Settlement

Payment of items is referred to in Chapter 4 as "settlement," which appears to be roughly synonymous with the lay term, "payment." It means to pay in cash, by clearing house settlement, in a charge or credit or by remittance, or as otherwise agreed. § 4.104(a)(11). Settlement may be either provisional or final. A number of provisions in Chapter 4 use one or the other of these adjectives to clarify which type of settlement is involved. If no qualification appears, it indicates that, for purposes of the particular rule, it is unnecessary to determine whether the settlement is provisional or final. See Official Comment 6 to § 4.104.

The most important feature of a provisional settlement is the right of charge-back that accrues to a collecting bank when it fails to receive final payment for a check from its transferee when it has provisionally credited the amount of that check to its transferor. The collecting bank may, in this circumstance, revoke the settlement given by it, charge back the amount of any credit given for the item to its customer's account, or obtain a refund from its customer, notwithstanding whether it is able to return the item if, by its midnight deadline or a longer, reasonable time after it learns the facts, it returns the item or sends notification of the facts. If the return or notice is delayed, the bank may act similarly, but then becomes liable for any loss resulting from the delay. These rights terminate if and when a settlement becomes final. § 4.214(a).

An item is returned when it is sent or delivered to a customer or transferor (or pursuant to its instructions). § 4.212(b). A depositary bank that is also the payor may charge back the amount to a customer's account or obtain a refund (see § 4.214(c) & 4.301). Charge-back rights are not affected by previous use of a credit given for the item or failure by any bank to exercise ordinary care with respect to the item (although a bank so failing remains liable). § 4.214(d).

Failure to charge-back or claim a refund does not affect other rights the bank may have against the customer or any other party. § 4.214(e).

An item is finally paid by a payor bank upon payment of the item in cash, settling for the item without having a right to revoke the settlement under statute, clearing house rule, or agreement, or making a provisional settlement and failing to revoke it in the time and manner permitted by statute, clearing house rule, or agreement, whichever first occurs. § 4.215(a).

If a collecting bank receives settlement for an item that is or becomes final, the bank is accountable to its customer for the amount of the item and any provisional credit given for the item in an account with the customer also becomes final. § 4.215(d). If provisional settlement for an item between the presenting and payor banks is made through a clearing house or by debits and credits in an account between them, to the extent that provisional debits or credits are entered between them or between the presenting and successive, prior collecting banks seriatim, they become final upon final payment of the item by the payor bank. § 4.215(c).
Medium and Time of Settlement by Bank

With regard to settlement by a bank, the medium and time for settlement are generally prescribed by federal reserve regulations or circulars, clearing house rules and the like, or agreement. Absent such prescription, Chapter 4 contains its own set of rules governing medium and time of settlement.

When the medium of settlement is cash or credit to an account in a federal reserve bank, the time of settlement is calculated on the basis of the type of medium used to make the settlement. If cash or a cashier's or teller's check is the medium of settlement, for example, settlement is deemed to have been made when the cash or check is sent (or delivered). § 4.213(a)(1) and (2). When the medium of settlement is credit to an account in a federal reserve bank, settlement occurs when the credit is made. When the method of tendering settlement is by credit or debit to an account in a bank, settlement occurs when the credit or debit is made (when tender of settlement is made by authority to charge an account, settlement occurs when the authority is sent or delivered). When settlement is tendered by funds transfer, settlement occurs when payment is made to the person receiving the settlement pursuant to the rules of Chapter 4A. See § 4A.406(a).

Further, if tender of settlement is made by cashier's or teller's check and the person receiving settlement before its midnight deadline presents or forwards the check for collection, settlement is final when the check is finally paid. § 4.213(c)(1). If the receiving person fails to present or forward the check, settlement is final as of the recipient's midnight deadline. § 4.213(c)(2).

If tender of settlement is not made by one of the methods provided for in the statute, no settlement occurs until the tender is accepted by the person receiving settlement. § 4.213(b).

If settlement is made by giving authority to charge the account of the settling bank in the bank receiving settlement, settlement is final when the charge is made if funds are available in the account to cover the amount of the item. § 4.213(d).

Collecting Bank's Security Interest in Items

Under certain conditions, a collecting bank has a security interest in items it handles (as well as in accompanying documents and any proceeds realized from either). § 4.210(a). No security agreement is necessary, no filing is required to perfect the security interest, and security interest takes priority over any conflicting, perfected security interests in the item, accompanying documents, or proceeds. §§ 4.210(c) and 9.322(f)(2). In other respects, the bank's security interest is governed by Chapter 9.

The security interest arises, in the case of an item deposited in an account, to the extent to which credit for the item has been withdrawn or applied.
in presenting it to the payor bank. § 4.202(a). When a check is presented to the payor bank for payment, however, the payor bank may be held strictly liable for failure to meet its obligations. § 4.302. Exercise of ordinary care does not excuse a payor bank for a breach of its duties as outlined in the ensuing discussion.

The payor bank's duties may be analyzed by addressing the following four questions: (1) Which items presented for payment are "properly payable?" (2) When must a payor bank pay or dishonor an item received for payment? (3) When may a bank charge its customer's account for the amount of an item? (4) What is a payor bank's liability to a customer for wrongful dishonor of an item?

Properly Payable

An item is properly payable from a customer's account if the customer has authorized the payment and payment would not violate the customer-bank agreement concerning the account. An item drawn for more than the balance of the customer's account is properly payable if the bank is willing to honor an overdraft. § 4.401(a). Pre–1996 Chapter 4 contained a narrower definition of "properly payable" that was discarded in the amendments as it implied that, if the balance in the customer's account was insufficient to pay the item, the item was not properly payable.

Note that, as the automated check collection system cannot accommodate post-dated checks, a customer wishing to post-date a check must notify the payor bank of the post-dating in time to allow the bank to act on the notice. § 4.401(c). A bank failing to act on timely notice may be liable for damages from the resulting loss. These damages may include damages for dishonor of subsequent items. However, absent notice of the post-dating, the bank may pay the check before the post-date without liability to its customer. § 4.401(c).

Apart from these rules, a check is not properly payable if the drawer/customer's signature has been forged, if the check has been altered, or if a necessary indorsement has been forged.

Decision Deadline

If a payor bank settles for a demand item (other than a documentary draft) presented otherwise than for immediate payment over the counter before midnight of the banking day of receipt, the payor bank may revoke the settlement and recover it if, before it has made final payment and before its midnight deadline, it returns the item or, if the item is unavailable for return, sends written notice of dishonor or non-payment. § 4.301(a). Once a payor bank has paid a check in cash over the counter or has made a final settlement, it has no power to revoke. § 4.301(a). If a demand item is received by a payor bank for credit on its books, it may return the item or send notice of dishonor and may revoke any credit given or recover the amount withdrawn by the customer if it acts in accordance with these time limitations and in this manner. § 4.301(b). Documentary drafts are covered by special rules. See § 4.501 to 4.504.

A payor bank that fails to pay or return a demand item by its midnight deadline is liable for the amount of the item, notwithstanding whether the item was properly payable. § 4.302(a). This liability is subject to a breach of presentment warranty defense (see § 4.208) or proof that the person seeking enforcement of the liability presented or transferred the item for the purpose of defrauding the bank. § 4.302(b). This means that, even if the check was forged so that the payor bank cannot charge its depositor for the check, the bank is strictly liable for the amount of the check if it fails to return it before its midnight deadline. In the case of a non-demand item, however, the bank is only liable for failure to act within the allowed time for payment or dishonor if the item was properly payable. § 4.302(a)(2).

Right to Charge Customer's Account

A bank may charge against the account of a customer an item that is properly payable from that account, even though the charge creates an overdraft. § 4.401(a).

A customer is not liable for the amount of an overdraft, however, if the customer neither signed the item nor benefited from its proceeds. § 4.401(b). This rule protects customers who are parties to accounts on which more than one customer is permitted to draw. A bank that, in good faith, makes payment to a holder may charge the indicated account of its customer according to the original terms of an altered item or the terms of a completed item, even though the bank knows the item has been completed, unless the bank has notice that the completion was improper. § 4.401(d).

Where payment of a check will create an overdraft, the payor bank may either return it or pay it, however, a payor bank may not charge its customer's account for a check that is not properly payable. In general (and subject to the rules discussed in the preceding paragraph), a bank is liable to its customer to re-credit the amount of any paid check that was altered, forged, or had a forged endorsement. In this case, the payor bank may be able to seek recovery from the bank that presented the check for payment due to the presenting bank's breach of a presentment warranty. The payor bank is not obligated to reimburse its customer for an improperly paid check if the customer failed to notify the bank promptly of the error or if the negligence of the customer caused the loss (§§ 4.404, 3.404, 3.405, and 3.406). This may, however, be altered in a number of ways, including by agreement.
Wrongful Dishonor, Time of Determining Insufficiency of Account

A payor bank wrongfully dishonors an item if the item is properly payable, but the bank may dishonor an item that would create an overdraft, unless it has agreed to pay the overdraft. § 4.402(a). The bank is liable for damages proximately caused by wrongful dishonor of an item. These damages must be proved and may include damages for arrest or prosecution of the customer or other consequential damages. The proximate causation question is a fact inquiry to be determined on a case-by-case basis.

A payor bank's determination of the customer's account balance on which a decision to dishonor for insufficiency of available funds is based may be made at any time between the time the item is received and the time the payor bank returns it or gives notice in lieu of return. § 4.402(c). No more than one determination need be made. If the payor bank elects to make a subsequent balance determination for the purpose of re-evaluating the dishonor decision, the balance at that time is determinative of whether the dishonor was wrongful.

Payor Bank, Termination of Authority to Pay

A number of events may terminate or suspend a payor bank's authority to pay checks and its right to charge them against the drawer's account. These include:

1. receipt of knowledge or legal notice of the drawer's bankruptcy or liquidation;
2. service of an attachment or garnishment of the drawer's account;
3. receipt of a stop payment order from the drawer;
4. exercise by the payor bank of a right of setoff against the drawer's account that would reduce the balance in the account below the amount of a check received for payment;
5. receipt of a stale check; and
6. death or incompetency of a customer.

Payment Priority

In the case of events (1) through (4) noted above, it is vital to determine when the event terminating authority to pay occurred during any one of the various stages of the payor bank's processing of the customer's checks. If the notice or other terminating event occurs before a certain cutoff point, the payor bank's duty to pay the check is discharged. Otherwise, the terminating event occurs too late and the check will be paid. The terminating event occurs too late upon the happening of the earliest of the following:

1. the bank accepts or certifies the item.
2. the bank pays the item in cash.
3. the bank irrevocably settles the item.
4. the bank becomes accountable for the check by failing to pay or return it by the deadline.
5. in the case of checks, a cutoff hour no earlier than one hour after the opening of the next banking day after the banking day on which the check was received and no later than the close of that next banking day or, if no cutoff hour is fixed, the close of the next banking day after that on which the check was received. § 4.303(a)(1) through (5).

When several checks reach the bank before the cutoff time, the bank may accept, pay, certify, or charge them to the customer's account in any order. The bank may have made a final determination to pay certain items before receiving the notice and not have done so with regard to others received earlier. The notice is timely with respect to the uncommitted items. § 4.303(b).

Stop Payment Orders

The drawer of a check has an absolute right to stop payment and the payor bank is liable to the drawer for the drawer's loss if it fails to observe an order received in time for the bank to act on the order before paying the check or making a final determination to pay. §§ 4.303(a) and 4.403(a). If there is more than one person authorized to draw on a customer's account, any one of them can stop payment of any check drawn on the account. § 4.403(a). The drawer has the burden of proving the amount of loss. § 4.403(c). Loss may include damages from dishonor of subsequent items.

A stop payment order is effective for six months, and, by a non-uniform Texas amendment, must be in writing. Stop orders may be renewed for additional six month periods by submitting a renewal in writing during the period of effectiveness. § 4.403(b). Note that it is customary for a bank to include a clause in its form absolving it from liability, but such a clause does not relieve a bank from its own negligence. See §§ 4.103(a) & (b) and § 4.403, Official Comment 7.

The danger of loss to a payor bank as a result of paying a check over the drawer's stop payment order is minimized by the Code's subrogation provisions. § 4.407. A payor bank that has paid a check over a stop payment order (or that has otherwise improperly paid a check) is subrogated to the rights of:

1. a holder in due course against the drawer;
2. the payee against the drawer either on the check or on the underlying transaction; and (3) the
drawer against the payee on the underlying transaction.

Consider this example. Suppose a buyer/drawer writes a check to a seller/payee for $500 for goods purchased. Buyer/drawer stops payment on the check after discovering that the goods are only worth $200. The bank improperly pays the check. The bank is only liable to the buyer/drawer for $300 because that is the amount of the loss and the bank is subrogated to the seller/payee's claim against the buyer/drawer for the value of the goods. In addition, the bank may recover from the seller/payee the $300 claim of buyer/drawer that arose from the transaction. The buyer ends up paying $200 for $200 worth of goods, the seller receives only $200, and the bank loses nothing.

Customer's Death or Incapacity

Chapter 4 sets a ten-day period after the drawer's death during which a bank may pay the drawer's checks, even if it knows of the death. § 4.405. This authority is subject, however, to the power of any person claiming an interest in the account to stop payment on any particular check. § 4.405(b).

Stale Checks

When a payor bank is presented with a check more than six months after its date, it may properly refuse payment. If it does pay, however, it may charge the drawer's account if payment is made in good faith. Once a check has been certified, there is no time limit on the bank's duty to pay. § 4.404.

Transfer, Presentment, Encoding, and Retention Warranties

The Code imposes certain liabilities, called warranties, on all persons and banks transferring an item for collection or receiving payment on an item. Warranties are imposed without regard to any indorsement or express agreement and cannot be disclaimed with respect to checks. §§ 4.207 and 4.208. The extent of these warranties varies according to the type of item involved and for whose benefit the warranty is imposed. The reader should note that Federal Reserve Regulation CC states warranties made by paying and returning banks in the upstream return of checks.

The first type of warranty is called a "transfer warranty." § 4.207. A customer or collecting bank that transfers an item and receives a settlement or other consideration warrants to the transferee and to any subsequent collecting bank that:

1. the warrantor is a person entitled to enforce the item;
2. all signatures on the item are authentic and authorized;
3. the item has not been altered;
4. the item is not subject to a claim in recoupment of any party that can be asserted against the warrantor; and
5. the warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.

Effective on July 1, 2006, amendments to Reg. J, 12 C.F.R. pt. 210, and Reg. J, 12 C.F.R. pt. 229, added a provision that checks collected through the Federal Reserve include a warranty for items created by third parties acting with the purported authorization of the customer. This solved a problem of inconsistent state laws dealing with such items as described in John Krahmer, 12 Texas Practice: Methods of Practice § 28.15 (3d ed., Thomson-West 2005). This warranty applies to both transfer warranties and presentment warranties.

If an item is dishonored, a customer or collecting bank transferring the item and receiving settlement or other consideration must pay the amount due according to the terms at the time the item was transferred or, if the item was incomplete, according to the completed terms. § 4.207(b). The transferor's obligation is owed to the transferee and a subsequent collecting bank taking the item in good faith. The transferor cannot disclaim this obligation by an indorsement "without recourse" or other disclaimer of liability.

Damages recoverable by a good-faith taker of an item include an amount equal to the loss suffered as a result of the breach, but not more than the amount of the item plus expenses and loss of interest incurred. § 4.207(c).

A cause of action for breach of this warranty accrues when the claimant has reason to know of the breach. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the claimant has reason to know of the breach and the warrantor's identity, the warrantor is discharged to the extent of any loss caused by the delay in giving notice. § 4.207(d).

The second type of warranty contemplated by Chapter 4 is called a "presentment warranty." § 4.208. The warranties described here cannot be disclaimed with regard to checks. § 4.208(e). If an unaccepted draft is presented to the drawee for payment and acceptance and it is paid or accepted, the person obtaining payment or acceptance and any previous transferor warrant to the drawee, if payment or acceptance is in good faith, that:

1. the warrantor is, or was at the time of transfer, a person entitled to enforce the draft or authorized to obtain payment or acceptance for it;
(2) the draft has not been altered; and
(3) the warrantor has no knowledge that the
signature of the purported drawer was
unauthorized.

Damages recoverable for breach include the amount
paid by the drawee less the amount received by the
drawee (or that the drawee was entitled to receive
because of the payment). The drawee is, additionally,
etitled to compensation for resulting expenses and
losses. These rights are unaffected by any failure of the
drawee to exercise ordinary care in making payment. If
the drawee accepts the draft, breach of warranty is a
defense and, if payment is made, the acceptor is
entitled to recover the breach amounts described
above. If a drawee asserts a breach of warranty claim
on the basis of unauthorized indorsement or alteration,
the warrantor may defend by proving that the
indorsement is effective or that the drawer is precluded
from asserting the issue against the drawee.

As with transfer warranties, unless notice of a
claim for breach is given to the warrantor within 30
days after the claimant has reason to know of the
breach and the identity of the warrantor, the warrantor
is discharged to the extent of any loss caused by the
delay in notice. The cause of action accrues when the
claimant has reason to know of the breach. § 4.208(e)
& (f).

If a dishonored draft is presented for payment to
the drawer or an indorser or any other item is presented
for payment to a party obliged to pay on it and the item
is paid, the person obtaining payment (and any prior
transferee) warrant to the person making payment (if in
good faith) that the warrantor is (or was) a person
entitled to enforce the item or authorized to obtain
payment on behalf of such a person. § 4.208(d). The
person making payment may recover, upon breach of
the warranty, an amount equal to the amount paid plus
expenses and resulting loss of interest.

A person who encodes information on, or with
respect to, an item after it is issued warrants to any
subsequent, collecting bank and to the payor bank (or other payor) that the information is correctly encoded.
§ 4.209(a). This provision, of course, is addressed to
the nearly universal MICR encoding system. If the
customer of a depositary bank does the encoding, that
bank also is charged with making the warranty.

A person retaining an item pursuant to an
agreement for electronic presentment warrants to the
same entities mentioned in the preceding paragraph
that the retention and presentment comply with the
agreement. If a customer does the retaining, the bank
also makes this warranty. § 4.209(b).

For breach of these two warranties, a person
taking an item in good faith may recover an amount
equal to the loss suffered as a result of the breach, plus
expenses and any loss of interest occasioned. § 4.209(c).

Some payment transactions may occur as
automated clearinghouse transactions (ACH
transactions) or point of purchase transactions (POP
transactions). In these situations, the payee of a check
uses the check only for the purpose of obtaining
information as to the amount, routing number, and
account number. The information is then sent
electronically and the check itself is returned to the
customer/drawer. These transactions are not governed
by Chapter 4, but are subject to Reg. E and to ACH
clearinghouse rules instead since no paper instrument
goes through the banking system.

Liabilities Regarding Forgery and Alteration

When a check has been wrongfully altered or
where blanks left by the drawer have been filled in, the
payor bank has a limited right to charge the drawer's
account, if the payment is made in good faith. The
altered check may be charged only as it was originally
drawn. The bank may not charge the drawer's account
for a larger amount to which the check has been raised.
§ 4.401 (d)(1).

When blanks have been filled, the bank may
charge the drawer's account for the full amount, even if
it knows that the blanks have been left and filled in
later. It may not do this, however, if it knows that the
person filling in the blanks acted wrongfully. § 4.401
(d)(2).

Customer's Duty to Discover and Report Forgeries
and Alterations

A bank making available to its customer a
statement of account showing payment of items for
that account must either return or make available to the
customer the items paid or provide information on the
statement sufficient to allow the customer to identify
the items. § 4.406(a). Description by item number,
amount, and date of payment is sufficient. If the items
are not returned to the customer, they must be retained
or, if destroyed, a copy of them (usually electronically
storage) must be retained that can be reproduced on
request by the customer and the bank must provide in
the account statement a telephone number through
which items or copies may be requested. By a non-
uniform Texas amendment, a customer may obtain at
least two items or copies without charge during each
statement period. § 4.406(b).

The customer must exercise reasonable
promptness in examining the statement or the items to
determine whether a payment was wrongful because an
item was altered or the customer's signature was
unauthorized. The customer is then required to notify
the bank promptly of the relevant facts. If the bank
proves the customer failed to comply with these duties
and that the bank suffered a loss by reason of the
failure, the customer is precluded from asserting the unauthorized signature or alteration against the bank, either on one item or on others presented by the same wrongdoer. § 4.406(d). With regard to other items, the customer is given a period not exceeding 30 days to examine the item or statement and notify the bank if payment was made before the bank received notice from the customer. A customer in these circumstances who can prove that the bank failed to exercise ordinary care in paying the item and that the failure contributed substantially to the loss can have the loss allocated between the customer and the bank according to the extent to which the customer's noncompliance and the bank's lack of ordinary care contributed to the loss. § 4.406(e). If the customer can prove that the bank did not act in good faith, these preclusionary rules do not apply to the customer.

Without regard to the foregoing, if the customer does not bring a wrongful alteration or signature to the bank's collection within one year after the statement or item is made available to the customer, the customer is totally precluded from asserting the wrongful alteration or signature against the bank. § 4.406(f). If the customer is so precluded, the payor bank may not recover for breach of warranty with respect to the signature or alteration to which the preclusion applies.

Note that these duties apply to the discovery and reporting of unauthorized customer signatures or alterations made to an item; they do not apply to discovery and reporting of forged indorsements since the customer usually has no knowledge about whether an indorsement was or was not proper.

Bank Insolvency

The underlying purpose of the Chapter 4 bank insolvency provisions is not to give the owner of a check priority over general creditors. § 4.216, Official Comment 1. Chapter 4 does require, however, that the liquidating officer return all checks that a payor or collecting bank has received if it becomes insolvent before making final settlement. For purposes of this requirement, any settlement that automatically becomes final upon the passing of time (e.g., the payor bank's midnight deadline) is treated as though it had become final before insolvency occurred. If, for example, a bank receives a check for collection at 1:00 p.m. on Monday and fails to open for business on Tuesday morning, the settlement becomes final at midnight on Tuesday and the check is not returned to the bank from which it was received. If the check was received from a depositor of the closed bank, it is returned to the depositor, if no final settlement has been made.

Once final settlement has been made between an insolvent collecting bank and its transferor, the owner of the check has a preferred claim against the insolvent bank, unless the insolvent collecting bank made final settlement with the bank to which it must account for the check. In the above example, if the bank receiving the check at 1:00 p.m. collected it from the payor bank at 2:00 p.m. and failed to remit or credit the proceeds on that day to the bank from which it received the check, the owner of the check would have a preferred claim. The same is true if the payor bank makes final payment on a check, but fails to account to the owner of the check before becoming insolvent.

Documentary Drafts

Sales contracts often authorize the seller to draw on the buyer for the purchase price and, if the goods are shipped, to withhold the bill of lading until the draft is paid or accepted. The seller sends the draft, with the bill of lading attached, to a bank, which, then, becomes its agent for collection. This draft is called a "documentary draft." § 4.104(a)(6). A similar process is followed in the transfer of securities or other certificates or statements that are to be received by the drawee or other payor before acceptance or payment of the draft.

It is the duty of the collecting bank to present the draft and accompanying documents to the drawee for payment. This must be done promptly. The papers may be sent separately, if the circumstances warrant. If the draft is not accepted or paid, the bank must seasonably notify its principal, even if that bank has purchased the draft. § 4.501.

Although most documentary drafts are to be presented as soon as received by the collecting bank, others provide for presentment upon arrival of goods being shipped to the buyer. The bank may wait for a reasonable time before presenting such an "on arrival" draft. The draft is not dishonored if the goods are delayed and the buyer refuses to pay. The bank must, however, notify its principal of the nonpayment. It should hold the draft and present it again when it knows that the goods have actually arrived or when its agent for collection. This draft is called a "documentary draft." § 4.104(a)(6). A similar process is followed in the transfer of securities or other certificates or statements that are to be received by the drawee or other payor before acceptance or payment of the draft.

Documentary drafts are either sight or time drafts. For purposes of this discussion, time drafts are those payable more than three days after they are presented. In the case of a time draft, the presenting bank must deliver the documents (e.g., a bill of lading or instructions for transfer of uncertificated securities) to the drawee when the draft is accepted. For sight drafts, documents need be delivered only upon payment. § 4.503(1).

If a draft is dishonored, the presenting bank must follow instructions concerning its ensuing procedure. The draft may name a referee and, if so, the bank may apply to the referee for instructions and follow them. The bank is not required to go to the referee, but, instead, may use diligence and good faith to discover why the draft has been dishonored and, then, notify its principal and ask for direct instructions. § 4.503(2).
The presenting bank is under no obligation concerning goods represented by the bill of lading unless it receives instructions covering them. If the bank incurs expenses in following these instructions, it has a right to be reimbursed by its principal. If no instructions are received within a reasonable time after they are requested, the bank may deal with the goods in any reasonable manner, such as by storing or selling them. It, then, has a lien for any expenses reasonably incurred. § 4.504.

The 2005 amendments did not affect the substance of the forms contained in this volume, but many of the forms can now be communicated in electronic form instead of in written form. However, the practitioner should be aware of the federal "Check 21" Act, 12 U.S.C.A. §§ 5001 to 5018, and its regulations in Part D of Reg. CC which permit banks to use "substitute checks" in the check collection process to promote the electronic transfer and payment of checks. If this system is used, the original check will be destroyed in the collection process and an electronic substitute check will take its place. Under the federal act, a substitute check can be used for all purposes for which the original check could be used (e.g., proving payment).