

How to Use This Manual

BACKGROUND

Notwithstanding the growth of alternative payment systems such as credit cards, check cards, debit cards, stored value cards, and electronic fund transfers, checks remain one of the dominant noncash means of payment. A 2007 Federal Reserve Payments Study concluded that, in 2006, 30.6 billion checks were paid in retail transactions with a value of 41.7 trillion dollars.¹ Although this represented a 6.4 percent decrease in the absolute number of checks written from 2003, checks remained the single largest noncash payment system. In addition, the average amount for which a check was written increased to \$1,280. Many checks, however, are converted electronically before they are paid. As a result, only 30.6 billion checks were paid, and the average amount for which they were paid was \$1,366. Unfortunately, the high volume of check use means that check fraud is also rampant. In its most recent survey of deposit account fraud, the American Bankers Association (ABA) found that the total amount of attempted check fraud against bank deposit accounts exceeded \$12 billion in 2006. Many of these attempts were detected prior to the materialization of any loss, but 80 percent of banks surveyed nevertheless incurred check fraud losses.²

Although the total amount of check fraud appears to be highest at large banks, these statistics reveal that community banks are increasingly susceptible as the war against check fraud focuses more on technological improvements, such as positive pay and electronic check presentment. The high initial cost of some of these improvements may be easier to justify for larger banks. Therefore, those who engage in check fraud, in response, may be targeting smaller banks as the path of least resistance. As a result, low-cost deterrents, such as teller training, may become more important tools for community and mid-size banks.

Fraud exists in all kinds of accounts. Fraudulent checks against consumer accounts have been the most common source of fraud, accounting for approximately three-quarters of all cases. Fraud in the form of forged drawers' signatures and forged indorsements constitutes the most common

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1. The 2007 Federal Reserve Payments Study: Noncash Payments Trends in the United States: 2003-3006, available at http://www.fbsservices.org/files/communications/pdf/research/2007_payments_study.pdf.
 2. See American Bankers Association, Deposit Account Fraud Survey Report (2007).

types of fraud, together accounting for about 33 percent of losses. Other major forms of fraud include new account fraud, checks written against closed accounts or insufficient funds, and counterfeit checks.

In addition, an increasing percentage of check fraud losses are attributed to identity theft. In community banks, identity theft cases constitute a majority of losses and of cases of check fraud. In mid-sized banks, identity theft accounts for a lower -- but still significant -- percentage of losses and cases. For obvious reasons, identity theft is considered the number one emerging threat to the banking industry.

The reasons for increases in check fraud are varied. Some check fraud is facilitated by federal requirements that funds represented by checks be made available to depositors within relatively short periods of time after deposit. The limited time in which banks can place “holds” on deposits allows defrauders to deposit checks drawn on insufficient funds or fraudulently created checks and then withdraw against those checks before the depository bank has discovered that the check will not be paid. New technologies such as desktop check writing and encoding and the widespread availability of low-cost scanners permit easier production of counterfeit checks and forgeries than has previously been possible. The failure of banks to train employees to identify categories of checks that historically contain a significant number of bad checks means that opportunities to detect and deter fraud are lost.³

Regardless of the reasons for check fraud and the increased difficulties in detecting its occurrence, financial institutions that handle checks for deposit, collection, or payment often are in a better position than bank customers to discover the existence of a fraudulent check. Moreover, banks that have significant historical experience with check fraud are often in a better position to determine which fraud deterrent and detection procedures are most effective. As a result, legal doctrine frequently places the loss that arises when fraud occurs on those financial institutions. (Of course, a financial institution will always have a right of recovery against the party who committed the fraud; those parties, however, are difficult to find and will rarely have the funds to reimburse bank losses.) In this way, legal principles induce financial institutions to take advantage of their relative ability to detect fraud, ensure against its occurrence, and develop better mechanisms for fraud deterrence.

3. For instance, one source reports that checks drawn on new accounts and numbered 1 through 150 or 1001 through 1200 account for 22.7 percent of all bad check losses nationally, although these same checks account for only 17.6 percent of the dollar value of all checks written. See *The Green Sheet*, Issue 96:01:02, at <http://multiplex.com/GreenSheet-/PriorIssues-/960102-/960102-7.html>.

Because legal principles often place the risk of fraud on financial institutions, it is essential that bank officials not only be aware of mechanisms for avoiding bad checks, but also understand how their legal responsibilities relate to their ability to reduce the amount of bad checks. Both industry and government sources seem to agree that the most effective preventive measure against check fraud is employee training, both at the teller level and in back offices. A significant amount of fraud can be detected simply by knowing how to screen new accounts properly, identify individuals who may be involved in check fraud, and determine which features on a check or within checking accounts are most vulnerable to fraudulent manipulation.

THE PURPOSE OF THIS MANUAL

The *Check Fraud Protection Manual* helps financial institutions understand the legal principles governing negotiable instruments and provides practical guidance to help institutions detect and deter check fraud. The purpose of this manual is:

- To recommend procedures that facilitate detection of fraudulent checks and, thus, reduce a financial institution's losses from check fraud.
- To provide financial institutions that handle checks with an understanding of the legal principles that allocate losses from check fraud.
- To offer examples of how courts have applied those principles either to impose losses on banks or to exonerate banks from liability for fraud.
- To help banks train personnel in detecting and deterring check fraud.
- To provide a convenient reference source of regulations and laws that govern check fraud.

Note on Terminology

The *Check Fraud Protection Manual* refers to all institutions that offer demand deposit accounts as "banks" since the legal rules that allocate losses and the preventive measures that can be taken apply regardless of whether institutions are structured as commercial banks, savings and loan associations, credit unions, or in some other form.

ORGANIZATION OF THE MANUAL

In each chapter of the *Check Fraud Protection Manual*, we provide training exercises and discussion points for the training exercises to help banks and their staff understand the important legal, regulatory, and practical issues that pertain to check fraud. We also provide procedures for banks to implement to help detect and deter fraud in their institutions. The manual is organized as follows:

Part 1 — Understanding Checks and Check Fraud

Chapter 1, *Understanding Checks and Check Fraud*, explains the legal mechanics of checks and the processes by which financial institutions deal with them.

Part 2 — Forgery of Drawer's Signature

Chapter 2, *Forgery of Drawer's Signature*, focuses on the legal rules governing the allocation of losses in cases where the drawer's signature has been forged. This chapter explains the role of banks in avoiding this type of fraud and indicates what banks must do to avoid incurring ultimate liability for the fraud that does occur.

Part 3 — Forged Indorsements

Chapter 3, *Forged Indorsements*, covers the legal rules concerning the allocation of losses from forged indorsements, which are more complicated than those concerning a forged drawer's signature. This chapter describes how banks can reduce these costs by explaining the legal rules and presenting guidance to help minimize the risk that a check presented for deposit or payment bears a forged indorsement.

Part 4 — Alteration of the Check

Chapter 4, *Alteration of the Check*, discusses the types of alterations that can be made to an instrument and legal rules that govern altered checks. It presents example scenarios to illustrate the rules and presents guidance for bank personnel to detect check alterations.

Part 5 — Fraud Involving Properly Completed Checks

Chapter 5, *Notice of Breach of Fiduciary Duty*, and Chapter 6, *Payment Over a Restrictive Indorsement*, are included in this section. Chapter 5 explains important concepts, such as holder in due course, as they relate to fiduciaries and examines the circumstances under which the law

holds a bank liable for a breach of fiduciary duty. Chapter 6 explains the different types of indorsements and the liability issues involved if a bank does not comply with a valid restrictive indorsement. It also provides guidance on identifying fraud related to restrictive indorsements.

Part 6 — Multibank Fraud Schemes

The chapters in this part cover fraud schemes that can affect several banks at one time. Chapter 7, Check Kiting, explains what a check kiting scheme is, discusses law and regulation that come into play when a check kite occurs, and presents guidance to help banks detect and deter this type of fraud. Chapter 7A, Fraud Involving Cashier's Checks, Teller's Checks, and Certified Checks, covers the allocation of fraud losses involving these instruments. Chapter 8, Encoding Fraud, deals with fraud stemming from alteration of the magnetic ink character recognition (MICR) figures that are found on the bottom of preprinted checks. Though MICR fraud is difficult to actually carry out and to detect, it is important for banks and their staff to understand how fraud of this nature can occur and to implement procedures to help detect it.

Part 7 — Training Materials

In this part of the manual, we provide all of the practical training materials that appear in the manual in one consolidated chapter so you can use this material as a training resource to educate and train staff.

Part 8 — Appendixes

The appendixes include:

Appendix A: UCC Articles 3 and 4 (Revised)

Appendix B: Check Fraud: A Guide to Avoiding Losses, February 1999

Appendix C: Regulation CC

Appendix D: Appendix J to Part 41 — Interagency Guidelines on Identity Theft Detection, Prevention, and Mitigation