Comparative Negligence Under the Code: Protecting Negligent Banks Against Negligent Customers

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COMPARATIVE NEGLIGENCE UNDER THE CODE:
PROTECTING NEGLIGENT BANKS AGAINST
NEGLIGENT CUSTOMERS

Julianna J. Zekan*

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The new Articles Three and Four\(^1\) of the Uniform Commercial Code\(^2\) purport to envision a proportional sharing of responsibility between a negligent bank and its negligent customer for losses caused by forged or altered checks.\(^3\) In

1. The American Law Institute and the National Conference of Commissioners on Uniform State Laws adopted revised Article Three and the conforming and miscellaneous amendments to Articles One and Four of the Uniform Commercial Code in 1990. U.C.C., 2 U.L.A. 5 (1991). Revised Articles Three and Four have been enacted, sometimes with slight alterations, in 20 states. See Ark. Code Ann. §§ 4-3-101 to 4-3-605, 4-4-101 to 4-4-504 (Michie 1991); CAL. COM. CODE §§ 3-101 to 3-605, 4-106 to 4-504 (West Supp. 1993); CONN. GEN. STAT. ANN. §§ 42a-3-101 to 42a-3-605, 42a-4-101 to 42a-4-504 (West Supp. 1992); FLA. STAT. ANN. chs. 673.1011 to 673.6051, 674.101 to 674.504 (Harrison Supp. 1992); HAW. REV. STAT. ANN. §§ 490:3-101 to 490:3-605, 490:4-101 to 490:4-504 (Michie 1991); Commercial Law—Negotiable Instruments and Bank Deposits and Collections, Public Act 87-1135, 1992 Ill. Legis. Serv. 2693 (West); KAN. STAT. ANN. §§ 84-3-101 to 84-3-605, 84-4-101 to 84-4-504 (Supp. 1992); LA. REV. STAT. ANN. §§ 3-101 to 3-605, 4-101 to 4-504 (West Supp. 1993); MINN. STAT. ANN. §§ 336.3-101 to 336.3-605, 336.4-101 to 336.4-504 (West Supp. 1993); MISS. CODE ANN. §§ 75-3-101 to 75-3-605, 75-4-101 to 75-4-504 (Supp. 1992); Uniform Commercial Code, S.B. No. 448, 1992 Mo. Legis. Serv. 911 (Vernon); MONT. CODE ANN. §§ 30-3-101 to 30-3-607, 30-4-101 to 30-4-504 (1992); NEB. REV. STAT. §§ 3-101 to 3-605, 4-101 to 4-504 (1992); N.M. STAT. ANN. §§ 55-3-101 to 55-3-605, 55-4-101 to 55-4-504 (Michie Supp. 1992); Okla. Stat. Ann. tit. 12A, §§ 3-101 to 3-605, 4-101 to 4-504 (Supp. 1993); Uniform Commercial Code Modernization Act, Act No. 1992-97, 1992 Pa. Legis. Serv. 383 (Purdon); Uniform Commercial Code—General Amendments, ch. 237, 1993 Utah Laws, available in WL, UT-Legis database; VA. CODE ANN. §§ 8.3A-101 to 8.3A-605, 8.4-101 to 8.4-504 (Michie Supp. 1992); WYO. STAT. ANN. §§ 34.1-3-101 to 34.1-3-905, 34.1-4-101 to 34.1-4-504 (Supp. 1992). As of March 29, 1993, the revised articles were pending in the legislatures of 9 more states: Alaska, Arizona, Indiana, Maine, Massachusetts, New Hampshire, Vermont, Washington, and West Virginia. Letter from John McCabe, Counsel to the National Conference of Commissioners on Uniform State Laws, to author (April 1, 1993) (on file with author).

2. For the complete 1990 Official Text of Article Three of the Uniform Commercial Code, see U.C.C. art. 3, 2 U.L.A. 17, 17–146 (1991) [hereinafter "Code" or "revised Code" or "U.C.C."]. For the Official Text of the revised Article Four, see U.C.C. art. 4, 2B U.L.A. 5, 5–73 (1991). The former Official Text [hereinafter "former Code" or "pre-revision Article Three"] still remains the law in most states. See supra note 1. For purposes of clarity, this Article distinguishes between citations to the revised and former U.C.C. by citing, respectively, to the 1990 and 1989 U.C.C. If unspecified, section references are to the revised Code.

The simultaneous existence of both an older and a newer version of the Uniform Commercial Code as law in different states has generated a grammatical "tense" problem in this Article. The former Official Text of Articles Three and Four is still existing law in 30 states. Referring to the former Code in the past tense may create the impression that the discussion no longer represents current law. Referring to the former Code in the present tense, however, conflicts with the existence of the new Official Text of Articles Three and Four, the revised Code. The revised Code is already the law in 19 states. In the majority of states, then, the effects of the revised Code are still future events. Every effort has been made to present the discussion clearly in this Article, even at the expense of uniformity in grammatical tenses.

3. For example, § 3-406 states that "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." U.C.C. § 3-406(b) (1990). Similarly, § 4-406 allocates the loss between the customer and the bank "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."
reality, the revisions to the Code will result in the reallocation of loss from the bank to the customer. This result is due exclusively to the synergistic effect of the new Code sections that establish comparative negligence as the new standard for loss allocation in the revised Code and companion changes to the standard of ordinary care by which the bank's negligence will be determined.

The revised Code's new definition of ordinary care creates a presumption that the bank is not negligent whenever it conforms to general banking practice. For example, under the revised Code a bank that abandons sight review of checks and instead processes checks for collection electronically is conclusively presumed to have met the standard of ordinary care if it is customary in the banking industry to process checks electronically. Even as to banking practice in areas other than the sight review of checks, the standard of ordinary care is conclusively presumed to be met whenever the bank conforms to Federal Reserve regulations or operating circulars. In effect, by operation of the new standard of

Id. § 4-406(e). Under both provisions, however, the bank is protected by the standard of care set forth in § 3-103. Id. §§ 3-103(a)(7), 4-104(c).

4. See id. §§ 3-404 to 3-406, 4-406.

5. Section 3-103 defines "ordinary care" generally as the observance of reasonable commercial standards [prevalent in the area] ... In the case of a bank ... reasonable commercial standards do not require the bank to examine the [check] if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage ....

Id. § 3-103(a)(7). Other changes also will affect this result. See, e.g., id. §§ 4-110, 4-406 (authorizing electronic presentment of checks and minimizing the information that banks must provide to their customers).

6. Revised § 4-103(c) states, "[A]ction or non-action consistent with clearing-house rules and the like or with a general banking usage not disapproved by this Article, is prima facie the exercise of ordinary care." Id. § 4-103(c). Revised § 4-103 imports the Article Three standards of good faith and ordinary care into Article Four. Id. § 4-103 cmt. 4. For an in-depth discussion of ordinary care, see infra part V.

7. The practice of viewing every check for forgery of the signatures or indorsements or alteration of any term is known as "sight review" or "sight examination." This procedure was established to satisfy the contractual obligation to pay only checks that were "properly payable" in accordance with the customer's order. See U.C.C. § 4-401 (1990); U.C.C. § 4-401 (1989).

8. U.C.C. § 3-103(a)(7) (1990). The definition of "ordinary care" does not merely state a standard; it in effect states a substantive rule of law. Banks are not required to examine checks "if . . . the bank's procedures do not vary unreasonably from general banking usage." Id.

9. Section 4-103(c) states, "Action or non-action approved by this Article or pursuant to Federal Reserve regulations or operating circulars is the exercise of ordinary care . . . ." Id. § 4-103(c); see also United States Fidelity & Guar. Co. v. Federal Reserve Bank, 590 F. Supp. 486, 492 (S.D.N.Y. 1984) (stating that if a U.C.C. or Federal Reserve regulation is applicable "it provides a safe harbor, and a bank may conclusively
ordinary care and other Code provisions, the revised Code establishes the conforming bank's "nonnegligence per se." 10

All of these changes implement the central purpose of the revisions to Articles Three and Four: modernization of the banking system to accommodate existing and future technological advances. At the same time, however, the changes in the Code will make it substantially more difficult for customers 11 to meet their obligations to prevent fraud and to detect forgeries and alterations. 12 The revisions have increased the customer's responsibilities 13 and enlarged the scope of the customer's potential liabilities. 14 For instance, Article Four


10. If a statute imposes a duty to exercise ordinary care not to injure another, violation of the statute constitutes negligence per se. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 36, at 226 & n.2 (5th ed. 1984); see U.C.C. §§ 3-103(a)(7), 4-103(c), 4-406 (1990).

11. A customer is "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank." U.C.C. § 4-104(a)(5) (1990). Very few courts have construed "customer." See American Nat'l Bank v. Stanfill, 252 Cal. Rptr. 861, 866 (Ct. App. 1988) (lamenting the "dearth of authority" construing the U.C.C. § 4-104 definition of customer).

12. For example, § 4-406(d)(2) precludes a customer from asserting against the bank a forged signature or alteration if 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" of the unauthorized modification to the check. U.C.C. § 4-406(d)(2) (1990). An "item" is an instrument that includes a check. U.C.C. §§ 4-104(a)(9), 3-104(b)(f) (1990). There are no exceptions for extended vacation, illness, or postal delay, nor for obtaining a copy of truncated checks. An "alteration" is "(i) an unauthorized change in an instrument that purports to modify in any respect the obligation of a party, or (ii) an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party." Id. § 3-407(a) (1990). Although Comment 1 indicates that this merely restates former U.C.C. § 3-407, the revised subsection does not refer to a "change in . . . the number or relations of the parties" as an alteration, as did the former subsection. See id. § 3-407(a) cmt. 1; U.C.C. § 3-407(1)(a) (1989). Apparently, under the revised Code, changing the number of the parties to an instrument does not necessarily modify the obligation of a party. But see PETER A. ALCES, THE LAW OF FRAUDULENT TRANSACTIONS ¶ 3.16, at 3-51 (1989) (stating that if the alteration changes either the number or relations of the parties liable on the instrument, the alteration is material).

13. For example, § 3-405(b) makes the customer responsible for the fraudulent indorsements of its employee if it gives the employee responsibilities such as preparing, storing, and depositing checks; reconciling bank statements and accounts; supplying information with respect to payees; controlling the disposition of the instruments issued in the name of the customer; and other unspecified actions. U.C.C. § 3-405(b) (1990); see also id. § 3-405(a)(3) (defining responsibility). The revisions further provide that a check may be enforced against the customer even though the customer's own signature does not appear on the check. Id. § 3-401(a).

14. The revisions increased the scope of liability by expanding the class of persons for whom the customer is responsible. Section 3-405(a)(1) includes as an "employee" of the customer "an independent contractor and employee of an independent contractor retained by the employer." Id. § 3-405(a)(1). It remains to be seen how persons in
authorizes electronic presentment of checks\textsuperscript{15} and facilitates check truncation—the conversion of the information on checks to electronic impulses at some point in the collection process.\textsuperscript{16} The changes are designed to reduce costs and to cope with the staggering volume of checks processed each year.\textsuperscript{17}

Under a check truncation system, banks will not be required to return the paper check to the customer, but instead will be required only to provide information concerning the check transaction on the monthly statement of account.\textsuperscript{18} Each customer will be required, nonetheless, to determine promptly whether a forged or altered check has been paid and to notify the bank promptly of any unauthorized payment if the customer “should reasonably have discovered the unauthorized payment.”\textsuperscript{19} If the customer fails to comply with the obligations, the customer “is precluded” from asserting that any item was forged or altered after the first such item and will not be able to recover the loss from the payor bank even though the bank paid the item contrary to the customer’s order.\textsuperscript{20}

These additional burdens will contribute to the placing of the loss from payment of forged or altered checks on the now “negligent” customer, despite the Code’s inclusion of a comparative negligence standard. These burdens may not be

\begin{itemize}
\item \textsuperscript{15} A “check” is a type of draft. \textit{Id.} § 3-104(f). A “draft” is a negotiable instrument that is an order to pay. \textit{Id.} § 3-104(b), (e). A “check” is therefore an order drawn on a bank to pay a fixed amount of money on demand. \textit{Id.} § 3-104(a), (c), (f); cf. U.C.C. § 3-104(1), (2) (1989) (requiring a check to be a “writing” that is “signed” by the drawer).
\end{itemize}

\begin{itemize}
\item \textsuperscript{16} Section 4-110 of the revised Code authorizes presentment of checks by means of the transmission of an image of the item or information describing the item rather than delivery of the item itself. \textit{Id.} § 4-110.
\end{itemize}

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\begin{itemize}
\item \textsuperscript{18} \textit{U.C.C.} § 4-406(a) (1990).
\end{itemize}

\begin{itemize}
\item \textsuperscript{19} \textit{Id.} § 4-406(e). Section 4-406(d)(2) states that the customer must be “afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank.” \textit{Id.} § 4-406(d)(2).
\end{itemize}

\begin{itemize}
\item \textsuperscript{20} \textit{Id.} § 4-406(d)(2). The customer will also be precluded if the bank proves that it suffered a loss because of the customer’s failure to report promptly the unauthorized payment. \textit{Id.} § 4-406(d)(1).
\end{itemize}
too difficult for meticulous customers who retain good records, but even these customers will be unable to detect reliably a forgery or alteration under the proposed truncation system because they will not see the checks themselves. In short, these changes will dramatically affect the consumers of banking services.

This Article will examine modern banking practices with respect to processing checks and the effect of technology on liability for forged or altered checks. Part I describes the magnetic ink character-recognition system. Part II discusses check truncation. Part III recounts the evolution of contract and tort theories of liability from traditional to modern bank practices. Part IV analyzes the new comparative negligence provisions. Part V investigates the standards of ordinary care. Part VI evaluates the respective duties of the banks and their customers in light of the provisions that reflect the banking industry's transformation from the Paper Age to the Electronic Era. Recognizing that the nationwide enactment of revised Articles Three and Four is inevitable, the final Part of this Article discusses the need for and concludes with recommendations for consumer legislation to protect consumers of banking services.

I. MODERN BANK PRACTICES: THE MICR SYSTEM

Normally, the recipient of a check, the payee, either cashes the check over the counter or deposits it in an account with a local bank. Traditionally, the bank reviews the signatures and examines the checks for alterations or other indicia of

21. Federal law and the Code revisions envision a system of check truncation whereby the physical checks will not be returned to the customer. See 12 C.F.R. § 229.36(c) (1992) (allowing truncation between presenting and paying banks); U.C.C. § 4-110 (1990) (defining an "agreement for electronic presentment" as one which allows presentment of an item by transmission of an image of the item). Revised § 4-406 does not require the bank statement to identify the payee or to reveal any information about signatures. Id. § 4-406. Therefore, because the paper check will not be returned, even a customer who promptly reviews bank statements will not be able to detect whether an indorsement is forged or if the second of two required signatures is forged or missing. Moreover, although the customer may see that the proper amount has been debited, the customer will not know whether the proper payee received the payment. For more on check truncation, see infra part II.

22. A "bank" is "a person engaged in the business of banking, including a savings bank, savings and loan association, credit union, or trust company." U.C.C. § 4-105(1) (1989).
fraud. In an automated system, the depositary bank sends the checks upon receipt to the proofing department where they are photographed on microfilm and bundled for sorting. The checks are then taken to data processing and sorted by a machine that reads the checks' magnetic ink characters.

The magnetic ink character-recognition (MICR) system revolutionized banking practices. At the bottom of a typical bank check there is a "clear band" strip reserved for encoding in magnetic ink the magnetic symbols called MICR characters. This MICR line contains a routing number, a transposition check digit, the check number, the branch number of the bank, and the account number. On another clear band on the check, a bank employee encodes in magnetic ink the amount of the check. The MICR characters identify the payor bank (the bank on which the check is drawn), the amount of the

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23. See, e.g., First Nat'l Bank & Trust Co. v. Cutright, 205 N.W.2d 542, 544-45 (Neb. 1973) (outlining the procedures used to examine signatures).

24. Section 4-105(2) defines the depositary bank as "the first bank to take an item." U.C.C. § 4-105(2) (1990). If the item is presented for immediate payment over the counter, however, the bank is considered to be the payor bank rather than the depositary bank. Id. § 4-105(2)-(3). For a detailed description of check processing, see Judge Knapp's opinion in Northpark Nat'l Bank v. Bankers Trust Co., 572 F. Supp. 524, 525-26 (S.D.N.Y. 1983).

25. See Nelson v. Platte Valley State Bank & Trust Co., 805 F.2d 332, 334 (8th Cir. 1986) (describing the processing of checks). Eventually image-processing technology may replace microfilm, but such a system would require substantial investments in equipment and programmers before cost savings are realized. Brian Whitehead, Several Roads Lead to Lower-Cost Data Processing, AM. BANKER, June 24, 1991, at 7A.

Presumably, banks that have not automated the collection process are expected to continue the traditional practice of manually reviewing checks for forgery or alteration. Section 3-103(a)(7) only exempts banks that take an instrument "for processing for collection or payment by automated means" from the traditional bank practice of sight review. U.C.C. § 3-103(a)(7) (1990). Many banks already have abandoned sight review for small dollar amount checks even though this provision was not in the former Code.

26. MICR-Shield Co. v. First Nat'l Bank, 404 F.2d 157, 158 (5th Cir. 1968); see also SOS Oil Corp. v. Norstar Bank, 548 N.Y.S.2d 308, 309 (App. Div. 1989) (holding the bank liable for erroneous magnetic encoding of a check that was deposited by a customer), aff'd mem., 786 F.2d 77 (2d Cir. 1986).


28. NATIONAL AUTOMATED CLEARING HOUSE ASS'N, supra note 17, at 162-63.

29. MICR-Shield Co., 404 F.2d at 158. For a description of error correction techniques and the problems created by MICR technology, see id. at 158-59.

30. A payor bank is a bank that is "the drawee of a draft." U.C.C. § 4-105(3) (1990). Former § 4-105(b) defined a payor bank as a bank "by which an item is payable as drawn or accepted." U.C.C. § 4-105(b) (1989). It is the bank that pays
check, and the customer's account number,\textsuperscript{31} which in turn identifies the drawer-depositor.\textsuperscript{32} The encoding can be read electronically, either by a magnetic or an optical character-recognition device, and checks therefore generally do not require manual attention for most of the check collection process.\textsuperscript{33} The automatic check sorting machine comes across the MICR line and automatically routes the item to a designated pocket of the machine.\textsuperscript{34}

After processing, the depositary bank forwards the check, usually through intermediary banks,\textsuperscript{35} to the payor bank. Upon receipt by the payor bank the check again is processed through sorters. Because the check was drawn on the payor bank, the check is further sorted by the account number. A sorter-reader machine physically "reads" the information from the MICR characters, passing the data electronically to a computer which performs the bookkeeping.\textsuperscript{36} A computer verifies the sufficiency of funds in the payor's account, stamps the check "paid," and debits the payor's account. Following this process, the check is sent to bookkeeping for verification of endorsements, signatures, and account balances, and for filing pending return to the drawer.\textsuperscript{37} The payor bank honors the check by debiting its depositor's account, and the payee's account is credited with the amount represented in the check.\textsuperscript{38}

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the check from the customer's account maintained at that bank. The payor bank may also be referred to as the drawee, or the drawee bank.

\textsuperscript{31} MICR-Shield Co., 404 F.2d at 158.


\textsuperscript{33} Id.

\textsuperscript{34} If the check were truncated at the point of entry, the check would be stored at the bank and the data from the MICR line would be transmitted electronically to the paying bank for verification and settlement. Jeffrey Kutler, \textit{Truncation Dispute is Settled}, AM. BANKER, Sept. 26, 1980, at 1.

\textsuperscript{35} See U.C.C. § 4-105(4) (1990) (defining intermediary bank); U.C.C. § 4-105(c) (1989) (same).

\textsuperscript{36} MICR-Shield Co. v. First Nat'l Bank, 404 F.2d 157, 158 (5th Cir. 1968).

\textsuperscript{37} The drawer is the person "who signs or is identified in a draft as a person ordering payment." U.C.C. § 3-103(3) (1990).

\textsuperscript{38} In Nelson Platte Valley State Bank & Trust Co., the court held that the process of posting was completed when the steps taken were completed, and the bank could not reverse the process to comply with a stop order payment even though posting was completed before the midnight deadline. 805 F.2d 332, 334 (8th Cir. 1986). \textit{But see} West Side Bank v. Marine Nat'l Exch. Bank, 155 N.W.2d 587, 593 (Wis. 1968) (construing the payment not to be final until all opportunity to reverse entries had passed). Revised § 4-215 deleted the provision on completion of the process of posting as unsuitable for a system of automated check collection or electronic presentment. See U.C.C. § 4-215 cmt. 5 (1990).
A. Technologically Induced Liability

1. MICR Fraud—MICR characters present their own intriguing brand of fraud.39 In *United States Fidelity & Guaranty Co. v. Federal Reserve Bank,*40 for example, the fraudster effectively used modern technology to perpetrate a fraud by delaying the discovery that his account had insufficient funds to cover the check. He inserted MICR numbers that did not correspond with the original, preprinted routing number written on the check that he deposited with Union Trust Company of Maryland. The MICR line routing symbol that he inserted started with the designation for the New York Federal Reserve District’s Utica Processing Center, but the pre-printed routing fraction on the check advised routing through the State Bank of Albany, New York.41 Because of the resulting delay, Union Trust, the depositary bank, paid $755,000 on the bogus $850,000 check. By analogy to U.C.C. section 3-406, the court placed the loss on Union Trust for having engaged in reckless conduct.42 The teller had failed to comply with the bank’s policy requiring tellers to inform the branch manager of check deposits in excess of $100,000 and had failed to place a hold on the balance of the account.43

2. Encoding Errors—Automated check processing may lead to liability not only for MICR fraud but also for honest mistakes in encoding. *SOS Oil Corp. v. Norstar Bank,*44 for example, presented the issue of whether misencoding constituted “gross negligence.”45 The payee expected to have $255,000, the face amount of the check, deposited to its


41. 590 F. Supp. at 490. The MICR number was “nonsensical.” Id. at 498. The MICR numbers were not printed in magnetic ink. 620 F. Supp. at 366; see also Leary & Fry, supra note 39, at 750 (describing the fraudulent scheme that is the subject of *U.S. Fidelity & Guaranty*).

42. 620 F. Supp. at 372 (“[I]t is appropriate to apply [U.C.C. § 3-406’s] spirit by analogy to apportionment of loss due to MICR fraud.”).

43. Id. at 364, 373.


45. Id. at 309.
account with the bank. Instead, the bank encoded the check as only $25,000 and credited the payee's account with that amount. The encoding bank was also the payor bank and the depositary bank. While the payor bank was held strictly liable for the full amount of the check, the issue of negligence was left unresolved.\(^4\)

In another misencoding case, *Bank One v. National City Bank*,\(^47\) the depositary bank encoded a $50,000 check as a $5000 item.\(^48\) The payor bank read the MICR encoding on the check and debited $5000 from the drawer's account. Naturally the payee complained. The depositary bank credited its customer's account with the additional $45,000 and brought an action to recover the $45,000 from the payor bank. Meanwhile, the drawer had filed for bankruptcy, and the drawer's bank refused to pay because it had set off the amount in the drawer's account to satisfy the depositor's debt to the drawee.\(^49\) Unlike the court in *SOS Oil Corp.*, the *Bank One* trial court found Bank One, the depositary bank, negligent in encoding the check. The Ohio Court of Appeals held that, in misencoding the check, the depositary bank breached its duty of ordinary care and its contractual duty to the payor bank by allowing the misencoded check to be included with the machinable items to be processed by the payor bank.\(^50\)

Ordinarily, the payor bank would be liable for the original amount of a check that it accepted for final payment.\(^51\) The parties, however, may agree to vary this outcome.\(^52\) In *Bank One*

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\(^46\) *Id.* The lower court held that the encoding error did not constitute “gross” negligence, and that the causes of action for breach of contract and negligence were defeated by the 14-day waiver-of-liability clause in the agreement between the depositor and the bank. The appeal from these issues was denied as moot because the court found strict liability under U.C.C. § 4-302 (1989). Under that section, the item was considered finally paid if the payor bank accepted the check, paid the item, or failed to return the check before the midnight deadline. *Id.*


\(^48\) *Id.* at 1123.

\(^49\) *Id.* The setoff right was exercised after payment of the misencoded check but before request was made for the balance. The court held that because the funds in the account were not earmarked the setoff was proper. *Id.* at 1127.

\(^50\) *Id.* at 1125–26. Encoding duties include the duty to exercise ordinary care in the encoding, the duty to verify the encoding, and, after discovering the error, the duty to make the misencoded check “non-machinable” or to properly re-encode the check. *Id.* at 1125.

\(^51\) See, e.g., *SOS Oil Corp.*, 548 N.Y.S.2d at 309.

\(^52\) U.C.C. § 4-103(a) (1990); U.C.C. § 4-103(1) (1989); *Bank One*, 10 U.C.C. Rep. Serv. 2d (Callaghan) at 1126 (Ohio Ct. App. 1990).
both banks were members of the same clearinghouse and the clearinghouse rules had the effect of an agreement between the banks without further formality. Under the clearinghouse rules, which controlled the duties owed between the institutions in regard to encoding and processing checks, the payor bank was entitled to rely on the depositary bank to remove misencoded checks from machinable checks. Therefore, the Bank One court held that the clearinghouse rules shifted the liability from the payor bank to the depositary bank when the depositary bank breached its agreement with the payor bank by misencoding the check.

The dissent in Bank One argued that the payor bank should be held strictly liable for having improperly paid the check and rejected the application of the clearinghouse rules to alter the loss allocation liability. Until the revisions to Article Four are enacted, observed the dissent, the traditional law should apply.

Bank One illustrates the creative use of clearinghouse rules to impose liability for misencoding without the assistance of encoding warranties, which are introduced by the revised Code. The loss for failing to pay the check according to its original amount was allocated to the bank in the best position to prevent loss—in this case, the encoding bank. The same result should be achieved under the revised Code through the encoding warranties.

53. The check was processed through the Cleveland Clearing House. Bank One, 10 U.C.C. Rep. Serv. 2d (Callaghan) at 1125. A "clearinghouse" is "an association of banks or other payors regularly clearing items." U.C.C. § 4-104(a)(4) (1990).

54. Former § 4-103 provides for operation of clearinghouse rules and regulations as agreements "whether or not specifically assented to by all parties interested in items handled." U.C.C. § 4-103(2) (1989). The substance of this provision is unchanged in revised Article Four. See U.C.C. § 4-103(b) (1990).


56. Id. at 1126.

57. Id. at 1127. The dissent, however, suggested that comparative fault and proximate cause should be considered. Id. at 1127–28 (Cirigliano, J., dissenting).

58. Id. at 1128 (Cirigliano, J., dissenting). The dissent also added that the forum suggested in the clearinghouse rules for dispute resolution should have been utilized. Id.

59. Revised § 4-209 sets forth the encoding warranties whereby the person who encodes the information warrants to any subsequent bank or other payor that the information is encoded correctly. U.C.C. § 4-209 (1990). This provision is new to the Code and is another example of adapting to modern technology by facilitating electronic presentment.
B. The Policy for Shifting Loss to Negligent Customers

Generally, the Code allocates loss to the person who is best able to prevent it.\textsuperscript{60} Various theories support the Code's loss-allocation rules. Under one theory, where both parties are equally innocent or equally culpable, liability rests on the last person to hold the instrument who could have prevented the success of the fraud.\textsuperscript{61} According to another theory, the loss falls upon the person with the greatest degree of culpability in terms of responsibility, based upon the mental state, conduct, or position of the party.\textsuperscript{62} Under this hierarchical "culpability scale," the loss would fall first on the one who intentionally created the situation, second on the one who knew of the relevant circumstances, third on the one who could have discovered the circumstances and who failed to exercise ordinary care, and fourth on the one who could have avoided the loss at the least cost.\textsuperscript{63} The traditional principles of loss allocation have been summarized neatly in two rules: "[F]or bearer instruments, the loss falls on the fellow before the scalawag; for order instruments, the loss falls on the fellow after the scalawag."\textsuperscript{64} Fixed rules such as these promote the transferability and use of checks and have the advantage of uniformity and certainty of application.\textsuperscript{65}


\textsuperscript{61} The party who most easily could have prevented the harm frequently is the best risk bearer. Bryan D. Hull, Common Law Negligence and Check Fraud Loss Allocation: Has Common Law Supplanted the U.C.C.?, 51 Ohio St. L.J. 605, 614 (1990); see also Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. 501, 510 (D. Kan. 1979) (holding the bank liable under direct and proximate cause theories and observing that both the bank and the customer were innocent as to the specific fraud perpetrated by the customer's employee, but that neither was totally without fault in permitting the fraud to be temporarily successful).

\textsuperscript{62} David M. Phillips, The Commercial Culpability Scale, 92 Yale L.J. 228, 228 (1982).

\textsuperscript{63} Id. at 228–29. Phillips categorizes the culpable conduct, in descending order of magnitude, in terms of intention, knowledge, negligence, and strict liability. Id.

\textsuperscript{64} Rogers, supra note 60, at 952.

\textsuperscript{65} Hull, supra note 61, at 612–13.
The need for adapting to modern technology has generated various other theories of loss allocation. Under one theory, the customer could be held strictly liable for forged checks up to a certain dollar amount and the bank could be liable for the remainder of the loss. Another proposal takes the entirely opposite approach. The bank would be strictly liable for payment of checks under a specified low dollar amount, such as $500, regardless of the customer's negligence, but the loss would be shared for amounts in excess of the threshold.

With the full-scale implementation of technological improvements, however, it no longer will be simply an equitable question of whether a bank or its customer should bear the loss of a forged or altered item. At the root of the loss-allocation scheme lies a fundamental policy question: should losses be absorbed by the providers or by the users of the system? Shifting the burden of losses from the banking institutions to their users may facilitate the process of modernization, but it will impose additional responsibilities on bank customers. If, however, banks are saddled with liability when they depart from the traditional bank practice of sight review, they will not be free to implement new technology that will expedite check processing and save costs.

To process enormous volumes of checks by automation, the revised Code permits check truncation and relieves banks of the obligation to sight review checks. Loss reallocation was perceived as essential to full implementation of modern

68. Nan S. Ellis & Steven B. Dow, Banks and Their Customers Under the Revisions to Uniform Commercial Code Articles 3 and 4: Allocation of Losses Resulting from Forged Drawers' Signatures, 25 LOY. L.A. L. REV. 57, 75-77 (1991). Ellis & Dow contend that a strict liability rule may encourage collusion, that the customer will be encouraged to take precautions because the customer does not know in advance whether the loss from a forgery will be greater than $500, and that such a rule would be fair because most customers are unlikely to litigate for low dollar amounts. Id.; see also Hull, supra note 61, at 612 & n.62 (stating that the costs involved in making factual determinations of negligence would be greater than all but catastrophic losses on consumer accounts).
69. Rogers, supra note 60, at 955.
technology. To enable banks to modernize without fear of liability for the departure from historical bank practice, the revised Code increases the responsibilities of all users and imposes losses on the negligent users of the system rather than on the banks.

Many of the changes may be necessary, and even desirable, from the vantage point of overall efficiency, economy, and federal preemption.\textsuperscript{71} However, if different standards of negligence will be imposed on consumers than on banks the fundamental fairness of the system may be challenged. Resistance to the new system could become particularly acute if consumers perceive that the losses disproportionately burden individual users of the system and therefore feel incapable of protecting themselves. It is unlikely that consumers will even become aware of the impact of the revisions until after enactment in their respective states. These revisions seem to anticipate a degree of consumer dissatisfaction by setting statutory limits to banks' obligations. Nevertheless, the customer's reaction to the changes will need to be addressed as the revisions continue to promote commercial expansion of the banking industry and contemplate further technological advances.

\textit{C. The Context of Modern Banking Practice in the Federal System}

The new rules allocating loss liability for fraud and forgery under revised Articles Three and Four are designed to facilitate the development of an electronically based system of check collection.\textsuperscript{72} The revisions remove impediments to the

\textsuperscript{71} Efficiency and economy are not the only goals of the Federal Reserve System. If certain markets of consumers are not served, the Federal Reserve will "ensure access to reasonably priced payment services by all depository institutions." Clyde H. Farnsworth, Jr., Remarks at the Check Processing Conference of the Bank Administration Institute (June 1991) (on file with The University of Michigan Journal of Law Reform).

\textsuperscript{72} The preface to revised Article Three specifically refers to the inadequacy of the existing Code to address the issues of responsibility and liability as they relate to modern technologies. U.C.C. prefatory note, \textit{reprinted in} 2 U.L.A. 7 (1991).
use of automation, reduce the risks to banks,\textsuperscript{73} and conform to the Expedited Funds Availability Act of 1987\textsuperscript{74} (EFAA) and the Federal Reserve Board’s Regulation CC.\textsuperscript{75} To the extent that the law of any state, including a state’s version of the Uniform Commercial Code, is inconsistent with the EFAA or Regulation CC, the federal statute controls.\textsuperscript{76}

The EFAA broadly delegates authority to the Federal Reserve Board “to allocate among depositary institutions the risk of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks.”\textsuperscript{77} The EFAA first was used to expedite the check return system.\textsuperscript{78} Regulation CC, the regulation implementing the EFAA, authorized the payor bank to return a dishonored check directly to the depositary bank instead of retracing the check through the circuitous route of the forward collection process.\textsuperscript{79} Formerly, the Code permitted the depositary bank to place a hold on checks to give them a reasonable time to clear.\textsuperscript{80} Some banks greatly extended these holding periods to prevent depositors from drawing against the deposited funds until the checks had cleared, causing consumer complaints.\textsuperscript{81} The EFAA and Regulation CC

\textsuperscript{73} Reducing the risks to banks was perceived as a benefit to the public interest. See id. at 10 (1991) (“Balance Achieved”). The preface to revised Article Three applauds the revisions as accommodating the needs of the public interest, users, and the banking community. Id.


\textsuperscript{76} 12 U.S.C. § 4007(b) (1988); see also U.C.C. § 4-102 cmt. 1 (1990) (stating that applicable federal law, specifically the EFAA and Regulation CC, supersedes the provisions of the Code). Revised § 3-102(c) provides that “[r]egulations of the Board of Governors of the Federal Reserve System and operating circulars of the Federal Reserve Banks supersede any inconsistent provision of this Article to the extent of the inconsistency.” U.C.C. § 3-102(c) (1990). Conflicts between Articles Three and Four are governed by the provisions of Article Four. Id.

\textsuperscript{77} 12 U.S.C. § 4010. Before Congress enacted the EFAA, the Federal Reserve Board could exercise bank collection functions and regulate payments handled by the Federal Reserve System. Id. § 221.

\textsuperscript{78} Consumer dissatisfaction with the long holding periods that some banks had placed on checks led to the enactment of the EFAA. See DOUGLAS J. WHALEY, PROBLEMS AND MATERIALS ON NEGOTIABLE INSTRUMENTS 278–79 (2d ed. 1988).

\textsuperscript{79} 12 C.F.R. § 229.30(a). The ability of a payor bank to route the check directly to the depositary bank or through a bank not involved in the forward collection process is an important departure from the former U.C.C., which required the return of the check through the chain of forward collection. See U.C.C. § 4-214 & cmts. 1–3 (1989).


\textsuperscript{81} WHALEY, supra note 78, at 278.
Negligent Banks

superseded contrary state provisions and expedited check processing so that funds could become available to consumers more quickly. 82

In addition to pleasing consumers, the expedited return was designed to advise the depositary bank whether the payor bank had refused to pay the check before the depositary bank allowed its customer to draw against that check. 83 By making funds available more quickly to consumers, however, Regulation CC also increased the likelihood that a depositary bank would allow a customer to draw against uncollected funds. 84 Therefore, even more rapid information transmission became necessary. The EFAA directed the Federal Reserve Board to consider requiring banks to utilize electronic processing of checks and check truncation. 85

II. CHECK TRUNCATION

Check truncation is the conversion of paper checks to electronic signals at some point in the collection process. 86 The checks are not returned to the bank customers. 87 The EFAA first authorized the Federal Reserve Board to consider requiring that banks provide for check truncation 88 and

82. Under Regulation CC, local checks should clear within two days, nonlocal checks within five days. See 12 C.F.R. § 229.12(b), (c). Regarding next-day availability of funds for checks under $100, see 12 C.F.R. § 229.10(c). Expeditions returns are regulated by 12 C.F.R. § 229.30(a)(1), (2). Two excuses for the bank's failure to meet its deadlines which are not listed in the U.C.C. are interruption of computer facilities and equipment failure. 12 C.F.R. § 229.38(c). It would not be unreasonable to assume that a bank would be able to raise these same excuses as a defense for its inability to produce a legible copy of the customer's check pursuant to revised U.C.C. § 4-406. If this were to be the case, the customer would have neither the original paper check nor a usable copy.

83. See 12 C.F.R. § 229.30.


86. NATIONAL AUTOMATED CLEARING HOUSE ASS'N, supra note 17, at 168.

87. Id.

88. 12 U.S.C. § 4008(b)(2) (1988); see supra part I.C (discussing the interaction of federal law with Articles Three and Four). The EFAA and Regulation CC supersede any inconsistent provisions of the U.C.C. as adopted in any state and any other state law to the extent of the inconsistency. See 12 U.S.C. § 4007(b) (1988); 12 C.F.R. §§ 229.20, 229.41 (1992). To the extent that federal law has preempted this area, this change is not dramatic. But, in the context of the U.C.C., electronic presentment will transform the way banking business is conducted, especially with respect to bank-customer relations.
Regulation CC now authorizes truncation of checks. Revised Code section 4-110 further paves the way for check truncation by changing the legal requirements in state law for the presentment of checks. It provides for presentment of a check by transmission of "an image" of the check "or information" describing the check rather than by delivery of the check itself, thus liberating the banking industry from processing paper checks.

Unlike many other changes in law, which arise legislatively in response to public opinion, check truncation is propelled by advances in technology and by the banking industry itself. Check truncation is endorsed by the banking industry because of the enormous costs saved from eliminating the processing, transportation, and mailing of tons of paper. These savings are maximized if the checks are truncated at the point of entry, usually the depositary bank. If the checks are truncated at the point of entry, however, the payor bank will not have an opportunity to review the original signatures on the checks prior to honoring them. Obviously, with no paper checks there will be no sight review. To require banks nevertheless to fulfill their traditional obligation to review signatures on checks before payment would pose a major obstacle to check truncation. Accordingly, eliminating sight review removes a major obstacle to implementing a national check truncation system for processing checks.

89. 12 C.F.R. § 229.36(c).
90. U.C.C. § 4-110(a) (1990). Revised § 4-110 is entirely new to the Code. Presentment of a check is a necessary precondition to payment of the check. See U.C.C. § 3-501 (1990); see also U.C.C. §§ 3-501 to 3-507 (1989) (detailing the process of presentment). The presentment of a check is the demand for payment. U.C.C. § 3-501 (1990).
91. U.C.C. § 4-110(a) (1990).
92. Jeffrey Kutler, Consultant's Search for Savings Creates a Revisionist View of Check Truncation, AM. BANKER, Nov. 19, 1980, at 12. (stating that check truncation is not demanded by the consumers; it is offered by the bankers to keep their costs down); see also Robert M. Garsson, Electronic Society: What's Holding It Up?, AM. BANKER, May 15, 1984, at 18 (expressing concern that the banking industry has been unable to move customers into the electronic age); Farnsworth, supra note 71 (asserting that bank operational changes will be driven by technological change, not by consumer demand).
94. Image technology can be used to reproduce the check, but it is regarded as too costly. Whitehead, supra note 25, at 7A.
A. Three Basic Truncation Models

1. Check Retention Plans—The most familiar model of check truncation is the agreement between the payor bank and its customer that checks will not be returned to the customer. This arrangement more accurately is referred to as a check retention plan; strictly speaking, this arrangement is not check truncation because the check proceeds through the entire collection process and stops only at the last processing point, the customer's bank. The principal benefits are savings on postage and familiarizing customers with the non-return of checks. If the customer requests a copy of the check, the customer often will have to pay a fee.

2. True Truncation—A true check truncation arrangement arises by agreement between the depositary bank, the collecting bank, the payor bank, and the customer of the payor bank. This second model is distinguishable from a check retention plan because the check is presented to the depositary bank and the paper check proceeds no further through the system. An identifier on the check automatically arrests the check in the collection process. The depositary bank, contract encoder, or participating Federal Reserve Bank then will encode the checks and only the electronic information will proceed through the check collection system. After encoding, presentment is made by presentment notice, which may be an electronic signal, and the check is retained at the first processing point, which is usually the depositary bank. Use of this truncation model will maximize the savings to the industry.

3. Payor-Payee Arrangements—The third model of check truncation resembles the prototype because the check will be

95. See U.C.C. § 4-110 cmt. 1 (1990). The credit union share draft is an example of this kind of truncation.

96. See id. § 4-406 cmt. 2.

97. See id. § 4-110 cmt. 1; Telephone Interview with George C. White, former Chairperson of the New York Payments Commission, publisher of the White Papers, and one of the original promoters of check truncation (June 2, 1992).

98. This is the most cost-effective model because it avoids transportation and storage costs after the point of entry at the depositary bank. Fred M. Grgutkas & Larry L. Cartile, New Law May Speed Payment of Bond Coupons Electronically, AM. BANKER, Aug. 14, 1980, at 17.

99. See U.C.C. § 4-110 cmt. 1 (1990). If the checks are not destroyed, the depositary bank or a contractor with the depositary bank will retain the checks.
truncated at the depositary bank. Unlike the prototype, however, this truncation system envisions an agreement between the customer and the payee. By agreement with the payee, the customer-payor would deliver the check to a designated lockbox for payment. The checks then would be collected from the lockbox and the depositary bank would encode the information and electronically present the check for payment. This would generate a transaction through a clearinghouse or bank and ultimately the payor bank would debit the customer's account. This third system is designed for use by a payee to whom repetitive or recurring payments must be made, such as utility companies. The payee cuts down on costs because the costs of encoding and electronic presentment are less than the costs of depositing the checks, particularly where there is a large volume of customers. The customer does not necessarily need the paper check, because the customer knows who the payee is and has an independent system of payment verification in addition to the regular bank statement by virtue of the utility company's monthly bills. Because check-processing costs still are higher for paper checks than for electronic signals, truncation participants might obtain a discount for agreeing to truncate checks, or conversely, nonparticipants might be assessed a fee for receiving their checks.

B. Transition from Sight Review to Truncation

The benefits of truncating checks notwithstanding, paper checks will be difficult to relinquish. Banks should expect resistance to any of the truncation models because paper checks are used as proof of payment, evidence of contracts in

100. Telephone Interviews with George C. White, publisher of the White Papers, former Chairperson of the New York Payments Commission and one of the original promoters of check truncation (June 2-4, 1991).
101. One of the purposes of the lockbox is to allow for customers who agreed to truncation, and those who did not. Id.
102. The depositary bank could contract for the encoding services of another company, thereby raising interesting privacy and liability issues. See infra, Part VII.
103. This type of truncation system will also work for small, premium, rebate-type items. The amounts are relatively low and constant, posing little risk of loss. The model will be initiated most successfully by utility companies, grocery stores, and department stores because these payees are likely to perceive financial benefits and still satisfy customer needs for record keeping. White, supra note 97.
the absence of any other writing, and for record keeping. Handwriting experts may need the original check to distinguish authentic signatures from forgeries.\textsuperscript{104} If satisfactory substitutes are provided, however, consumer acceptance may follow.

The revised Code discards sight review as an outmoded practice and endorses the conversion from a paper-based system to a system of electronic presentment and check truncation. While losses from forgeries may be relatively small in the current paper-based check processing system, they are viewed from the perspective of the practice as it exists today.\textsuperscript{105} A new system, in which checks will not be returned either to the bank customers or to the payor bank, presents a vista of possibilities for clever fraudsters.\textsuperscript{106} There are no alternative safeguards to sight review while the system is paper-based or in transition, nor are any safeguards built into the electronic systems to protect against the possibility of forgery and alteration. Consequently, the losses arguably can be expected to increase.\textsuperscript{107} Until check truncation is implemented fully, then, sight review should not be abandoned completely. Banks may develop procedures out of a sense of fairness or good-faith efforts to avoid loss to others, but the banks will not have a direct, legally enforceable incentive to establish such procedures because bank negligence will be difficult to establish under the revised Code.\textsuperscript{108}

To restore some balance, the definition of "ordinary care" in the revised Code should be amended to require banks to

\begin{footnotes}
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\footnote{105. Moreover, the knowledge that sight-review procedures are in effect may well have deterred forgery or alteration. Fraudsters, "unlike rivers, microbes, and other nonhuman subjects of government regulation, are conscious entities, capable of engaging in strategic behavior." Robert D. Cooter & Edward L. Rubin, \textit{Orders and Incentives as Regulatory Methods: The Expedited Funds Availability Act of 1987}, 35 UCLA L. REV. 1115, 1168 (1988) (noting that if a rule applies only to checks over $5000, the thief will respond by writing a bad check for $4999). Cooter and Rubin argue that a pricing mechanism is the best solution to the funds availability problem and the best way to implement the EFAA. \textit{Id.} at 1173.
}
\footnote{106. The American Bankers Association recognizes the risks inherent in check truncation. "These risks are similar to those encountered in bulk filing. One difference between truncation and bulk filing might be that forgers may not yet understand bulk filing techniques but, because of publicity, will understand truncation." GERALD A. GOODWIN, \textit{HOW TO EVALUATE AND IMPLEMENT CHECK SAFEKEEPING} A-11 (n.d.).
}
\footnote{107. Telephone Interview with Joseph Madison, consultant and expert witness on electronic funds transfers (June 4, 1991).
}
\footnote{108. Revised § 3-103(a)(4) introduces a standard of good faith that banks must meet, but the standard is linked to fairness, not to ordinary care. See U.C.C. § 3-103(a)(4) & cmt. 4 (1990).
}
\end{footnotes}
examine checks whenever the failure to do so would increase the risk of forgery or alteration or whenever the costs of examination are below the losses anticipated by reason of forged or altered checks. Moreover, although it may be commercially reasonable not to examine every check, it should not be permissible for the bank to escape responsibility for choosing a system that may be less costly to the bank but very costly to the individual customer. What constitutes ordinary care should include an evaluation of the commercial reasonableness of the activity, but ordinary care should not be swallowed by commercial reasonableness. The risk of loss should be shared, as the revised Code suggests, between a negligent bank and a negligent customer, but the principles of comparative negligence should not be undermined by distorting the meaning of ordinary care. The tension between honoring the bank's duty to its customer, measured by its exercise of ordinary care, and the bank's duty to itself or to its full array of customers, measured by the commercial reasonableness of its activities, should not result in a sacrifice of one duty to the other. Rather, a balance should be struck that enables the bank to satisfy its multiple obligations and to serve justly all of its constituencies. Implementing the comparative negligence standard in revised Article Three strikes that balance, but not if the standard of ordinary care effectively precludes a finding of bank negligence.

III. EVOLUTION OF CONTRACT AND TORT THEORIES OF LIABILITY FROM TRADITIONAL TO MODERN BANK PRACTICES

To a large extent, the burden of paper coupled with technological relief propelled changes in the banking law and

109. The risk may be increased because of the absence of any deterrent function that signature examination provides or because there is no physical check that the customer may examine after payment has been made.

110. Losses suffered by anyone should be considered, not just those losses that a bank may suffer in terms of its liability.

111. The efficient breach theory does not account for the customer's enforcement costs and the presence of these costs may preclude an action by the customer, thereby removing the economic discipline on the inefficient breach. Glen O. Robinson, Explaining Contingent Rights: The Puzzle of "Obsolete" Covenants, 91 COLUM. L. REV. 546, 557 (1991).
mandated a reevaluation of loss allocation policies.\textsuperscript{112} Loss allocation, of course, presupposes liability. Bank liability may be established under the Code and under common-law principles.\textsuperscript{113} For example, the payment of a forged or altered check creates a claim under section 4-401 of the Code,\textsuperscript{114} constitutes a breach of the bank's contract with its customer and also may give rise to a cause of action for conversion under the Code.\textsuperscript{115} While the former Code used traditional tort principles to determine a bank's liability,\textsuperscript{116} the revised Code explicitly adopted comparative negligence principles to reallocate losses.\textsuperscript{117} The revised Code preserves the analytical structures of contract and tort principles but redefines certain elements so that traditional expectations no longer are valid. These constructs will now be examined, followed by an analysis of the redefined components.

\textsuperscript{112} Telephone Interview with Professor Robert Jordan, Co-Reporter and drafter of revised U.C.C. Articles Three and Four (June 2, 1991).

\textsuperscript{113} See U.C.C. § 1-103 (1990) (stating that unless displaced by particular provisions common law may supplement Code provisions). The common-law action for “money had and received,” for example, survived enactment of the Code. See, e.g., Peerless Ins. Co. v. Texas Commerce Bank, 791 F.2d 1177, 1181 (5th Cir. 1986) (holding that the common-law action survived and that a forged indorsement is ineffective to pass title to a collecting bank). Unlike an action under the Code, the defenses of “good faith” and adherence to “reasonable commercial standards” are not available under the common law action for money had and received. The bank may assert laches, fault by the payee, or ratification or authorization of the forged instrument as defenses to the common law action. \textit{Id. at 1179}; see also Hechter v. New York Life Ins. Co., 385 N.E.2d 551, 554 (N.Y. 1978) (holding that the payee could recover from the depositary bank on the theory that the depositary bank acquired no title to a check on which the indorsement had been forged). \textit{But see} Moore v. Richmond Hill Sav. Bank, 502 N.Y.S.2d 202, 208 (App. Div. 1986) (denying recovery by the payee from the depositary bank).

\textsuperscript{114} U.C.C. § 4-401(a) (1990); U.C.C. § 4-401(1) (1989); see also Perini Corp. v. First Natl Bank, 553 F.2d 398, 403 (5th Cir. 1977) (holding that an item with a forged indorsement is not “properly payable” under § 4-401 and may not be charged to a customer’s account); Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co., 546 N.E.2d 904, 906 (N.Y. 1989); Hartford Accident & Indem. Co. v. American Express Co., 542 N.E.2d 1090, 1096 (N.Y. 1989).

\textsuperscript{115} U.C.C. § 3-420(a) (1990); U.C.C. § 3-419(1)(c) (1989); see also Kuwait Airways v. American Sec. Bank N.A., 890 F.2d 456, 463 (D.C. Cir. 1990) (allowing the defense of contributory negligence to a conversion claim).

\textsuperscript{116} See Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. 501, 505 (D. Kan. 1979) (rejecting the argument that the bank had no duty “under the U.C.C., or otherwise, to examine items for alterations of the payee”).

\textsuperscript{117} See U.C.C. §§ 3-306, 4-406 (1990).
A. The Contractual and Commercial Code Relationship

The underlying relationship between a bank and its customer is the contractual one of debtor and creditor. Fundamental to this relationship is the agreement that the bank may not debit a customer's account without that customer's authorization. This understanding of the bank's obligation and liability is essential to the negotiability of checks because the customer needs to know that the bank will withdraw money from the account only upon the customer's, and no one else's, instruction. The bank's liability protects the customer from risks after the check leaves the customer's control. Placing liability on the bank seems equitable because the bank has final control before executing the order of payment and can prevent loss by reviewing and confirming the customer's order. If the customer's authorized signature

118. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NCNB National Bank, 695 F. Supp. 162, 163 (S.D.N.Y. 1989), affd, 872 F.2d (1984). The bank is the debtor of the depositor for the money deposited. See Danning v. Bank of Am., 199 Cal. Rptr. 163, 167 (Ct. App. 1984). Articles Three and Four import Federal Reserve regulations and operating circulars, clearinghouse rules, and the like into the contractual obligations between the parties, whether or not the parties are signatories thereto. See U.C.C. § 4-103(b) & cmt. 3 (1990). While this provision also was part of the former Code, it will become much more significant in light of the comparative negligence provisions and the new standard of ordinary care. See id. § 4-102(a) (subordinating Article Three to Article Four in the event of a conflict between the provisions).

119. Merrill Lynch, Pierce, Fenner & Smith, Inc., 695 F. Supp. at 164 (holding that the indorsement was effective and that the drawee was liable for having failed to honor the drawer's order). Former § 4-401(1) authorized a bank to charge the account of its customer for any item which is "properly payable" from that account. See U.C.C. § 4-401(1) (1989). Revised § 4-401(1) similarly authorizes the bank, but adds that "an item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank." See U.C.C. § 4-401(a) (1990). This flexibility to redefine what is properly payable by modifying the agreements between the parties potentially may result in nonuniform practices. It is more likely, however, to alter the bank's obligations significantly, thereby effectively precluding a customer from even asserting a prima facie case against the bank for negligence.

120. Brigham v. McCabe, 232 N.E.2d 327, 332 (N.Y. 1967); see also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank, 442 N.E.2d 1253, 1258 (N.Y. 1982) (stating that a bank is to apply funds in the drawer's account for check payment only upon receiving the payee's authorized indorsement).

is not on the check, the bank is not authorized to pay the check. Nor may a bank properly pay an item containing a forged indorsement. Payment of a forged check is a breach of the bank's agreement to pay out funds only upon the customer's authorization. To meet their contractual obligations, banks visually inspected each check for evidence of forgery or alteration that would interfere with the customer's authorization to pay.

If payment nevertheless is made on a check that is not properly payable, the payment is deemed to have been made solely from the funds of the drawee bank rather than from those of its customer. In the event that the bank has paid a check improperly, the bank must recredit the customer's account and bear the loss unless it can establish facts which would preclude the customer from asserting the forgery or

122. Under the former Code, the customer is not liable on the check if the signature is not authorized unless the customer ratifies the signature or is precluded from raising this defense. U.C.C. § 3-404(1) (1989). The definition of "signature" is broader under the revised Code and now specifically includes mechanical means of making a signature. U.C.C. § 3-401(b) (1990). Furthermore, an authorized signature may be that of an authorized representative of the customer and no longer must be the customer's own signature. Id. § 3-401(a).


124. U.C.C. § 4-401 cmt. 1 (1990). An "indorsement" is a signature of a person other than the drawer of the check that, with or without other words, is made on the check to negotiate the check, restrict payment, or to incur liability on the check. See id. § 3-204(a). Former Article Three did not define indorsement. Where an indorsement has been forged, one of the parties must bear the risk of loss. For an excellent comparison of the way in which common- and civil-law systems resolve risk allocation, see William C. Vis, Forged Indorsements, 27 AM. J. COMM. L. 547 (1979).

125. The legend on the check "Pay to the order of" authorized the bank to pay. Such an explicit instruction is not required under the revised Code. Compare U.C.C. §§ 3-109, 3-110 (1990) with U.C.C. §§ 3-110, 3-111 (1989).

126. While the term "drawee bank" is not defined in the Code, it frequently is used to refer to the drawer's bank, which is more formally known as the "payor bank." See U.C.C. § 4-105(3) (1990).


129. Vending Chattanooga, Inc. v. American Nat'l Bank & Trust Co., 730 S.W.2d 624, 625–26 (Tenn. 1987). It is possible for the payor bank to shift its loss to the depositary bank under a breach of warranty theory under former §§ 3-417(1) and 4-207(1)(a), (c), or it may have recourse against the person whom it paid, including a collecting bank, for the breach of warranties under §§ 3-417(1)(a) and 4-207(1)(a). U.C.C. §§ 3-417(1)(a), 4-207(1)(a) (1990); U.C.C. §§ 3-417(1), 4-207(1)(a), (c) (1989).
alteration against the bank, because the bank is strictly liable under its debtor-creditor contract.

B. Strict Liability and Negligence in Tort

The bank also may be held liable under a traditional tort analysis. Each bank owes a duty to its customer to comply with the customer's order with respect to the payment of checks drawn on the customer's account. The bank breaches that duty if it fails to pay according to the customer's order. This is a form of strict liability, wherein the act of wrongful payment constitutes the breach, whether or not payment appears to be justified, such as in the case of a perfect forgery. This—of course—also is consistent with contract theory. The bank breaches its contractual obligation if the bank pays a check upon a forged signature rather than upon

130. The customer's negligence precludes the customer from bringing a claim against the bank for the forgery or alteration. Compare U.C.C. § 3-406(a) (1990) (stating that a person whose failure to exercise ordinary care substantially contributes to an alteration or forgery of an instrument is precluded from asserting the forgery or alteration against a person who in good faith pays the instrument) with U.C.C. § 3-406(1)(d) (1989) (stating that a person who by his negligence substantially contributes to a material alteration of an instrument or the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a drawee or other payor who pays the instrument in good faith).

131. Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co., 546 N.E.2d 904, 906 (N.Y. 1989); see also Hartford Accident & Indem. Co. v. American Express Co., 542 N.E.2d 1090, 1096 (N.Y. 1989) (stating that a bank and its depositor have the contractual relationship of debtor and creditor with the implicit understanding that the bank will pay out the depositor's funds only in accordance with its instructions).


133. Payment of unauthorized drafts, even in good faith, violates the duty to pay only those checks that are "properly payable and failure to exercise ordinary care precludes the bank from asserting the customer's negligence." Wilder Binding Co., 527 N.E.2d at 358.


135. A "perfect forgery" is one which is undetectable without the use of mechanical devices. An example of a perfect forgery is one in which the signature of the indorser matches the name of the payee, but is not by the person intended to receive the check. For example, the insurance company draws a check to "Sarah Smith" but by mistake mails the check to a different "Sarah Smith" in another city. The Sarah Smith who indorsed the check has forged the indorsement of the intended payee. See U.C.C. § 3-406 cmt. 3 (1990).
the customer’s own signature.136 Under either a theory of breach of contract or of strict liability in tort, the loss would fall on the bank.

Exclusive application of a strict liability rule, however, would impose liability on the bank even if the loss is caused by the customer’s negligence. To mitigate this harshness, the former Code introduced principles of tort duty and estoppel to reallocate the loss more equitably.137 The former Code permitted estoppel to preclude the assertion of a contract claim and allowed negligence to override the estoppel.138 A customer whose negligence “substantially contributes”139 to the forgery or alteration is precluded from asserting the forgery against a bank, even though the bank breached the contract and paid the forged or altered check.140 Thus, if the bank breached its contract but showed that the customer was negligent, the loss would fall on the customer.141 If, however,

136. See supra notes 118–131 and accompanying text. Paying a forged check is not the only way that a bank may breach its contract with its customer. For instance, in Your Style Publications, Inc. v. Mid Town Bank & Trust, 501 N.E.2d 805 (Ill. App. Ct. 1986), appeal denied, 508 N.E.2d 738 (Ill. 1987), the court remanded to find whether the payor bank breached its contract with its depositor by not giving the full amount of the check to the payee when the payee cashed the depositor’s check and the payor bank deducted a service fee. Id. at 810.

137. These principles first were enunciated in the former Code by Professor William L. Prosser, who was the Reporter for Article Three and the preeminent expert on torts. For interesting details on Professor Prosser’s involvement with Article Three, see Donald J. Rapson, Loss Allocation in Forgery and Fraud Cases: Significant Changes Under Revised Articles 3 and 4, 42 ALA. L. REV. 435, 448 n.50 (1991).


139. The substantial contribution test under both revised and former U.C.C. § 3-406 is the equivalent of the substantial factor test applied in the law of negligence generally. Dominion Constr. Inc. v. First Nat’l Bank, 315 A.2d 69, 74 (Md. 1974). Causation is proved more easily under this test than under the “direct and proximate cause” test. Id. at 73–74. A leading case contrasting “substantially contributes” with “direct and proximate cause” as the test for causation is Thompson Maple Prods. v. Citizens Nat’l Bank, 234 A.2d 32, 34 (Pa. Super. Ct. 1967).

140. U.C.C. § 3-406(a) (1990); U.C.C. § 3-406 (1989); see also Robert M. Lewis, Note, Allocation of Loss Due to Fraudulent Wholesale Wire Transfers: Is There a Negligence Action Against a Beneficiary’s Bank After Article 4A of the Uniform Commercial Code?, 90 MICH. L. REV. 2565, 2583–84 (1992) (describing the allocation of losses under the comparative negligence framework of Articles Three and Four). The negligent party is estopped from raising the forgery against the bank, but is not liable in tort for damages resulting from the alteration. See U.C.C. § 3-406 cmt. 1 (1990); U.C.C. § 3-406 cmt. 5 (1989).

141. The negligent drawer is “precluded from asserting the alteration or lack of authority” against a person who “pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee’s or payor’s business.” U.C.C. § 3-406 (1989). Revised § 3-406 broadened the category of persons who may invoke the preclusion against the customer to include any person who, “in good faith, pays the instrument or takes it for value or for collection.” U.C.C. § 3-406(a) (1990).
the customer then proved that the bank was negligent in having paid the check, the preclusion no longer would apply and the bank would bear the loss. ¹⁴²

Recasting the theory of the bank's liability from strict liability to negligence transferred the focus under the Code from the contractual nature of the bank's obligations to both a consideration of the bank's duty and a balancing of the factors that determine whether due care has been exercised. ¹⁴³

In a tort analysis, the bank owes the customer a duty to exercise due care in processing the checks. The bank could meet this standard of care by reviewing the signature and the indorsements on the check to determine whether the customer, and not an impostor, had ordered payment. If the bank failed to properly review the checks or failed to discover the customer's lack of authorization before payment, the bank breached its duty to use due care. ¹⁴⁴ Through following proper sight-review procedures, the bank could recognize the forged signature or alteration, not pay the check, and avoid loss to the customer. In this fashion, the former Code imposed liability for a loss caused to the customer by a bank's failure to review checks, not under a theory of strict liability in tort, but by application of contract principles and a negligence theory of tort liability. ¹⁴⁵

The bank's ability to meet the standard of care and the soundness of this negligence theory in practice depends upon the validity of fundamental assumptions. For instance,

¹⁴² Under the revised Code, the loss would then be allocated between the bank and the customer. U.C.C. § 3-406(b) (1990).

¹⁴³ In contract, the duty is established directly between specific parties in a binding personal relationship before any dispute or breach arises. In tort, the relationship between the parties arises as a result of the breach, not a priori. See Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 102 (N.Y. 1928) (Andrews, J., dissenting). The dissent in American Heritage Bank & Trust Co. v. Isaac, 636 P.2d 1296 (Colo. Ct. App. 1981), aff'd, 675 P.2d 742 (Colo. 1984), criticized the majority for proceeding on general negligence principles instead of on contract principles, asserting that the relationship between the depositor and the bank is fundamentally one of contract. Id. at 1299 (Berman, J., dissenting); see also BARKLEY CLARKE, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS §§ 2.1[2] (Cumulative Supp. No. 3 1989) (discussing the Isaac case). Under contract theory, the duty to honor only properly payable items does not hinge on negligence but arises from the contract between the bank and the depositor.


requiring a bank to review the signatures on checks presented for payment presumes that a forgery or alteration will be detected.\textsuperscript{146} This assumption itself presumes that the signature on the check will be compared with the signature card on file for the customer and that the forgery will be discovered through such a comparison.\textsuperscript{147} Because of the sheer volume of paper checks that it faces, the banking industry already has challenged the assumption that sight-review procedures will necessarily lead to discovery of forgery or alteration. The most fundamental assumption of all, that there is a paper check to be inspected, will be refuted by the advent of electronic presentment of checks in which no paper will proceed through the system.\textsuperscript{148}

Throughout the industry, banks have determined that the risk to the bank of incurring losses from the payment of forged or altered checks of a low dollar amount is less than the costs of sight-review procedures which would prevent the losses from occurring.\textsuperscript{149} Applying the Learned Hand formula for balancing benefits and burdens, the expense of reviewing every check outweighs the benefit of discovering those few checks on which the signature may be forged.\textsuperscript{150} Consequently, the traditional banking practice of sight review has yielded to the modern practice of limited sight review where the aggregate savings outweigh the probable losses for any individual case. By this decision not to sight review checks, the banks consciously have exposed themselves to liability to

\textsuperscript{146} See, e.g., Medford Irrigation Dist., 676 P.2d at 329 (holding that the bank failed to exercise ordinary care or follow reasonable commercial practices by paying all checks under $5000 without any procedures to detect forgeries).

\textsuperscript{147} See, e.g., Perley v. Glastonbury Bank & Trust Co., 368 A.2d 149, 155 (Conn. 1976). That the examination of signature cards to determine the genuineness of indorsements may not be practical does not necessarily relieve banks of the risk of loss from payment on forged checks. \textit{Id.} Under the revised Code, a person may be bound, even if his signature does not appear on the check, if the person who signed the instrument is an agent of the person whose check is signed. U.C.C. §§ 3-401(a)(ii), 3-402(a) (1990) (significantly expanding the liability of the person whose check is used).

\textsuperscript{148} See supra part II.

\textsuperscript{149} See infra part V.A (discussing limited sight review).

\textsuperscript{150} See New England Coal & Coke Co. v. Northern Barge Corp. (The T.J. Hooper), 60 F.2d 737, 740 (2d Cir.) (applying what has come to be known as the Learned Hand Formula), \textit{cert. denied sub nom. Eastern Transp. Co. v. Northern Barge Corp.}, 287 U.S. 662 (1932); \textit{see also} United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (explicitly presenting the Learned Hand Formula).
the customer in the event that forged checks are paid.\textsuperscript{151} This
decision to incur liability for an "efficient breach" may be
commercially reasonable, but at the same time it respects the
underlying contractual obligation to the customer because the
breaching party shoulders the liability for its commercially
reasonable decision to breach.\textsuperscript{152}

The revised Code, however, effectively shields the bank from
liability for breaching its contract by equating a "commercially
reasonable" decision with the exercise of ordinary care.
Through operation of the definition of "ordinary care," the
revised Code eliminates the bank's obligation to conduct sight
review.\textsuperscript{153} Because the discontinuation of sight review is not
linked to a dollar-value of the check, or to any balancing of
the benefits and burdens,\textsuperscript{154} the revised Code reduces the
incentive to make cost-effective decisions and ultimately
disrespects the contractual agreement between the bank and
its customer.\textsuperscript{155} Because the revisions insulate the banks from

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\textsuperscript{151} Cf. David J. Leibson, \textit{Handling Re-Presented Checks—Risky Business for Collecting and Payor Banks}, 72 KY. L.J. 549, 557 (1983-84) (pointing out that a bank's decision to re-present a dishonored check without notifying the customer of the dishonor may be economically feasible, but is "no reason to insulate a bank from any loss caused by its failure to give notice").

\textsuperscript{152} It is inherent in the efficient breach theory that the market, not the courts, determines when the breach is appropriate, because a breach is efficient only when the market provides a superior alternative to performance of the obligation under the contract. Robinson, \textit{supra} note 111, at 547. Achieving an optimum allocation of resources, which is key to the theory of an efficient breach, requires avoiding undercompensation as well as overcompensation. Applied to this situation, if the customer is undercompensated and suffers a loss and if the bank does not bear the full cost of its breach, the bank is encouraged to engage in a breach that produces an economically inefficient reallocation of resources. By systematically undercompensating customers without the bank bearing the full cost of its breach, as, for example, when the customer is made to bear the loss incurred by the bank's decision not to sight review checks, the revisions risk encouraging too much breach, and too much loss, rather than too little. See John A. Sebert, Jr., \textit{Punitive and Nonpecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation}, 33 UCLA L. REV. 1565, 1572 (1986).

\textsuperscript{153} U.C.C. § 3-103(a)(7) (1990).

\textsuperscript{154} See id. § 3-103(7) cmt. 5.

\textsuperscript{155} As discussed earlier, the bank's contractual agreement to pay only according to the order of the customer simultaneously creates the bank's tort obligation. \textit{See supra} notes 137-145 and accompanying text. If the bank can escape this obligation by altering the meaning of the standard of care, it affects fundamental expectations under the contract. Not reviewing the checks eviscerates the bank's ability to fulfill its obligations, contrary to the expectations of the customer. Query whether not disclosing this material fact could give rise to a tort claim against the bank by the customer separate from the actual claim of breach of the underlying obligation. \textit{But see} Spokane Valley State Bank v. Lutes, 233 P. 308, 310 (Wash. 1925) (finding that the bank was not required to disclose the manner of collection, or that it had accepted a draft from the issuing bank instead of cash).
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their negligence through the change in the meaning of "ordinary care," customers now will bear losses that used to be borne by the banks under the former Code. Thus, even though comparative negligence principles now are imported into revised Article Three, the new interpretation of "ordinary care" dramatically diminishes the bank's contractual obligations to its customers.\textsuperscript{156}

Moreover, the revised Code ignores the central purpose of a comparative negligence system, which is to distribute the loss equitably between negligent parties in proportion to their share in causing the harm.\textsuperscript{157} Statutorily protecting the bank's conduct undermines the equitable justification for introducing comparative loss provisions to the Code because it effectively prevents the customer from proving bank negligence. The evolution from theories of strict liability in contract or tort to comparative negligence rules theoretically may distribute losses more fairly, but in practice will reallocate losses from negligent banks to negligent customers. Banks, then, will be the beneficiaries of the new comparative negligence provisions.

\textbf{C. The Convergence of Tort and Contract in Conversion}

The broader use of tort principles to expand benefits to banks in one context is at odds with the stricter application of contract principles to limit customers' options in another.

\textsuperscript{156} Arguably, the bank's good-faith obligations, codified in § 3-103(a)(4), will promote bank practices that minimize risk of loss to customers because of either bank competition or a heightened sense of business ethics. See U.C.C. § 3-103(a)(4) (1990). A companion argument also can be advanced: that banks will develop screening techniques because they do not know in advance which customers will be negligent (thus shielding the bank from liability) and which will not be (thus exposing the bank to some liability). While these hopes may be realized, consumers nevertheless are left without the legal artillery to expedite these developments and without much of an effective remedy if these reforms fail to materialize. Furthermore, because it will be far easier under the revised Code for banks to establish customer negligence, bank exposure to liability will be far less of a motivating force for change than optimists predict.

\textsuperscript{157} KEETON ET AL., supra note 10, § 67, at 470–72. Revised §§ 3-405(b) and 3-404(d) both state that "the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss." The person "bearing the loss" is the customer. The language of the provision indicates that the customer bears the primary responsibility for loss in the context of forgery or alteration caused by a person within the customer's employment. The customer will be able to recover only that portion of the loss which the customer can prove was caused by the bank's negligence. See U.C.C. §§ 3-403(b), 3-404(d) (1990).
Banks are gaining ground as the tort aspects of conversion\textsuperscript{158} seem to give way to stricter contract standards that will limit a customer's litigation options. Under the former Code, it was unclear whether the drawer of a check on which the indorsement was forged could assert rights directly against a depositary bank that had converted the check.\textsuperscript{159} The revised Code prevents the drawer from bringing a suit directly against the depositary bank\textsuperscript{160} because, in the opinion of the drafters of the Code, the drawer already has an adequate remedy.\textsuperscript{161} The drawer could enforce its contract against the payor bank to recredit the drawer's account for unauthorized payment of the check.\textsuperscript{162} The payor bank then could recover from the depositary bank for the losses caused by the latter's wrongful payment of a forged indorsement.\textsuperscript{163}

Under the former Code, the loss usually fell upon the depositary bank\textsuperscript{164} because it had converted the instrument by taking it from the forger.\textsuperscript{165} Under the standards of the revised Code, however, the customer effectively may be

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\item[158.] A bank may be liable in conversion for paying an instrument that bears a forged indorsement. "[An instrument is converted if it is taken by transfer other than a negotiation" or "for collection or payment from a person not entitled to enforce the instrument or receive payment." See U.C.C. § 3-420 cmt. 1 (1990). Conversion was covered under former § 3-419. See U.C.C. § 3-419 (1989).
\item[159.] Compare Wymore State Bank v. Johnson Int'l Co., 873 F.2d 1082, 1087 (8th Cir. 1989) (holding that the drawer had standing to bring a negligence suit against the depositary bank) with Moore v. Richmond Hill Sav. Bank, 502 N.Y.S.2d 202, 208 (App. Div. 1986) (holding that a depositary or collecting bank in most circumstances is not liable to the rightful payee of the stolen draft for paying out funds on an instrument over the forged indorsement of the plaintiff payee's signature).
\item[160.] U.C.C. § 3-420(a) (1990). This also is based on the asymmetric defenses at the depositary bank's disposal; see WHITE & SUMMERS, supra note 128, § 15-4; see also Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co., 184 N.E.2d 358, 364 (Mass. 1962) (denying the drawer the right to enforce a claim against the collecting bank).
\item[161.] See U.C.C. § 3-420 cmt. 1 (1990) (stating that "[t]here is no reason why a drawer should have an action in conversion").
\item[162.] See id.
\item[163.] The revised Code adopted the rule of Stone & Webster Eng'g Corp., 184 N.E.2d at 362, which forbids the drawer to bring a conversion action, but noted that an action by the drawer against the collecting bank might have some "theoretical appeal as avoiding circuit of action" where the collecting bank is liable to the drawee and the drawee is liable to the drawer. U.C.C. § 3-420 cmt. 1 (1990).
\item[164.] Wymore State Bank v. Johnson Int'l Co., 873 F.2d 1082, 1085 (8th Cir. 1989) (stating that the loss usually falls on the first party to accept the check). Depositary bank liability presumes, of course, that the forger is not available for recovery.
\item[165.] The general rule of former U.C.C. § 3-419(1)(c) is carried over into revised U.C.C. § 3-420. See U.C.C. § 3-420(a)(1990). For a discussion of conversion, see Lary Lawrence, Misconceptions About Article 3 of the Uniform Commercial Code: A Suggested Methodology and Proposed Revisions, 62 N.C. L. REV. 115 (1983).
\end{enumerate}
precluded from recovering from the payor bank because of the customer’s virtual inability to establish the bank’s negligence.\textsuperscript{166} If the payor bank is not liable to the drawer, there is no incentive for the payor bank to institute an action against the depositary bank. Therefore, if the drawer is precluded from recovering from the payor bank and no longer has the option to sue the depositary bank, the drawer effectively is left without a remedy and will bear the loss. Under the revised Code, then, the loss actually is more likely to fall on the customer than on the depositary bank.

The revised Code removes the option to sue the depositary bank not only from the drawer but from certain payees as well.\textsuperscript{167} Formerly, courts were divided on whether a payee who had never received the check from the drawer could bring an action in conversion against the depositary bank.\textsuperscript{168} Reasoning that a payee still had a cause of action against the payor for the underlying transaction, the drafters could find no reason to allow the payee to sue the depositary bank directly.\textsuperscript{169} The removal of the drawer’s and payee’s option to bring a direct action against the depositary bank impliedly resurrects the defense of the lack of privity of contract.\textsuperscript{170}

\textsuperscript{166} See \textit{supra} notes 153–156 and accompanying text.
\textsuperscript{167} A payee who received the check from the drawer and was thereafter injured by a forgery, as, for example, where a thief stole the check from the payee and then forged the payee’s indorsement, still may bring a conversion action under the revised Code. See U.C.C. § 3-420 (1990).
\textsuperscript{168} Compare Knez v. Central Jersey Bank & Trust Co., 477 A.2d 806, 816 (N.J. 1984) (holding that the depositary bank acted in a reasonable manner in accepting the forged indorsement because it dealt with the customer and not the forger) and Moore v. Richmond Hill Sav. Bank, 502 N.Y.S.2d 202, 208 (App. Div. 1986) (holding that the depositary bank was not liable to the payee in conversion or for the common-law action of money had and received) with Cooper v. Union Bank, 507 P.2d 609, 618 (Cal. 1973) (holding that the collecting bank was liable to payee for conversion where the payee was not negligent in failing to receive the check) and Hechter v. New York Life Ins. Co., 385 N.E.2d 551, 554–55 (N.Y. 1978) (holding that a valid cause of action exists when a bank collects an instrument over a forged indorsement).
\textsuperscript{169} U.C.C. § 3-420 cmt. 1 (1990) (stating that “there is no reason to give any additional remedy to the payee” because the payee still may enforce the underlying obligation). This view does not consider the consequences to a payee of the payor’s insolvency. The “additional” remedy of suing the depositary bank directly could be valuable to the payee if the error was not discovered and corrected prior to the payor’s bankruptcy.
\textsuperscript{170} Traditional negotiability doctrine contractually obligated drawers of checks to holders of checks even in the absence of direct privity. Weinberg, \textit{supra} note 104, at 592.
The Code recognizes circumstances in which a bank may avoid strict liability for its payment of forged or altered checks. Generally, under the former Code, the loss caused by forged signatures on negotiable instruments fell on the person who forged the instrument or on the first party who took the instrument from the forger. This general rule did not apply if the drawer negligently created the opportunity for the forgery or failed to take reasonable precautions to prevent subsequent forgeries, unless the bank also was negligent. The revised Code continues these basic exceptions but increases the scope of their application and changes the distribution of the loss.

A. Revised Articles Three and Four Introduce Loss-Sharing Provisions

The revised Code provides that the loss may be shifted from one party to the other, may be reduced by the amount of loss caused by the other, or may be shared in proportion to the degree of negligence of the respective parties. To impose liability on the customer under sections 3-404, 3-405, or 4-406, 

171. For an excellent discussion of "Three Basic Cases" of forgery and the loss allocation theories applied under the former and revised Codes, see Rapson, supra note 137.


173. U.C.C. § 3-406 (1989). The drawer was not precluded from raising the § 4-401 improper payment claim if the bank also was negligent. See id.


175. Id. §§ 3-404, 3-405, 4-406.

176. Id. § 3-406.

177. Revised §§ 3-404 and 3-405 cover the subject matter of former § 3-405. They include fraud through use of an impostor, fictitious payees, and padded payrolls. See id. §§ 3-404, 3-405. While former § 3-405 had been silent on the issue of negligence, revised §§ 3-404 and 3-405 impose loss on the employer without regard to the employer's negligence. See id. §§ 3-404, 3-405; U.C.C. § 3-405 (1989).
the bank need only show that the customer failed to comply with certain obligations or that the indorsement was effective against the customer. Thus, the customer may be strictly liable under revised sections 3-404, 3-405, and 4-406 without regard to the specific circumstances of the customer's exercise of due care. The customer then may reduce the amount of loss under those sections to the extent that the customer can prove that the bank was negligent and that the bank's negligence substantially contributed to the loss. As revised, sections 3-404 and 3-405 state that "the person bearing the loss [the customer] may recover from the person failing to exercise ordinary care [the bank] to the extent the failure to exercise ordinary care contributed to the loss."

178. See, e.g., U.C.C. § 4-406 (1990) (imposing the duty to examine the checks or bank statement and to notify the bank of "unauthorized payments" that the customer "should reasonably have discovered"). Revised § 4-406 increased the customer's obligations from those under former § 4-406, which merely required the customer to notify the bank of any forgery or alteration that the customer discovered. Compare id. with U.C.C. § 4-406 (1989).

179. Revised § 3-405 makes the indorsement of a faithless employee effective to bind the customer if the customer entrusted the employee with certain responsibilities, even if the customer exercised ordinary care in the selection, supervision, and control of its employee. U.C.C. § 3-405 (1990); see also id. § 3-404 (stating that the indorsement of an impostor will be effective even if the impostor tricked the customer to make the check payable to the impostor). The effect of the customer's exercise of ordinary care was unresolved under the former Code.

180. Former § 4-406 merely required the customer to exercise reasonable care. See U.C.C. § 4-406(1) (1989). In some measure, it is helpful that the revision articulated specific obligations informing the customer of how to avoid liability. Liability for noncompliance without any flexibility for considering the reasonableness of the customer's behavior under the circumstances, however, increases the probability that the customer will be liable for losses. For example, revised § 4-406 requires the customer to discover and to report any unauthorized payments without taking into account such reasonable excuses for delayed reporting as taking a vacation or irregular delivery of mail. See U.C.C. § 4-406 (1990).

181. U.C.C. §§ 3-406(b), 4-406(e) (1990); see also East Gadsden Bank v. First City Nat'l Bank, 281 So. 2d 431, 435–36 (Ala. Civ. App. 1973) (requiring the payor bank to prove that the drawer caused the loss by showing that the bank relied on the drawer's negligent act or that the drawer affirmatively induced the bank to accept the forged instrument).

182. U.C.C. §§ 3-404, 3-405 (1990). The former Code left to the courts the issue of whether a negligence standard applied to shift the loss. See, e.g., Commercial Cotton Co. v. United Cal. Bank, 209 Cal. Rptr. 551, 553–54 (Ct. App. 1985) (placing the loss on the bank); see also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NCND National Bank, 695 F. Supp. 162 (S.D.N.Y. 1988) (holding that the bank was not negligent in accepting a check issued to a fictitious payee and containing language to name the payee so that the proceeds could be deposited), aff'd, 872 F.2d 1021 (1989). But see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank, 442 N.E.2d 1253, 1259–60 (N.Y. 1982) (Cooke, C.J., concurring) (stating that the omission of a negligence standard in former § 3-405 was intentional and calling for the revision of § 3-405).
Like sections 3-404 and 3-405, revised section 4-406 invokes strict liability principles to impose the loss on the customer.\textsuperscript{183} Unlike sections 3-404 and 3-405, however, revised section 4-406 compares the relative contributions of the customer's noncompliance and the bank's negligence in causing the loss. "\textquote{[T]he loss is allocated between the customer... and the bank... according to the extent to which the failure of the customer to comply with subsection [4-406](c) and the failure of the bank to exercise ordinary care contributed to the loss.}"\textsuperscript{184} Because it weighs the bank's negligence against the customer's noncompliance with statutory obligations, section 4-406 can be considered to apply a comparative negligence standard only if the customer's noncompliance is denominated as negligence per se as opposed to a breach of the customer's contractual obligations.\textsuperscript{185}

By contrast, revised section 3-406 states that the loss is allocated between the customer and the bank "according to the extent to which the failure of each to exercise ordinary care contributed to the loss."\textsuperscript{186} Only in section 3-406 is the exercise of ordinary care an essential component of negligence for both parties, the bank and the customer. Only revised section 3-406, therefore, articulates true comparative negligence principles to allocate the loss between the bank and the customer in proportion to their respective degrees of negligence.

\textsuperscript{183} Compare U.C.C. § 4-406(1) (1989) (requiring the customer to "exercise reasonable care and promptness to examine the statement and items") with U.C.C. § 4-406(c) (1990) (disallowing the flexible standard of care and requiring the customer to "exercise reasonable promptness in examining the statement or items"). Under the former Code, the customer received the checks as well as the bank statement, U.C.C. § 4-406(1) (1989); under the revised Code, banks need only provide the bank statement, U.C.C. § 4-406(c) (1990).

\textsuperscript{184} U.C.C. § 4-406(e) (1990). If the customer proves that the bank failed to exercise good faith in paying the check, the customer is free to assert the forgery or alteration against the bank. \textit{Id.}

\textsuperscript{185} In the tort law setting, courts find parties negligent per se for statutory violations if they proximately caused an injury to a person protected by the statute. See, e.g., Davidson v. Williams, 235 N.E.2d 90, 97 (Ind. Ct. App. 1968) (Faulconer, J., dissenting); Schmitt v. Clayton County, 284 N.W.2d 186, 188 (Iowa 1979); Hayes v. Hagemeier, 400 P.2d 945, 947 (N.M. 1963).

\textsuperscript{186} U.C.C. § 3-406 (1990).
Negligent Banks

B. Section 3-406 Applies Comparative Negligence Principles to Allocate the Loss

As just noted, revised section 3-406 adopts comparative negligence principles to allocate loss between a negligent customer and a negligent bank. Initially, revised section 3-406(a) permits a bank to preclude a drawer-customer from asserting its breach of contract claim if the customer substantially contributed to an alteration or to the making of a forged signature. Thus, by application of estoppel principles, section 3-406 initially imposes the loss from payment of a forged or altered check on a customer if the customer's negligence substantially contributed to the forgery or alteration. For example, a bank may estop the customer from holding the bank responsible for losses caused by the forgery or alteration if the customer wrote the check in a manner that made it easy for someone else to alter either the amount or the payee. The effectiveness of the estoppel,

187. Id. § 3-406(b).

188. See supra note 139 (discussing substantial contribution). The "substantial contribution" causation test also applies to §§ 3-404(d) and 3-405(b). U.C.C. §§ 3-404(d), 3-405(b) (1990); see id. § 3-406 cmt. 2.

189. U.C.C. § 3-406(a) (1990). Compare this with former § 3-406, which provides substantially the same preclusion power to the banks as does revised § 3-406. See U.C.C. § 3-406 (1989). Revised § 3-406, however, does not require that the alteration be "material." See U.C.C. § 3-406(a) (1990). This now may enable banks to exercise more easily the preclusion power. The former Code, in contrast, explicitly referred to "negligence" and used the broader term "unauthorized" instead of "forged," leaving the issue of authorization to other sections of the Code. See U.C.C. §§ 3-307, 3-402, 3-406 cmt. 2 (1989).

190. The leading case in this area is Young v. Grote, 130 Eng. Rep. 764 (C.P. 1827). In this case the husband left signed checks with his wife while he went on a trip. The wife authorized a clerk at the office to complete the checks and to cash them after showing them to the wife. The clerk, however, left enough room between the words to change the amounts. Failure to notice the extra space was held to be negligent on the part of the drawer, so the bank was not liable. 130 Eng. Rep. at 766. In Weiner v. Chase Nat'l Bank, 253 N.Y.S. 203 (1931), the drawer was illiterate in words, but not in figures. The drawer had one of his employees complete the checks for the correct amount in figures, but the amount in writing was for a larger amount. After the drawer signed the checks, the employee raised the figures to match the written amounts and cashed them. The court held that these facts created an "assisted misinterpretation" estoppel in favor of the bank, which was not liable. 253 N.Y.S. at 208.

191. See Edelen v. Oakland Bank of Sav., 178 P. 737, 737–38 (Cal. Ct. App. 1918); Trust Co. of Am. v. Conklin, 119 N.Y.S. 367, 367–68 (1909). Both cases involved checks which were signed by the customer while blank, filled out by an unauthorized party, and cashed by the bank on which they were drawn. Under these facts, the courts held that the banks were not liable because the customers were negligent. See Edelen, 178 P. at 738; Trust Co. of Am., 119 N.Y.S. at 369. In Dominion Constr. v. First Nat'l Bank,
however, under the former and revised Codes, is conditioned upon the bank itself having acted in accordance with the reasonable commercial standards of the banking business.\(^1\)

If the customer is negligent and the bank is not, the customer will bear the loss.\(^2\)

For a negligent customer to reshift the liability to the bank, the customer must prove both that the bank breached its agreement when it paid the forged check contrary to the customer's order and that the bank was negligent in paying the item.\(^3\) For the bank to escape liability, it would have to show that the drawer was negligent, that the negligence substantially caused the forgery,\(^4\) and, in some cases under the former Code, that the bank was not negligent.\(^5\) In this context, the revised standards for establishing ordinary care, negligence, and commercial reasonableness are pivotal to the imposition of, and freedom from, liability.

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\(^1\) P. at 738; Trust Co. of Am., 119 N.Y.S. at 369. In Dominion Constr. v. First Nat'l Bank, 315 A.2d 69 (Md. 1974), the check was not made properly payable to the joint payees, so one of the two payees deposited it in its own account. The court held that the drawer had been negligent and that the bank was not liable. Id. at 74–76.

Under common law, however, if the instrument could be altered without leaving traces that would be noticed by the ordinary person, the drawer was not necessarily held responsible. 4 AM. JUR. 2D Alteration of Instruments §§ 69–70 (1962).\(^6\)

192. See, e.g., Hermetic Refrigeration Co. v. Central Valley Nat'l Bank, Inc., 493 F.2d 476, 477 (9th Cir. 1974) (holding that the bank could not assert the defense of contributory negligence because it failed to comply with the reasonable commercial standards of the banking business).

193. If the customer and the bank both are negligent, former § 3-406 provides that the bank will bear the loss. See U.C.C. § 3-406 cmt. 6 (1989). Revised § 3-406, in theory, distributes the loss between the negligent parties in proportion to their negligence. See U.C.C. § 3-406(b) (1990). But see supra part IV.A (challenging the realistic outcome of the comparative negligence plan because of the companion changes in the standard of care).

194. See, e.g., Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. 501, 510 (D. Kan. 1979) (stating that the conspicuous nature of the payee alterations and the bank's admission through its employees that it had no procedure for examining checks regarding the payees were significant factors in finding that the bank failed to exercise ordinary care so as to shift the liability from the negligent customer to the negligent bank and that its negligence proximately caused the loss).

195. See, e.g., East Gadsden Bank v. First City Nat'l Bank, 281 So. 2d 431, 435–36 (Ala. Civ. App. 1973) (requiring that the payor bank have relied on the drawer's negligent act or that the drawer affirmatively induced the bank's acceptance of the forged instrument before precluding the drawer's recovery).

196. Former § 3-406 imposed the burden on the defendant banks to affirmatively establish their own due care. See U.C.C. § 3-406 (1989); Perley v. Glastonbury Bank & Trust Co., 368 A.2d 149, 155 (Conn. 1976). Generally, however, the burden of proving negligence rests on the party asserting it and revised § 3-406 reflects that principle. See U.C.C. § 3-406(c) (1990) (providing that the burden of proving failure to exercise ordinary care under U.C.C. § 3-406(a) is on the person asserting the preclusion or, under subsection (b), on the person precluded).
The new standards will render a negligent customer's success far less likely under the revised Code than formerly. For the customer to prove that the bank failed to exercise ordinary care under section 3-406 of the revised Code, the customer will have to prove what the industry custom is and that the bank failed to observe it. Because the revised Code defines "ordinary care" for banks and imposes the standard of the industry as the standard of ordinary care for banks, the burden on the customer to overcome the statutorily imposed presumption that the practice is reasonable will be far more difficult to overcome now than it was under the former Code. Moreover, the bank may assert the customer's breach of duty to a third person, the holder, to protect the bank from loss caused by its payment of the instrument. Even though there is no contract between the customer and the holder of a check, the customer owes a duty to the holder to exercise ordinary care with respect to the check. Whereas, under the former Code, a negligent customer could shift the entire loss to a negligent bank, under the revised Code such a customer may, at best, be able to share the loss with the bank. The customer, therefore, will invoke the comparative negligence principles of section 3-406(b) to minimize, but not to avoid, loss.

C. The Customer Must Exercise Ordinary Care Under Section 3-406 to Avoid Loss-Sharing

The former Code did not require the drawer to take unusual precautions to satisfy the duty to exercise ordinary care, but

197. U.C.C. §§ 3-103(a)(7), 4-103(c) (1990). The attempt to shift the responsibility to the customer through judicial means has met resistance in the courts. See, e.g., Hanover Ins. Cos., 482 F. Supp. at 509 ("Any shifting of this responsibility to the customer must be accomplished by legislative action and not by a ruling of the court.").

198. See infra part V.


200. See U.C.C. § 3-406 cmt. 1 (1990); U.C.C. § 3-406 cmt. 2 (1989). The holder of the check is not necessarily the original payee. The holder who took the instrument may be fully protected against a forgery or alteration and can treat the instrument as having been issued in the altered form. U.C.C. § 3-407(c) (1990). The requirements for a holder in due course are set forth in § 3-302. See id. § 3-302; U.C.C. § 3-302 (1989). Under the revised Code, a person need not be a holder in due course to be able to enforce an instrument. See U.C.C. § 3-301 (1990).
this no longer may be true under the revised Code.201 The revised Code introduces a definition of "ordinary care" with respect to a person engaged in business; it is the "observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged."202 But the definition does not state what "ordinary care" means with respect to a customer who is not in business. As a result, common-law principles apply: the bank will establish a breach of the customer's duty to exercise ordinary care by applying traditional negligence principles under section 3-406.203 To preclude the customer from asserting the bank's breach of contract, the bank must prove that the customer did not comply with sections 3-404, 3-405, or 4-406. Courts have found customers negligent when they left personalized rubber signature stamps or check-authenticating devices and blank checks in unlocked desk drawers that were easily accessible to unauthorized persons.204 Other examples of negligent customer conduct include mailing the check to the wrong party with the same name as the payee,205 leaving enough space for a forger to alter the

201. Comment 3 to former § 3-406 states that "[n]o unusual precautions are required," and sets forth three examples of conduct that will not preclude the customer from bringing a claim against the bank for wrongfully paying the customer's check. U.C.C. § 3-406 cmt. 3 (1989); cf. U.C.C. § 3-406 cmt. 3 (1990) (omitting the statement on unusual precautions).

202. U.C.C. § 3-103(a)(7) (1990). For the definition of "ordinary care" as applied to banks, see infra part V.

203. Both revised and former § 1-103 provide that "the principles of law and equity . . . shall supplement" the Code. U.C.C. § 1-103 (1990); U.C.C. § 1-103 (1989). The standard of care in an informal setting may be different from that in a highly commercial setting. Compare Perley v. Glastonbury Bank & Trust Co., 368 A.2d 149, 154 (Conn. 1976) (a check was made payable to neighbors who were real estate brokers) with Fidelity & Casualty Co. v. Constitution Nat'l Bank, 356 A.2d 117, 124–25 (Conn. 1974) (a finance company manager had issued checks in a highly commercial setting to persons based on loan applications that had not been signed). An example of the test for negligence in a highly commercial setting would be the conduct of a "prudent person in the position of the finance company's manager." Id.

204. See, e.g., Terry v. Puget Sound Nat'l Bank, 492 P.2d 534, 535 (Wash. 1972) (stating that the customer's practice of leaving blank checks in an unlocked drawer easily accessible to an unauthorized employee could amount to negligence); see also U.C.C. § 3-406 cmt. 7 (1989) (stating that a drawer who makes use of a signature stamp and is negligent in looking is precluded from asserting bank's breach of contract); cf. Fred Meyer, Inc. v. Temco Metal Prods. Co., 516 P.2d 80, 83 (Or. 1973) (holding that there was no negligence where the blank checks were stolen from a locked office in a locked building).

205. U.C.C. § 3-406 cmt. 7 (1989).
numbers or words on a check, or putting a blank check or note into the stream of commerce. While it may not be negligent for a person to draw a check at the request of an attorney or agent of the payee if the drawer is unaware that the person was not authorized to request the check, it may be negligent to draw a check at the request of other persons without confirmed authority or to entrust a check to persons who do not have even apparent authority.

Both the former and revised Codes require customers to prevent forgery from occurring, to prevent further occurrences of forgery, and to discover forgeries and to report them promptly to the bank. But the revised Code imposes additional specific responsibilities and implies that special precautions now may be warranted. Such precautions may include preventing unauthorized access to checks, preparing checks properly, and assigning check preparation and account reconciliation to different employees. Because of

206. Id. § 3-406 cmt. 3.

207. F.D.I.C. v. Investors Assocs. X, 775 F.2d 152, 154–56 (6th Cir. 1985). An instrument negligently drawn because it includes blanks does not differ from an instrument that is completed but so negligently drawn that it can be altered. U.C.C. § 3-406 cmt. 1 (1990). But see F.D.I.C. v. Turner, 869 F.2d 270, 273–74 (6th Cir. 1989) (holding that the fraudulent procurement of the instrument in blank and the criminal character of the alteration were real defenses that could be asserted against a holder in due course). The dissent in Turner argued that leaving blank checks accessible substantially contributed to the alteration because it made the forger's job easier. See id. at 276–77 (Ryan, J., dissenting).


211. U.C.C. §§ 3-404, 3-405 (1990); U.C.C. § 3-405 (1989).


213. See, e.g., U.C.C. § 4-406 (1990); see also id. § 3-405(a)(1) (1990) (expanding the scope of the employer's obligations by defining "employee" to include an independent contractor). Revised § 3-405 articulates numerous responsibilities of the employer. See id. § 3-405(a)(3). Comment 3 to revised § 3-406 omits the statement that no unusual precautions are required, formerly in comment 3 to § 3-406. Id. § 3-406 cmt. 3; U.C.C. § 3-406 cmt. 3 (1989).

214. An instrument that is so negligently drawn that it can be altered is tantamount to an instrument that includes blanks. The drawer in either case is considered negligent. U.C.C. § 3-406 cmts. 1 & 3 (1990); U.C.C. § 3-406 (1989).

215. See, e.g., Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co., 546 N.E.2d 904, 905 (N.Y. 1989). In Putnam Rolling Ladder, the customer was negligent because it had assigned the duties of preparing its company checks and reconciling its bank statements to the same person, its bookkeeper. Id. The bookkeeper forged 37 checks over a period of 10 months and embezzled nearly $50,000. Id. For a similar holding, see Vending Chattanooga, Inc. v. American Nat'l Bank & Trust Co., 730 S.W.2d
the strict liability aspects of revised sections 3-404 and 3-405, a customer will bear the loss of a forgery committed by an employee even if the customer exercised reasonable care in hiring and supervising the employee. The customer even will be responsible for the acts of independent contractors and their employees. It is not clear, however, what additional special precautions a customer must take to avoid bearing the loss of forged or altered checks. Moreover, while the common-law standard of ordinary care will continue to be applied to customers under revised section 3-406, it is likely that the additional scope and depth of responsibilities imposed on customers by other sections of the revised Code will affect the determination of whether the standard has been met. Customer conduct that formerly was regarded as within the exercise of ordinary care may in the future be considered negligent. The customer therefore will have to bear the loss of the forgery or prove that the bank did not exercise ordinary care and share the loss with the bank.

V. THE BANK'S EXERCISE OF ORDINARY CARE

The comparative loss provisions of the revised Code decree that losses will be shared between the bank and the customer "according to the extent to which the failure of each to exercise ordinary care contributed to the loss." It is

724, 727 (Tenn. 1987) (finding that delegating the duties of preparing checks and reconciling bank statements to the same person created opportunities for fraud).

216. Sections 3-406 and 4-406 of both the revised and former Codes oblige the drawer to exercise ordinary care and to detect and report any forgery or alteration promptly. U.C.C. §§ 3-406, 4-406 (1990); U.C.C. §§ 3-406, 4-406 (1989).

217. Revised § 3-406 states that "employee" includes an independent contractor and employee of an independent contractor." U.C.C. § 3-405(a)(1) (1990). The use of the word "includes" leaves open for judicial expansion a broader category of persons for whom a customer may be responsible than those mentioned in the definition.

218. Neither the former Code nor the revised Code defines "negligence." The revised Code substituted the words "failure to exercise ordinary care" for the word "negligence" in the text of § 3-406. See U.C.C. § 3-406 (1990). While tort concepts would equate the terms, application of the new definition of "ordinary care" sets one standard of negligence for banks and a different standard of negligence for bank customers. See supra notes 153-56 and accompanying text.

219. U.C.C. §§ 3-404(d), 3-405(b), 3-406(b), 4-406(e) (1990).

220. Id. § 3-406(b); see id. §§ 3-404(d), 3-405(b). Revised § 4-406(e) also adopts a comparative negligence standard, allocating the loss between the customer and the bank "according to the extent to which the failure of the customer to comply with subsection
essential, therefore, to examine more closely the meaning of “ordinary care” as defined in section 3-103(a)(7) of the revised Code:

“Ordinary care” in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4.221

The most significant impact of the revised Code's introduction of a definition for “ordinary care” is the specific exclusion of sight-review procedures. This exclusion is important because, under the former Code, litigation over forged or altered checks frequently considered the bank's failure to sight review checks as evidence of negligence. Thus, the revised Code effectively will prevent consumer suits against banks for losses suffered from forged or altered checks because there can be no realistic expectation of finding the bank negligent for failing to detect the forgery or alteration.222 Most banks already have discontinued sight examination of small dollar amount checks and, under the former Code, absorb the occasional loss due to forgery. The revisions effectively will eliminate even this exposure to liability.

A. Limited Sight Review and Ordinary Care

Banks that have decided that the costs of examination far exceed any anticipated loss the bank might suffer in having

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221. Id. § 3-103(a)(7).
222. This is especially troublesome considering that customers already frequently absorb the loss of wrongful payment because it is not cost effective to litigate against the bank. Hull, supra note 61, at 612 & n.62.
to pay small checks if forgery is established already have limited the sight review of small dollar amount checks.\textsuperscript{223} This practice of limited sight review\textsuperscript{224} has mushroomed, in part, because of the sheer volume of checks that must be processed each year.\textsuperscript{225} Most banks in the nation, therefore, no longer routinely examine checks below a specified face amount.\textsuperscript{226} Instead, banks review only a small percentage of randomly selected checks below the specified dollar amount. The rest of the small dollar amount checks are not examined unless the bank has reason to suspect a problem with the check.\textsuperscript{227}

Failing to sight review all checks predictably resulted in losses and litigation. Under the former Code, courts were divided on whether the bank practice of limited sight review satisfied the bank's duty to exercise ordinary care with respect to the payment of checks. Some courts held that ordinary care necessarily implies that every check must be scrutinized individually.\textsuperscript{228} Other courts held the bank strictly liable

\textsuperscript{223} See, e.g., Wilder Binding Co. v. Oak Park Trust & Sav. Bank, 552 N.E.2d 783, 785 (Ill. 1990) (stating that the bank in question set its sight-review threshold at $1000); Florence P. Berkley, Computerized Check Processing and a Bank's Duty to Use Ordinary Care, 66 11. L. REV. 1173, 1199 n.183 (1987); see also Fairfax Leary, Jr., Check Handling Under Article Four of the Uniform Commercial Code, 49 MARQ. L. REV. 331, 334 (1965) (supporting arguments for savings and efficiency as grounds for interpreting Code rules).

\textsuperscript{224} The sight-review procedures of the Manufacturers Hanover Trust Company's bookkeeping division that were in effect in the early 1980s typify these practices. A clerk compared each check that came into the bookkeeping center against the signature card on file. During a four-hour shift, the clerk reviewed approximately 4200 checks, spending at most four seconds to inspect each check. See Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co., 546 N.E.2d 904, 905 (N.Y. 1989).


\textsuperscript{226} Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp., 489 F.2d 291, 294 (1st Cir. 1973) (stating that the amount beneath which most banks do not examine signatures on all checks is $2500 or more). Already by the early 1980s, most banks in Chicago used an automatic check-sorting device to process large volumes of checks rapidly. The machine separates checks in amounts below a threshold amount and pays them automatically. Wilder II, 552 N.E.2d at 785; see also Five Towns College, 489 N.Y.S.2d at 341 (discussing safeguards in addition to sight review). Banking industry experts recommend limited sight review. Rhode Island Hosp., 489 F.2d at 294.

\textsuperscript{227} The bank has reason to know that the check is not valid if the customer warned the bank of a possible forgery or if the check was drawn on an account with insufficient funds. Rhode Island Hosp., 489 F.2d at 294.

\textsuperscript{228} Frankini v. Bank of Am. Nat'l Trust & Sav. Ass'n, 88 P.2d 790, 793 (Cal. Dist. Ct. App. 1939) (holding that the teller has a duty to acquaint himself with the signature of the depositor). More recent cases involving unreasonable practices include Hanover
pursuant to the bank's contract with the drawer even if the forgeries were so well done that they would not have been detected by individual sight examination.229 Still other courts held that "[a]n industry-wide practice that saves money without significantly increasing the number of forged checks that the banks erroneously pay is a practice that reflects at least 'ordinary care.'"230 The First Circuit, in Rhode Island Hospital Trust National Bank v. Zapata Corp.,231 suggested that, even if less sight review resulted in some increase in the number of undetected forgeries, the customer must prove that the increased loss would be unreasonably excessive compared to the savings in costs in order to establish the bank's negligence.232

**B. The Interplay Between Check Truncation and Ordinary Care**

Decoupling sight-review obligations from the exercise of ordinary care promotes bank acceptance of check truncation without fear of liability. It therefore is not surprising that the definition of "ordinary care" in the revised Code releases banks from the obligation to sight review and at the same

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231. 848 F.2d 291 (1st Cir. 1988).

232. The bank's exercise of ordinary care was a "matter of costs of prevention compared with correlative risks of loss." Rhode Island Hosp., 848 F.2d at 295; see also Vending Chattanooga, 730 S.W.2d at 628, 629; cf. United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (defining "duty" by calculating the probability of injury times the gravity of harm to determine the "burden of precaution" that is warranted). By asserting that the bank exercised no care with respect to the checks it failed to examine, the Rhode Island Hospital Court simply assumed that the selective examination system was unreasonable and did not prove that the bank did not exercise care.
time omits any reference to balancing the costs of sight review against the benefits of detecting the forgery of large dollar items. If the anticipated substantial savings from check truncation are weighed against the small losses anticipated from not detecting forged or altered checks, the decision to eliminate sight review and to embrace check truncation is commercially reasonable.

C. Reasonable Commercial Standards and Ordinary Care

The revisions to the Code explicitly equate the exercise of ordinary care with the observance of reasonable commercial standards. This resolves the judicial debate over the interpretation of “reasonable care,” “reasonable banking standards,” “reasonable commercial standards,” and “ordinary care” in terms of general banking practice rather than in terms of a bank’s duty to its customer. It is understandable how the linguistic confusion may arise. The word “reasonable” in “reasonable commercial standards” implies that the commercial practice is not by itself negligent or lacking in

233. If a paper-based system were retained, it very well could be cost effective to continue sight-review procedures for large dollar amount checks, because, under the former Code, the losses for wrongful payment could be substantial. But in anticipation of the electronic presentment system and check truncation, eliminating the sight-review procedure will reduce costs and make check truncation possible.

234. The U.C.C’s decision to allow banks to eliminate sight review apparently considered not only sight-review costs but also those costs associated with processing paper checks regardless of the issue of fraud, forgery, or sight review, because no limitation on dollar value of checks was imposed or suggested.

235. “Ordinary care” previously was not defined in Article Three. Instead, conduct was guided by the Article One definition of “good faith,” which meant “honesty in fact in the conduct or transaction concerned.” U.C.C. § 1-201(19)(1989). Proving that a bank was negligent in not sufficiently instructing its staff to discover forgeries is not enough to establish bad faith. Retail Shoe Health Comm’n v. Manufacturers Hanover Trust Co., 558 N.Y.S.2d 949, 951–52 (App. Div. 1990). Revised § 3-103(a)(4) imported the merchant standard of “good faith,” which is “honesty in fact and the observance of reasonable commercial standards of fair dealing.” U.C.C. § 3-103(a)(4) (1990). The Official Comments state that “fair dealing” and “ordinary care” must be judged in light of reasonable commercial standards, but they also state that “ordinary care means observance of reasonable commercial standards.” See id. § 3-103 cmts. 4–5.

ordinary care. Rather, one would expect a bank, and banks in the aggregate, to conduct business in an economic and efficient manner; in other words, one would expect banks to operate in a commercially reasonable fashion.

But a choice that may be "commercially reasonable" for a bank in the conduct of its own business is not necessarily the same choice that would satisfy the obligation to exercise "ordinary care" in fulfilling its duties to its customers. "Reasonable care," or "ordinary care" in the traditional understanding of the term, is not necessarily the same as "commercially reasonable" or "reasonable commercial standards." Some courts facing these issues have recognized these distinctions.

In Medford Irrigation District v. Western Bank, an Oregon court faced the question of whether a commercially reasonable practice constituted ordinary care. The depositor's bookkeeper had forged several checks which the bank then automatically paid through its computerized check-cashing system. The depositor sought to impose liability on the bank for the losses suffered, asserting that the bank had failed to exercise ordinary care in determining whether the signatures on the checks were authorized. Under Western Bank's computerized check-payment system, all checks with a face amount under $5000 automatically were paid without human intervention or sight review of the signatures.

Western Bank argued in its defense that it was commercially reasonable to abandon sight review because the $200,000 annual cost of reviewing checks for signatures far exceeded the losses due to the small number of forgeries that it would detect by individually reviewing the checks. Western Bank contended, moreover, that it had exercised ordinary care

238. The "reasonable care" of § 3-406 may be defined as the care of an "ordinarily prudent person under the circumstances." Perley v. Glastonbury Bank & Trust Co., 368 A.2d 149, 153 (Conn. 1976).
240. Id. at 331. The depositor conceded that he was negligent in not supervising the bookkeeper, in not auditing the accounts, and in not reviewing the bank statements, and that such negligence substantially contributed to the forgeries. Id. Nevertheless, the depositor claimed that his own negligence did not preclude him from asserting the unauthorized payment by the bank because the bank also was negligent. Id.; see U.C.C. § 3-406 (1989).
241. Medford, 676 P.2d at 331. Checks under $5000 were reviewed if a "hold" or "stop payment" order had been received by the bank, but not otherwise. Id.
because its procedures conformed to methods used by most banks of its size throughout the United States, and the banking practice was commercially reasonable.242

The Medford court rejected the bank's attempt to equate commercially reasonable conduct with the exercise of ordinary care. Instead, the court stated that the bank owed a duty to its customers under the U.C.C. to use ordinary care to debit the customer's account only upon the customer's proper authorization. Therefore, whatever procedure the bank used to process checks and to review signatures must "reasonably relate to the detection of unauthorized signatures in order to be considered an exercise of ordinary care or reasonable commercial banking standards."243 The Medford court held the bank negligent as a matter of law.244

As in Medford, the court in Wilder Binding Co. v. Oak Park Trust & Savings Bank245 held that the bank's system of automatically paying all checks below a threshold amount without any sight review "completely ignore[d] the customer's signature as a criterion for accepting drafts" and demonstrated a lack of ordinary care as a matter of law.246 According to Wilder, even if the automatic check-cashing procedures are used by all banks, they do not satisfy the bank's duty under the Code to exercise ordinary care.247 The bank, therefore, was "foreclosed" from asserting the depositor's negligence and was liable for paying the face amount of the forged checks.248

242. Id. at 332.
243. Id.
244. See id. at 334.
245. 527 N.E.2d 354 (Ill. App. Ct. 1988), rev'd on other grounds, 552 N.E.2d 783 (Ill. 1990). For a discussion of the Illinois Supreme Court decision reversing Wilder Binding Co., see infra notes 262-268 and accompanying text. For purposes of clarity, the Illinois Supreme Court opinion will be referred to as Wilder I.
246. 527 N.E.2d at 358. Because the bank had the duty to know "the genuineness of the depositor's signature" and "an absolute duty not to pay unauthorized drafts, such payment, even in good faith, violates the duty to pay only those items which are 'properly payable.'" Id. (citations omitted).
247. Id.; accord Perley v. Glastonbury Bank & Trust Co., 368 A.2d 149, 155 (Conn. 1976) (stating that even if a procedure is common among banks, the banks must show that such conduct is reasonable); Medford, 676 P.2d at 332 (stating that a procedure common throughout the banking industry is not reasonable by virtue of that fact alone; the bank's procedure must be reasonably related to the detection of unauthorized signatures). Contra Wilder II, 552 N.E.2d at 787 (indicating that a practice consistent with general banking usage is prima facie the exercise of ordinary care); Vending Chattanooga, Inc. v. American Nat'l Bank & Trust Co., 730 S.W.2d 624, 628 (Tenn. 1987) (holding that a bank that pays a check in good faith and in accordance with reasonable commercial standards exercises ordinary care).
Wilder Binding Co. adopted, as a cornerstone of ordinary care, Medford's requirement that a check-processing procedure must bear a reasonable relationship to detecting improper signatures and rejected the concept that general banking usage "magically insulate[s] banks from the duty of ordinary care."249 That most banks used similar automatic check-cashing procedures was "immaterial if the procedure itself fails to comport with the bank's statutory duties to the customer."250

Vending Chattanooga, Inc. v. American National Bank & Trust Co.251 broke from this tradition and held that "a bank exercises ordinary care when it pays a check in good faith and in accordance with the reasonable commercial standards of the banking industry."252 Rather than a "reasonable relationship to detection of forgery" test to determine whether the bank exercised ordinary care, the Vending Chattanooga court took into account the "general banking usage" with respect to check processing.253 While broader than a practice of a mere two or three banks, "general banking usage" is not necessarily broader than usage followed generally throughout a metropolitan area.254 According to the Vending Chattanooga court, the facts of a particular case and the reasonable commercial standard of the banking industry would determine whether a bank exercised ordinary care.255

Thus, Vending Chattanooga rejected the traditional view that a bank must examine closely the signature on each check with the signature card because "[t]o follow such a rule would place the bank in an impossible situation."256 Either the banks would be insurers of all forgeries regardless of the customer's lack of reasonable care, or the banks would be obliged to hire

249. Id.; see also Medford, 676 P.2d at 332 (stating that although a procedure may be common throughout the banking industry, it is not by that fact alone a reasonable procedure).

250. Wilder Binding Co., 527 N.E.2d at 358.

251. 730 S.W.2d 624 (Tenn. 1987).

252. Id. at 628.

253. Id. at 629. Both the revised and former Codes state that "action or non-action consistent with . . . a general banking usage" prima facie constitutes "the exercise of ordinary care." U.C.C. § 4-103(c) (1990); U.C.C. § 4-103(3) (1989).

254. Vending Chattanooga, 730 S.W.2d at 629 (stating that general banking usage "should be taken to mean a general usage common to banks in the area concerned").

255. Id. at 628.

256. Id. Vending Chattanooga expressly overruled the holding in Jackson v. First Nat'l Bank, 403 S.W.2d 109 (Tenn. Ct. App. 1966), on the grounds that it in effect required the bank employees to be handwriting experts. 730 S.W.2d at 628.
such a large number of skilled handwriting experts that it would be "economically not feasible, and certainly not commercially reasonable." The Vending Chattanooga court considered such a result to be incompatible with the intent of the Code. The revised Code obviously shares this opinion.

D. Ordinary Care as a Question of Law or Fact

Courts also have disagreed on whether commercial reasonableness and the exercise of ordinary care is a question of law or of fact. Medford held that the bank was negligent as a matter of law because it failed to have any sight-review procedures for checks under the face amount of $5000. Wilder observed that "[d]epending on the circumstances the question of ordinary care may be a question of fact or law." The Supreme Court of Illinois reversed this straddling approach in Wilder Binding Co. v. Oak Park Trust & Savings Bank (Wilder II) and held that "whether a bank exercised ordinary care in paying a check presents a genuine issue of material fact" and that it is not up to the court but up to the fact finder to weigh the competing concerns. The dissent in Wilder Binding Co., whose view was adopted by the

257. Vending Chattanooga, 730 S.W.2d at 628.
258. Id. at 628-29.
262. 552 N.E.2d 783 (Ill. 1990).
263. Id. at 786. The dissent in Wilder II vigorously argued that there was no question of material fact as to whether the bank exercised ordinary care. The dissent argued that "[a]utomatic preclusion from review of 93% of all checks processed based solely on the amount of the check" constituted a lack of ordinary care as a matter of law. Id. at 789 (Calvo, J., dissenting).
majority in *Wilder II*,264 addressed the question of “ordinary care” as a question of fact under section 4-103(3).265 The issue of whether the bank’s “action or non-action [was] consistent with . . . general banking usage” reflected the intent of the drafters “to provide for flexibility in determining what constitutes ordinary care” and necessitated a factual determination of whether the bank paid the check in good faith and in accordance with “the reasonable commercial standards of the banking industry.”266

Whereas *Medford* found a bank negligent as a matter of law, *Wilder Binding Co.* treated the issue as a matter of law or fact, depending upon the circumstances. *Wilder II* and *Vending Chattanooga*, in contrast, treated the ordinary care issue as a question of fact.267 Yet all of these courts recognized the bank’s absolute duty to pay only authorized drafts. Given the bank’s duty to pay only on the customers authorization, liability hinged on the location of the burden of proving the bank’s exercise, or failure to exercise, ordinary care. Because the bank’s lack of ordinary care was resolved as a question of law in *Wilder Binding Co.*, the customer was not called upon to meet this burden and therefore was successful in its action against the bank. The burden shifting was significant in *Wilder II* and in *Vending Chattanooga*, however, where the issue of lack of ordinary care was a question of fact. *Vending Chattanooga* placed the burden of proving the bank’s lack of ordinary care on the customer.268 The customer in *Vending Chattanooga* failed to establish that the bank was negligent and consequently was unable to recover from the bank for the losses sustained by the bank’s payment of the forged checks.269 The revised Code would reach a similar result because customers will be unable to meet this burden.270 Due to the permissible elimination of

264. *Id.* at 786.
265. *See id.* at 789–90 (Calvo, J., dissenting). Because the former Code did not define “ordinary care,” this issue frequently was resolved in terms of former § 4-103(3).
266. *Wilder Binding Co.*, 527 N.E.2d at 360 (Jiganti, J., dissenting) (citations omitted). The dissent also linked the question of ordinary care to U.C.C. § 4-103(3) because comment 4 thereto refers to the general usage common to banks in the area concerned. *See id.*
267. *See Vending Chattanooga*, 730 S.W.2d at 628; *supra* notes 262–65 and accompanying text.
268. *Vending Chattanooga*, 730 S.W.2d at 629.
269. *Id.* at 629–30 (holding that the depositor’s negligence in failing to discover and report the forgeries was a proximate cause of the bank’s payment of the forged checks).
sight-review procedures, the revisions effectively will preclude a discussion of whether a bank meets the standard of ordinary care either as a matter of fact or of law.\textsuperscript{271}

\textbf{E. General Banking Usage and Ordinary Care}

The revised Code establishes the bank's standard of care for the sight review of checks by reference to the general practice of the banking industry. The definition of ordinary care authorizes banks that use automated procedures to discontinue the traditional practice of sight review by which forged or altered checks are detected.\textsuperscript{272} Authorizing banks to eliminate sight-review procedures altogether, of course, resolves the judicial debate over whether limited sight review is sufficient to establish the bank's exercise of ordinary care.

The new standard, however, countermands the traditional judicial view concerning the weight that banking practice should be afforded in evaluating the bank's exercise of ordinary care. Courts deciding cases under the former Code held that even if a bank proves its conformity with local practice, the bank is "not automatically exonerated" from exercising ordinary care.\textsuperscript{273} Rather, the formulation of a standard for reasonable or ordinary care could include, but was not defined by, banking practice.\textsuperscript{274} The customer could show that the entire industry's practice reflected a lack of ordinary care and therefore was unreasonable for an individual bank to adopt.\textsuperscript{275}

\begin{itemize}
  \item \textsuperscript{271} See U.C.C. § 4-406 cmt. 4 (1990); U.C.C. § 1-103(a)(7) (1989).
  \item \textsuperscript{272} U.C.C. § 3-103(a)(7) (1990).
  \item \textsuperscript{273} Hanover Ins. Cos. v. Brotherhood State Bank, 482 F. Supp. 501, 506 (D. Kan. 1979). Quoting from the plaintiff's brief, the court noted that "no matter what minimal standards are suggested by local banking usage [such usage] cannot amend the statutory requirement of ordinary care." \textit{Id.} at 506. Quoting from Prosser's \textit{The Law of Torts}, the court continued, "Even an entire industry, by adopting such careless methods to save time, effort or money, cannot be permitted to set its own uncontrolled standard." \textit{Id.}
\end{itemize}
For example, the trial court in *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.* held that a bank was negligent because its sight-review procedures were ineffective to discover forgeries and because the bank had paid checks with missing signatures. The Appellate Division disagreed and held that the bank's negligence must be determined not by the reasonableness of the bank's own review procedures, but by whether the bank's procedures were consistent with clearinghouse rules or general banking usage. In so holding, the Appellate Division equated banking practice with the exercise of ordinary care. Under this analysis, testimony describing banking practices could make out a prima facie case of "ordinary care" under former section 4-103(3).

The Appellate Division reversed the trial court's decision on the grounds that the plaintiff failed to overcome the presumption that the bank had exercised ordinary care and consequently failed to meet its burden of proof. The New York Court of Appeals rejected the views of both the trial court and the Appellate Division and held that the plaintiff is not required to disprove the "safe harbor" features of section 4-103(3). Instead, the plaintiff needs only to establish the bank's failure to exercise "ordinary care" in its normal tort meaning. That is, a plaintiff can "prove a bank lacked

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277. Id. at 905.
278. Id.
279. Id. at 907; see also Rhode Island Hosp., 848 F.2d at 294–95 ("An industry-wide practice that saves money without significantly increasing the number of forged checks that the banks erroneously pay is a practice that reflects at least 'ordinary care.' "). Section 4-103 now provides:

Action or non-action approved by this Article or pursuant to Federal Reserve regulations or operating circulars is the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent with clearing-house rules and the like or with a general banking usage not disapproved by this Article, is prima facie the exercise of ordinary care.

U.C.C. § 4-103(c) (1990).
281. Id. at 907–08. Apparently, the bank is "safe" from allegations of negligence if it acts pursuant to federal regulations and bank operating circulars or if it does what other banks normally do. The court in *Putnam Rolling Ladder* put the burden on the bank to prove that it came within the safe harbor. *Id.* at 907. The safe-harbor provision mitigates the harshness of imposing the entire loss on the bank when both the bank and its customer have been negligent, especially when the customer is by far the more negligent party. See, e.g., Phillips, supra note 62, at 240 n.62.
ordinary care by presenting any type of proof that the bank failed to act reasonably."

Ultimately, under the former Code, the customer successfully could prove the bank's negligence by challenging the bank's failure to examine the checks as a breach of the bank's duty to exercise ordinary care. But with the revisions enacted, customers no longer will be able to challenge the bank's lack of ordinary care with respect to the absence of sight-review procedures. Whether courts discussed ordinary care in terms of the bank's duty to the customer's account, by the commercial reasonableness of the conduct, or by reference to general banking practice, one principle was clear under the former Code: conformity to general banking practice did not conclusively establish the exercise of ordinary care.

VI. TRANSFORMATION FROM THE PAPER AGE TO THE ELECTRONIC ERA

Electronic check presentment and truncation ultimately will benefit both the banking industry and consumers of banking services. The costs of manufacturing, transporting, mailing, and storing paper are extremely high and probably will continue to soar. At best they are fixed costs that cannot be reduced. Physical limitations also present time constraints: paper can be moved only so fast in the best of worlds. Under the former Code, banks recognized these limitations by adopting limited sight-review procedures. Banks consciously breached their agreements with customers and absorbed, as part of their cost of doing business, the expense of occasional forgeries that passed through the banking system. Under

283. Id.
284. Id. at 906-07.
285. This is due principally to the explicit reference to the absence of sight review in revised § 3-103(a)(7) and to the check truncation features of new § 4-110 and revised § 4-406. U.C.C. §§ 3-103(a)(7), 4-406, 4-110 (1990). The former Code, however, remains the law in most states. See supra notes 1-2.
289. See supra notes 223-227 and accompanying text.
290. See supra note 151 and accompanying text.
these circumstances, letting the loss remain with the bank was "neither unforeseen nor unfair."\textsuperscript{291} It simply was a cost of doing business.\textsuperscript{292} The costs of transformation from the paper age to the electronic era, however, should not necessitate blanket protection for banks against a newly qualified class of negligent persons.

A. Who Should Bear the Losses?

The revised Code, for all practical purposes, passes on these costs of doing business to negligent customers. Banks that under the former Code would have been considered negligent no longer will be negligent under the revised Code. The rationale for the revisions, that an electronic system will be faster and more efficient than a paper-based system, considers the banking system as a whole, not the costs and benefits realized by any individual customer.\textsuperscript{293} Likewise, a bank's decision to abandon sight review for some categories of checks is based on an evaluation of the overall cost to the bank of bearing the losses for wrongful payment compared to the overall benefit of processing checks more rapidly.\textsuperscript{294} Under


\textsuperscript{292} Even if the customer were negligent, it would be "improper" for a bank to refuse to inspect the checks and then nevertheless to pass through to the customer the cost of any forged items that got through the check-processing system. \textit{Id.} at 358–59.

\textsuperscript{293} \textit{See, e.g.,} U.C.C. § 4-406 cmt. 1 (1990) (explaining that requiring less information on the statements that banks provide to customers results in "less cost to the check collection system and, thus, to all customers of the system").

\textsuperscript{294} The decision to implement limited sight-review procedures under the former Code was in part based on the assumption that relatively few forgeries occurred. The occurrence of a greater number of forgery cases would tend to lead, under the former Code, to the bank's decision to restore sight-review procedures or their equivalent. The revised Code's elimination of all sight-review procedures will destroy any deterrent function that sight review served and therefore will increase the frequency of future forgeries. Deterrence is difficult to measure. It cannot be mere coincidence, however, that forgers draw checks for dollar amounts just below the threshold sight-review amounts. \textit{See, e.g.,} \textit{Wilder II}, 552 N.E.2d at 784 (forger forged $25,000 worth of checks, each for less than $1000, the threshold sight-review amount). The losses to consumers should be expected to increase as the deterrent function of a sight-examination procedure will disappear with the demise of the procedure. Moreover, as the paper-based system converts to electronic transmission of data in a system of check truncation, the opportunities presented for fraud will further increase losses to the consumer. \textit{See, e.g.,} Carreker, \textit{supra} note 93, at 18. It will be difficult for customers to deter or to detect electronic or computer-literate fraud.
this cost-benefit analysis, in effect under the former Code, the bank bears the loss, an anticipated consequence of its decision.

The cost-benefit test works if the bank is willing to absorb the loss, but it malfunctions if the loss is transferred to an individual customer, because the decision is not related to the effects on the individual customer who will bear the loss if the check is paid wrongfully. For example, an occasional loss of $4999 compared to benefits in the millions would reasonably justify, from the bank's perspective, the elimination of sight review for checks under $5000. This cost-benefit analysis reflects a commercially reasonable decision under the former Code, where the bank bears the occasional loss. But under the revised Code the bank would not pay the loss—the consumer would. This cost-benefit test therefore is inapposite under the revised Code because the costs and benefits are not compared for the same entity. The costs to an individual are instead weighed against the benefits to a whole system. The revised Code implicitly recognizes this inapplicability because it permits a bank, or a group of banks, to decide that the benefits enjoyed by the system as a whole justify the elimination of sight review without any consideration of the losses to be sustained. But should there be no cost-benefit analysis for individual consumers, whose entire life savings could be destroyed by a $4999 loss? Surely the relatively small cost of reviewing that check, if weighed by the individual in a cost-benefit analysis, is preferable to suffering the loss.

The losses incurred under a system that is adopted in order to benefit the aggregate population should be distributed among all users and providers.295 The loss, which in the larger scheme may be inconsequential, should not be transferred to individual users, to whom such a loss could be personally catastrophic. Using the example above, a $4999 loss may be minimal from an overall bank perspective, but it could represent a tremendous loss to a consumer with limited financial resources. Therefore, the costs incurred as a result of the adoption of technological advancements should not fall on individual victims, but should be distributed among all recipients of those benefits. This is so, not only because of the inherent fairness of such a policy decision, but also because symmetric application of the cost-benefit analysis demands that result.

295. The cost of transformation to such a system also should be shared.
One may point out that the "victims" who will suffer the loss are persons who themselves have been negligent and therefore "deserve" to bear the consequences. That it is the negligent customer who will bear the additional loss sustained from larger checks being paid without review does not change this analysis. A customer who is negligent, through inadvertence or carelessness, is not likely to be less negligent simply because the penalty is larger. While the comparative negligence provisions theoretically would distribute the loss between the negligent bank and its negligent customer, the synergistic operation of the new provisions almost certainly will cause the loss resulting from the unauthorized payment of a forged or altered check to fall on the individual "negligent" customer and not on the "negligent" bank, despite the adoption of the comparative loss provisions in the revised Code.

B. Departures from Traditional Doctrine

The revised Code departs from the traditional tort principles that permit review of the custom of the industry. The customer no longer will have an opportunity to challenge whether the bank has exercised ordinary care, as that term conventionally is understood. Instead, the customer must

296. A customer should not be insulated from its own gross negligence, however, where the customer paid no attention to the potential for loss. See generally Edward Rubin, Efficiency, Equity and the Proposed Revision of Articles 3 and 4, 42 ALA. L. REV. 551 (1991) (discussing issues of social equity and concluding that the revisions perpetuate inefficiency and inequity and should not be enacted by the state legislatures).

297. The new provisions, as previously discussed, introduce comparative negligence, see supra part IV.A-B, authorize the complete elimination of sight review, see supra notes 220-222 and accompanying text, ratify electronic presentment and check truncation, see supra part V.B, and increase the scope and degree of the customer's responsibilities, see supra part IV.C.

298. According to Prosser and Keeton, an "arbitrary rule" in which the ordinary usage of a business or industry becomes the sole criterion as to what a reasonable person should have done "prove[s] in the long run impossible to justify. ... [C]ustoms which are entirely reasonable under the ordinary circumstances which give rise to them in the first instance may become entirely unreasonable in the light of a single fact altering the situation in the particular case." KEETON ET AL., supra note 10, § 33, at 194.

299. According to Prosser and Keeton, "Even an entire industry, by adopting such careless methods to save time, effort or money, cannot be permitted to set its own uncontrolled standard." Id.; accord New England Coal & Coke Co. v. Northern Barge Corp. (The T.J. Hooper), 60 F.2d 737, 740 (2d Cir.) (L. Hand, J.) (holding that the lack of industry practice requiring radios on ocean-going barges does not preclude liability for damage caused by the lack of a radio), cert. denied sub nom. Eastern Transp. Co. v. Northern Barge Corp., 287 U.S. 662 (1932).
prove what the banking practice is and that the bank failed to conform to that practice. Plaintiffs who are not familiar with the customs of the banking industry already face a staggering burden of proof. The customer's burden of proving bank negligence will be even greater because the revised Code protects banking practice with respect to the sight review of checks.

Customers, moreover, will not be treated equally with banks because the standard of ordinary care is different for customers than for banks. Whereas a bank will be able to successfully assert conformity to general banking practice to establish nonnegligence, it is unlikely that a customer will be able to successfully defend against a claim of negligence by showing that the customer's actions conformed to customary consumer behavior. Instead, the customer's negligence will be measured by the duty of the customer to the bank and by that customer's exercise of ordinary care in acquittal of that duty. Thus, customers will be held to a standard of care different from that to be applied to banks.

Establishing banking practice as the standard of ordinary care further departs from traditional tort principles because it transforms the bank's duty from one owed to its individual customers to one owed to customers in the aggregate—in other words, to a duty owed by the bank to itself. Reducing overall bank costs may be in accordance with a bank's duties as a profit-making institution to itself, to its shareholders, and even to its customers in general, and in that sense may be commercially reasonable. Such cost reduction, nonetheless, may disadvantage a particular customer. To state that a bank which acted in a commercially reasonable manner therefore exercised ordinary care in fulfilling its obligation to its

301. Where the special knowledge or ability of the defendant is involved, as in the case of banks, the customer effectively may be deprived of any remedy in the absence of expert testimony to support the customer's assertion of the bank's negligence. See generally Keeton et al., supra note 10, § 32, at 185–88.
302. See supra part V.
304. Id. § 4-103(c).
305. While the general practice among customers may be to leave their checkbooks in unlocked drawers or on top of desks, the relevant test of ordinary care for customers is not whether the customer behaves the way most other customers do, but whether that customer satisfied its duty to the bank to exercise ordinary care. See id. § 4-406.
306. See id.
customer is equivalent to concluding that a manufacturer who reduced costs of production therefore exercised due care even though its product injured a particular plaintiff. Cost reduction and ordinary care are not synonymous. Rather, equating ordinary care with reasonable commercial standards confuses duty with economy.

That a bank may have acted in a commercially reasonable manner does not satisfy the bank's contractual obligation to the customer. The decision to breach may be commercially reasonable, but under contract theory, the person who causes a breach, even if it is an efficient breach, is liable for the damages arising from that breach. To the extent that, under the revised Code, banking practice will relieve a bank from the consequences of failing to honor its agreement with the customer to pay only authorized checks, it contradicts fundamental expectations and undermines the contractual relationship between the bank and its customer. Moreover, imposing a standard of care unrelated to the contract or to the usual evaluation of tort duty effectively eliminates the customer's remedy for the bank's breach of contract. To allow a bank to negate its contractual obligation to pay only authorized checks and then to shift the loss to the customer for that failure is equivalent to breaching a contract and then making the nonbreaching party pay for the damages.

307. Formerly, the absence of any sight-review procedures, rather than the ineffectiveness of the existing procedures with respect to detecting the forgery on a particular check, occasioned greater judicial concern. As one judge stated, "[E]very check crossing defendant's threshold should be subject to some probability of examination." *Wilder II*, 552 N.E.2d 783, 789 (Ill. 1990) (Calvo, J., dissenting).

308. These decisions resulted in substantial savings to the banks. See, e.g., Carreker, *supra* note 93, at 19; see also Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp., 848 F.2d 291, 294 (1st Cir. 1988) (stating that implementing the practice of limited sight review saved the bank about $125,000 annually).

309. For more on the doctrine of efficient breach, see *supra* notes 111, 152.

310. For the bank to absolve itself from any obligation because the customer may have been negligent is, by analogy to tort law, equivalent to abrogating the theory of the last clear chance of the defendant to avoid harm. Even a negligent plaintiff is entitled to the protection of a defendant who is in a position to avoid harm by taking preventive action. The classic expression of this doctrine is found in Davies v. Mann, 152 Eng. Rep. 588 (Ex. 1842). Of course, the introduction of comparative negligence principles has eroded this doctrine. See, e.g., *Li v. Yellow Cab Co.*, 532 P.2d 1226 (Cal. 1975). By analogy, the bank has the last opportunity before paying the check to determine that payment conforms to the customer's order.

311. See, e.g., *Medford Irrigation Dist. v. Western Bank*, 676 P.2d 329 (Or. Ct. App. 1984); see also *Wilder II*, 552 N.E.2d at 789 (Calvo, J., dissenting) (contending that the defendant bank "cannot abdicate its duty of ordinary care under section 4-406(3) to plaintiff" by "relying on its customers' duty of review to fulfill its own duty of ordinary care"). Perhaps the contract between the bank and the customer should include an explicit
Furthermore, the bank's failure to sight review will not necessarily reflect an economically efficient result under the revised Code. By establishing the practice of no sight review as per se nonnegligent bank behavior, without any requirement to balance costs and benefits even with respect to large dollar checks, and without any substitute procedures for detection of electronically induced forgery, the revisions remove the banking industry's incentive to consider cost effectiveness with respect to the detection of forged or altered checks.\(^\text{312}\) If a bank routinely pays checks in accordance with established banking practice, the bank will have exercised ordinary care even if the checks were for large dollar amounts and even if none of the checks were examined. Arguably, under the new system it could even be commercially unreasonable for a bank to examine any checks, and legally unnecessary to develop alternative detection procedures, because there would be no losses incurred by the bank for failure to sight review but there would be costs to the bank if it did sight review or develop other procedures.

Sections 4-110 and 3-103(a)(7) have brought Articles Three and Four into the modern electronic age. Together with sections 3-404, 3-405, 3-406, and 4-406, they have transformed the issue of loss allocation to make the electronic leap economically feasible. The former Code weighed the costs of sight-review procedures to detect forgeries against the losses incurred from the payment of forged checks; in short, a loss resulting from forgery generally was allocated to the banks. In contrast, the revised Code relieves the banks from potential liability for discontinuing sight review. The revised Code departs from tradition by modifying the definition of "ordinary care" and by introducing the comparative loss provisions. Under the revised Code, the anticipated savings from electronic presentment and, ultimately, a check truncation system, are predetermined to exceed substantially the losses incurred by the occasional payment of forged checks. Thus, banks are freed

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agreement by the customer to take precautions to prevent forgery. These precautions should be stated with specificity and should be subject to prior consumer review and companion consumer legislation.

312. U.C.C. § 3-103(a)(7) eliminates sight review without setting dollar amounts or requiring the weighing of burdens and benefits. The bank practice itself establishes ordinary care. See U.C.C. § 3-103(a)(7) (1990); see also Ellis & Dow, supra note 68, at 57, 74 (concluding that the revisions are unsound and that state legislatures should not adopt them).
from liability for individual decisions in a new system that is not paper-based. A loss-allocation policy that formerly was concerned only with liability between a bank and its customer has yielded to a broader policy that echoes the dominant theme of all of the revisions to Articles Three and Four: the conversion from a paper-based system to a technologically advanced system for electronically processing checks.

VII. THE NEED FOR COMPANION CONSUMER LEGISLATION

A. Section 4-406: The Customer's Obligations

Section 4-406 imposes on customers the duty to examine, discover, and report to the bank any unauthorized payments promptly, whether due to forgery, alteration, or unauthorized signature. The customer must notify the bank promptly of the relevant facts if the customer "should reasonably have discovered the unauthorized payment." This new test expands the scope of the customer's obligation from prompt examination to prompt discovery and imports an objective standard for discovery of the unauthorized payment. To recover damages for a bank's negligent payment of a check, the customer, if also negligent, must prove either that the bank failed to exercise ordinary care and that the failure "substantially contributed" to the loss, or that the bank did not pay the item in good faith.

313. U.C.C. § 4-406(c) (1990); cf. U.C.C. § 4-406(1) (1989) ("The customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on an item and must notify the bank promptly after discovery thereof."). Section 4-406 bears the caption, "Customer's Duty to Discover and Report Unauthorized Signature or Alteration." The bank's obligations, such as they are, also are included in § 4-406. U.C.C. § 4-406 (1990). The one-sidedness of the caption calls to mind the reference to the Code as the "lawyers and bankers relief act" when it first was introduced in 1953. See Charles A. Bane, From Holt and Mansfield to Story to Llewellyn and Mentschikoff: The Progressive Development of Commercial Law, 37 U. MIAMI L. REV. 351, 372 (1983).


315. Compare id. with U.C.C. § 4-406(1) (1989). The time period for review, however, was increased from a "reasonable period not exceeding fourteen calendar days" to a reasonable period not exceeding 30 days. Compare U.C.C. § 4-406(2)(b) (1989) with U.C.C. § 4-406(d)(2) (1990).

316. U.C.C. § 4-406(d), (e) (1990). If the customer fails to take action within one year after the bank statement or checks are "made available," the customer is precluded from asserting the bank's negligence. Id. § 4-406(f).
Neither former nor revised section 4-406 requires a bank to return the customer's checks. But the former Code requires the bank to make the statement and checks available to the customer. Under the revised Code, the bank satisfies its obligation to the customer if it merely "provide[s] information in the statement of account sufficient to allow the customer reasonably to identify the items paid." Revised section 4-406(a) establishes the bank's nonnegligence per se by conclusively limiting the bank's obligation to provide information: "The statement of account provides sufficient information if the item is described by item number, amount, and date of payment." This major change facilitates the transition to an electronic system and true check truncation, where there will be no paper checks to return.

1. The Sufficiency Standard Is Flawed—This standard of sufficiency is flawed because it only requires banks to provide information to customers to enable them "to identify the items paid." Customers should be entitled to enough information to comply fully with all of their obligations under revised section 4-406 to avoid liability. A customer not only must identify the items, but also must "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." Banks therefore should be required to provide more information than would enable customers merely to "identify the items paid."

2. Information Is Not Sufficient—What needs do paper checks satisfy? A check may evidence the payment of an

317. Id. § 4-406(a); U.C.C. § 4-406(1) (1989).
320. This phrase borrows the concept from the tort phrase "negligence per se" by which the negligence of a defendant is established from the defendant's violation of a statute. See, e.g., Osborne v. Mcmasters, 41 N.W. 543 (Minn. 1889). In the case of revised § 4-406(a), the nonnegligence of the bank is established by the bank's compliance with the statute. U.C.C. § 4-406(a) (1990).
321. U.C.C. § 4-406(a) (1990). This provision states the "safe-harbor rule." Id. § 4-406(a) cmt. 1. Comment 1 to § 4-406 interprets § 4-406(c) as not triggering the preclusion under § 4-406 if the customer could not "reasonably" have discovered the unauthorized payment from the information provided by the bank in lieu of the check. See id.
322. Id. § 4-406(c).
323. Even this obligation is elastic: the information must only be "sufficient to allow the customer reasonably to identify the items paid." Id. § 4-406(a).
obligation to a particular person of a specific monetary amount. A check may prove the existence of a contract. It may satisfy the Internal Revenue Service or other taxing authority, governmental bureau, or licensing body. A check may trigger an accord and satisfaction or otherwise settle a legal dispute. The return of a paid check may simply serve a person’s need to be reassured.

Inspection of an original check may reveal a forgery or alteration. It offers proof of an authorized payment or, if the instrument is incomplete, shows evidence of having been tampered with, proof of unauthorized payment. A check will reveal whether all of the required signatures appear on the check and how the check was indorsed. Even if a customer agrees to participate in a check truncation or check retention plan, the customer still may need to see one or more checks for litigation or other purpose. Handwriting experts frequently require the original check in order to be able to give an opinion as to its authenticity. The check provides a paper trail of its travels through the banking system.

As long as the checks themselves are made available, all of these needs can be satisfied. When checks are not routinely available, customers must have adequate substitute information. Customers must have enough information to reconcile their own records. The name of the payee, the amount of the check, the date of the check, and the check number should satisfy most needs for information. In certain instances, it would be useful also to have a record of the date of payment.

Revised section 4-406(a), however, does not require a bank to supply the customer with the name of the payee or with the date of the check. It requires only that the bank provide the customer with “sufficient information,” which it defines as the “item number, amount, and date of payment.” This clearly is not sufficient information. Even a careful customer will not be able to determine whether the intended payee cashed the check, whether all the proper signatures were provided, or whether the check had been altered. The date of the payment will not identify the check because the customer’s records will

324. See id. § 4-406 cmts. 1–2.
325. See Weinberg, supra note 104, at 580.
327. A drawer of the check may require the signature of two authorized employees to negotiate the check properly. If only one of the two have signed and the account is debited, the drawer will have no way of knowing whether the second signature was obtained at all, or was by the proper person, if the physical check or an image thereof is not returned.
indicate the date on which the check is drawn, not the date on which it is paid. If the check number has been altered, the customer will not be able to correlate the information with her own records.

Contrary to claims by banking industry representatives, the technology does exist to provide additional information to customers. Because revised section 4-406(a) protects banks by locking into current technology, it already is anachronistic. The safe-harbor rule, which defines legal sufficiency, removes any legal incentive or obligation to develop new technology to improve the information flow to ordinary customers. The final sentence of section 4-406(a) of the revised Code therefore either should be amended to include the additional information that the customer needs or should be deleted to encourage responsiveness to the customer's needs.

3. Legislative Alternatives to the Safe-Harbor Provision—Serious concern already has been voiced in state legislatures over the safe-harbor provision, which enables banks to provide minimal information to customers without fear of liability. Drastic alternatives have been suggested to the legislatures in Michigan and in New York: either exempt the transactions involving consumer checking accounts from Article Four or refuse to adopt Article Four.329

328. Banking industry representatives persuaded the drafters of revised § 4-406 that the banking industry did not have the technology to provide more information than the item number, amount, and date of payment. Telephone Interview with Professor Robert L. Jordan, Co-Reporter and drafter for revised Articles Three and Four (June 2, 1991); see also U.C.C. § 4-406 cmt. 1 (1990) (stating that the provision in subsection (a) regarding sufficient information was "based upon the existing state of technology" and was chosen because it can be obtained by the bank's computer from the check's MICR line without examination of the items involved"). In early 1992, however, some banks began to offer image statements, which provide compressed images of checks, instead of returning cancelled checks to customers. Carreker, supra note 93, at 22. Resistance is due to expense and to the data-storage requirements involved in transmitting an image of an entire check, which are 300 times more than transmitting only MICR data. Id. at 28.

329. The issue of "legal sufficiency" has been debated for four decades and is not confined to Articles Three or Four. See, e.g., Julianna J. Zekan, The Name Game—Playing to Win Under Section 9-402 of the Code, 19 Hofstra L. Rev. 365 (1990) (discussing the legal sufficiency of a financing statement under § 9-402).

330. Professor Edward L. Rubin suggested that this exemption, which he proposed, could be accomplished by a provision stating that the "Article does not apply to accounts owned by a natural person." Letter from Prof. Edward L. Rubin, University of California School of Law (Boalt Hall) and former chair of the ABA's Ad Hoc Committee on the Payment System, to United States Representative John Bennett, Chairman House Corporations and Finance Committee (Mar. 24, 1992) (on file with the University of Michigan Journal of Law Reform).

331. Id. Professor Rubin observed that the check collection system already was governed by federal statute and would not be disrupted by failing to enact Article Four, that loss allocation provisions do not need to be uniform throughout the country, and that "[a]doption of the revisions by every state will simply establish the same disadvantageous terms for consumers throughout the U.S., rather than achieving
Negligent Banks

The New York State Banking Law Committee recommended that New York delete the definition of "sufficient information." This change would motivate banks to develop cost-effective technology and to offer more information on the statement of account, and would restore to the customer the ability to challenge whether the bank exercised ordinary care with respect to the information it provides on the bank statement.

The California legislature retained the safe-harbor provision but added a five-year sunset provision to section 4-406 which will compel banks or other interested persons to prove why it is not technologically appropriate to provide more information than the item number, amount, and date of payment. In addition, California law entitles consumers to copies of two checks at no charge for each statement period and requires each bank statement to contain a telephone number which the consumer may call for a copy of the check.

The California modification offers greater certainty to banks in the short-term and also is a good compromise. It provides transitional protection to banks which otherwise may be reluctant to convert fully to electronic processing of checks. The fundamental assumption, that the technology is not uniformity in the collection process." Id. at 2–3.

332. Report from the New York State Bar Association Banking Law Committee, Comments of Working Group to Proposed Revisions to Article 3 and 4 of the New York Uniform Commercial Code 16 (May 6, 1992). The Working Group recommended that the statute be enacted "only after consideration of consumer protection issues on an overall basis." Id.

333. See CAL. COM. CODE § 4-406 (West Supp. 1993). The safe-harbor provision will expire after January 1, 1998. Id. § 4-406(g); see also Memorandum from Gail Hillebrand, Counsel to Consumers Union (California), Changes Made to Proposed Uniform Articles 3 and 4 by California Legislators as a Condition of Passage (Sept. 9, 1992).

334. CAL. COM. CODE § 4-406(a), (b) (West Supp. 1993).

335. The California compromise also emphasized banks' obligations to act in good faith. Interview with Gail Hillebrand, Counsel to Consumers Union (California), in San Francisco, Cal. (Jan. 7, 1993); see also U.C.C. § 3-103(a)(4) (1990) (defining good faith), But see U.C.C. § 4-406 cmt. 4 (1990) (stating that "[t]he connotation of this [good-faith] standard is fairness and not absence of negligence"). The emphasis on good faith as a regulator of bank conduct may not be sufficient. As Professor Rubin pointed out, although a significant number or even a majority of banks treat individual consumers with as much deference as their corporate customers, "there are also a significant number of banks which are much less scrupulous about consumer interests, and some which are truly negligent or oppressive. One reason for adopting protective legislation is to bring this latter group into line. The existence of highly reputable practices by some banks should be a guide to legislation that would make such practices obligatory, not an argument for letting all banks act as they please." Letter from Prof. Edward L. Rubin, supra note 330, at 4.
available or is too expensive, is subject to review in five years under the California sunset provision. By mandating a procedure to reassess fundamental assumptions in light of legal or economic developments, the California modification curbs the impact of institutionalized resistance to a changing technology.

C. Revisions and Further Recommendations

Perhaps all of section 4-406 should be referred to as the banks' "safe-harbor" provision because it provides banks with latitude in defining the scope of their obligations. To a large degree, this flexibility is desirable because it allows the system to evolve as technology develops and as needs are identified. Protecting banks with a degree of certainty during the course of transition is important, but it does not necessitate ignoring consumers. Rather, the Code implicitly recognizes the need for consumer legislation where the needs of the system conflict with the needs of the individual user.³³⁶

For example, section 4-406 does not require a bank to furnish or to retain the original checks; it need only "maintain the capacity to furnish legible copies."³³⁷ The Code thus leaves open to debate whether a bank's obligation to a customer is discharged simply by "maintain[ing] the capacity to furnish legible copies" even if, in a given instance, the bank is unable to provide the customer with the original check or a legible copy. If so, the customer may be left with neither the original check, nor a legible copy, nor an adequate remedy. Revised section 4-406(b) allows a bank to supply a legible copy of the check if it is destroyed "or is not otherwise obtainable."³³⁸ But when is a check "not otherwise obtainable?" A bank should not be allowed to escape its obligation to provide the actual check on the assertion that it is too costly or too inconvenient to retrieve it and the check is therefore "not obtainable." If the check has been destroyed inadvertently, cannot be reproduced electronically, or is unobtainable for other

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³³⁶ Comment 3 to § 4-110 states that "[t]he parties affected by an agreement for electronic presentment, with the exception of the customer, can be expected to protect themselves." U.C.C. § 4-110 cmt. 3 (1990) (emphasis added).
³³⁷ Id. § 4-406(b). No standards have yet been set for legibility.
³³⁸ Id.
reasons, the customer should be compensated. Consumer legislation should protect customers from a potentially arbitrary interpretation of this provision and should describe the circumstances in which the original check, a copy, or an image of the check will be provided.\footnote{339}

Revised section 4-406(b) also allows checks to be destroyed even without a minimum holding period.\footnote{340} A bank should be required to retain the original check for at least a minimum time period to enable an attentive consumer to discover irregularities promptly and to obtain the original check. The minimum time period, which should begin only after the statement has been provided to the customer, should consist of at least sixty days. Until the electronic system is fully operational under the revised Code and the risks and losses are reassessed, legislation may be necessary to require that checks be stored for the statutory period within which an action may be brought concerning the check.

Revised section 4-406 does not contemplate remedies for a bank's failure to comply with obligations other than those related to the bank's unauthorized payment of a check. A bank's failure or inability to provide a customer with the original check or with legible copies, for example, may cause substantial loss to the customer. Companion legislation should specify the remedies available to the customer for various types of bank noncompliance, and should create dispute-resolution procedures which will give the customer a realistic opportunity to recover its loss. Optimally, public education programs\footnote{341} can educate attorneys, bankers, and especially consumers about their respective responsibilities under the new system.

The Official Texts of Uniform State Laws, such as the Uniform Commercial Code, typically do not set fees.\footnote{342} Accordingly, bank fees for storing or retrieving checks, producing legible copies, or for any other services are omitted from Articles Three and Four. Maximum fees and other charges also may be appropriately regulated by such legislation.

\footnote{339} Such legislation or implementing regulations also should articulate the standards for the quality of the copies.
\footnote{340} Section 4-406 provides that "[i]f 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." U.C.C. § 4-406(b) (1990).
\footnote{341} These programs could be sponsored by banks, bar associations, consumers unions, law firms, government agencies, or other interested organizations.
\footnote{342} See, e.g., U.C.C. § 4-406 cmt. 2 (1990) (leaving it to the bank to set fees).
The advent of an electronic system of processing checks and eventual check truncation introduces additional persons to the bank-customer relationship. For example, revised section 4-406 refers to "the person retaining the items," and imposes various obligations on that person. Yet the "person" holding the check or maintaining the capacity to produce copies is not likely to have an established relationship or direct contract with the bank's customer. What incentives exist to make such a person responsive to the customer's request for a check or legible copy? A Task Force of banking and consumer representatives could develop procedures to facilitate prompt responses to consumer requests.

Revised section 4-406(b) creates potential causes of action against persons other than banks. The person who holds the checks has access to the customer's financial and other personal information. Consumers have come to expect privacy and confidentiality from their banks. What is the liability of a "person" who has custody of the checks or of the information abstracted from the checks for wrongful disclosure, inadvertent mistake, or other infraction of a perceived fiduciary responsibility? What is the liability for improper or premature destruction of checks or electronically stored information? If companion legislation does not materialize to inform the providers of their obligations, protect consumers, fashion remedies, and establish procedures for dispute resolution, consumers may face expensive legal battles in court or be forced, as a practical matter, to absorb the losses.

CONCLUSION

The success of the Uniform Commercial Code provisions that introduce comparative negligence, modify the standard of ordinary care, and authorize check truncation rely in great measure on the ability of customers to meet their increased obligations under section 4-406 to examine, detect, and report a forgery or other alteration of the check promptly. But the

343. Id. § 4-406(b).
344. According to the Code, "(a) 'person' includes an individual or an organization." Id. § 1-201(29).
345. For an interesting introduction to the conflict of interest a bank may have with respect to the disclosure or nondisclosure of confidential information by a bank to its customer, see Ronald L. Hersbergen, Banking Law, 44 LA. L. REV. 247, 264–65 (1983).
ability of the customer to meet these obligations depends upon the availability of the checks or upon the completeness and accuracy of the information provided to the customer in lieu of the checks.

Banks are protected against a claim of negligence in the very area that most directly will lead to losses to customers: forged or altered checks. Revised Articles Three and Four do not obligate banks to develop alternative procedures to sight review, nor are banks required to develop equivalent procedures to detect MICR fraud. To the contrary, the Code institutionalized its protection of banks through section 3-103(a)(7), which defines "ordinary care," and by the safe-harbor rule of section 4-406(a).

Section 3-107(a)(3) does not link the elimination of sight-review procedures to economic costs, to the dollar value of losses, to the frequency of forgery occurrences, to the obsolescence of paper checks, or to the introduction of check truncation. It does not provide any interim standard during the transition from paper-based to an electronic-based system of banking. The new standard of ordinary care to be applied to banks by section 3-107(a)(7) does not require banks to implement any alternative method of forgery detection, nor does it require banks to develop forgery detection procedures when presentment of checks is made through electronic signals rather than by the transmission of paper checks. Because the revisions institutionally protect the banks from resuming any active role to detect forgery, the revised Code in effect places the entire responsibility for detecting forgery on the customer, who will have a difficult time detecting it.

The comparative negligence scheme, therefore, should be adjusted to truly distribute losses among negligent parties. Accordingly, a standard of care should be reintroduced to the definition of "ordinary care," and banks should not be guaranteed statutory protection against losses resulting from the elimination of all sight-review procedures, even if the customer is negligent. Customers should be encouraged to exercise ordinary care, but they should not be burdened with excessive losses that are not truly related to their degree of negligence. At the very least, while the public becomes informed of the changes and their increased responsibilities, transition
provisions should be established while sight review gradually is eliminated. In addition, banks should be required to develop procedures to detect MICR fraud and other types of electronic fraud. Moreover, each bank or association of banks should establish procedures to review customer grievances, to settle disputes cooperatively and fairly, and to avoid the expense and time of litigation.

Finally, the success of the system envisioned by revised Articles Three and Four depends upon an educated public. Customers should be informed that banks no longer will undertake the same responsibilities as under the former Code, and that customers will be expected to assume more responsibility with respect to their checks in order to avoid liability. The transformation from the paper age to the electronic era may require more prudent behavior and ultimately may justify a redistribution of loss. Comparative negligence should not mean, however, that negligent banks are protected against negligent customers.