



# CHECK FRAUD LIABILITY

*By Debbie Yokota, ARM, SDRMA Chief Risk Officer*

Check fraud is one of the biggest challenges facing the nation's financial system. Through the use of computer technology and basic resourcefulness, criminals, either independently or in organized gangs, are finding it increasingly easy to manipulate checks in such a way as to defraud consumers and businesses. While both consumers and businesses may suffer financial loss from check fraud, consumers also face the inconvenience and anxiety caused by resolving problems with their banks and local merchants, as well as possible repercussions with credit bureaus. Here is some key information on what businesses and consumers can do to prevent becoming the victim of check fraud.

## **Types of Check Fraud Schemes**

Fraud schemes involving checks take many forms. Checks may be:

- Altered, either as to the payee or the amount – Criminals will change the amount or payee on a valid check.
- Counterfeited – using false check drawn on legitimate bank accounts.
- Forged, either as to signature or endorsement.
- Drawn on closed accounts.
- Used in a variety of schemes.

Check fraud criminals may be insiders, independent operators, or organized gangs. The methods they use to further check fraud include:

- Getting customer information from insiders.
- Stealing bank statements and checks.
- Working with dishonest employees of merchants who accept payments by check.
- Rifling through trash for information about bank relationships.

## CHECK FRAUD RESPONSIBILITIES FOR BANKS

Current Uniform Commercial Codes (UCC) outline specific check fraud responsibilities for banks and corporations. Court decisions have already established guidelines for legal responsibilities, and failure to meet these guidelines can cause a bank or company to experience financial loss.

UCC Revisions now define responsibilities for check issuers and paying banks under the term ordinary care. Under Sections 3-403(a) and 4-401(a), a bank can charge items against a customer's account only if they are "properly payable" and the check is signed by an authorized individual. However, if a signature is forged, the corporate account may be liable if one of the following exceptions applies:

According to UCC Section 3-103(7), ordinary care requires account holders to follow "reasonable commercial standards" prevailing in the area for their industry or business. Under 3-406, if they fail to exercise ordinary care, they may be restricted from seeking restitution from the payee bank if their own failures contributed to a forged check signature or an alteration - (for example, raising a check amount from \$50 to \$5000).

Section 4-406 also requires customers to reconcile their bank statements within a reasonable time to detect unauthorized checks. This typically means reconciling statements as soon as they are received.

The concept of comparative fault - Sections 3-406(b) and 4-406(e) - can shift liability to the check issuer. If both the bank and corporate account holder have failed to exercise ordinary care, a loss can be allocated based upon the extent that each

party's failure contributed to the loss. Since banks are not required to physically examine every check, companies may be held liable for all or a substantial portion of any given loss - even if the bank did not verify the signature on a fraudulent check.

Liability for counterfeits that are virtually identical to originals will be examined on a case-by-case basis. The process used when issuing the check will be reviewed to determine if the company exercised ordinary care or contributed to the loss.

## REDUCING EXPOSURE TO CHECK FRAUD

Taking proactive measures to protect your company against check and payment fraud can go a long way to protecting your organization. Following are a few simple suggestions that can be implemented in your company:

1. Purchase a "For Deposit Only" stamp and have the employee who opens the mail immediately stamp it on the back of each check received.
2. Separate duties of invoice payment approval, check preparation, check signing, and bank reconciliation to different individuals in your organization.
3. Implement Direct Deposit payments for vendors and employees.
4. Implement Positive Pay with your bank for both Accounts Payable and Payroll. This insures the bank will not cash any check that doesn't exactly match the file you sent to them containing the check number, amount, etc.

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5. Check Clearing for the 21st Century Act (Check 21) is a federal law that makes it easier for banks to electronically transfer check images instead of physically transferring paper checks. Check 21 speeds up processing, controls costs and reduces fraud by providing early notification of return items.
6. Consider using special checks to help deter check fraud by making checks difficult to copy, alter or counterfeit such as watermarks, copy void pantograph, chemical voids, high-resolution microprinting, three-dimensional reflective hologram, or security inks.
7. Create a budget and compare the actual results against it at least monthly.
8. Review monthly financial reports with budget, year to date and prior year comparisons.
9. Actively participate in the approval, review and oversight functions of your company.
10. Require that bank statements and copies of checks remain available for review and check them periodically.
11. Require that bank reconciliation be performed within the accounting system – not on a spreadsheet or manually and by a person that does not write the checks and make bank deposits.
12. Require two signatures on all checks over a specific high dollar amount.
13. Configure your network and financial software so only certain printers can print certain types of forms (easy to do for most financial software).
14. Be mindful of certain “red flag” behavior in employees, such as them living beyond their means, experiencing financial difficulties, or unwilling to share duties or refusing to take a vacation.
15. Purchase adequate fidelity bond coverage on all employees who handle cash.
16. Implement and enforce a company credit card usage policy. This policy should include who can use the cards, for what purposes and require original receipts.
17. Implement and enforce a detailed expense reimbursement policy. Require original receipts, as well as date, location, purpose and amount.

Checks can be stolen, manipulated, or counterfeited. Illicitly obtained checks can be negotiated immediately, altered, or used for future counterfeiting. Generally, only unsophisticated criminals acting alone will immediately negotiate stolen checks by forging the signature. Most organized groups steal checks as a prelude to more enterprising endeavors.

Security and law enforcement officials agree that the problems associated with check fraud and counterfeit negotiable instruments have reached epidemic proportions. As criminal organizations become more sophisticated in the devices they use, businesses and consumers must be more alert to this growing problem and the prevention tools available.

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