Document Security – Summary For Business Executives

CHECK FRAUD is an increasingly serious problem for companies in every industry. Not long ago, business executives could rely on their banks to cover losses from check fraud. That's no longer true. Increasingly, business owners are paying for losses resulting from forged, altered and counterfeited checks. This booklet is designed to help you learn more about this growing problem. It also offers some relatively simple steps that you can take to increase the security of your checks and decrease the likelihood that you will become a victim of check fraud.

The Magnitude of Check Fraud

CHECK FRAUD HAS BECOME A HUGE PROBLEM IN THE UNITED STATES. To get an idea of the magnitude of the problem, consider the following:

1. Business Week magazine estimated in its September 4, 1995 edition, that annual losses to check fraud are $10 billion.
2. Bank Automation News, estimates that annual losses to check fraud are over $10 billion.
3. The FBI reports that approximately 500 million checks are counterfeited annually. That's an increase of more than 350% since the 1970s.
4. The FBI also reports that an astounding 55 percent of all criminal referrals it receives are for check fraud and counterfeiting cases.

The Future of Check Fraud

CAN WE EXPECT CHECK FRAUD TO DECREASE IN THE FUTURE? In a word, the answer is "No."

Recently, the American Bankers Association asked executives of large banks to predict whether check fraud would decrease, stay the same or increase. Here are the results:

1. 73% said check fraud would increase.
2. 18% said the problem would stay the same.
3. 3% said check fraud would decrease.
4. 6% had no opinion

Electronic Banking and Check Fraud

SURPRISINGLY, ELECTRONIC BANKING HAS BARELY MADE A DENT IN CHECK USAGE. According to the American Banker newspaper, Americans currently write 60 billion checks a year. The newspaper also reports that the number of checks processed in the United States:

1. Increased 7% in the 1970s
2. Increased 5% in the 1980s
3. Is increasing 2% today
4. It should be noted that a 2% increase in 60 billion checks will generate more than one billion more checks annually.

The Uniform Commercial Code

AS OF AUGUST, 1996, FORTY SEVEN STATES PLUS THE DISTRICT OF COLUMBIA AND PUERTO RICO HAVE PASSED A SET OF REVISED STATUTES GOVERNING CHECKS.

This group of statutes is part of the Uniform Commercial Code (UCC). In a sentence, the UCC is a comprehensive law of commercial transactions. There are 10 articles in the UCC. The ones that we're concerned with are Articles 3 and 4, which deal with checks.

At the heart of Articles 3 and 4 is this concept: Both banks and their customers have specific responsibilities they must take to avoid potential liability for check fraud.

Many of these responsibilities fall under the heading of "Ordinary Care."

Ordinary Care

JUST WHAT IS ORDINARY CARE? Here is the technical definition: "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."

Still, what does ordinary care mean to business owners? The answer is this: Among other things, Ordinary Care is a group of responsibilities, or controls, that business owners must exercise to fully demonstrate that they've taken reasonable action to safeguard their company's checks.

There are six controls that will help assure that Ordinary Care is being exercised. In a moment, we will examine those responsibilities in detail. But first, let's look at another important facet of the revised UCC: Comparative Negligence.

Comparative Negligence

PRIOR TO THE REVISIONS IN ARTICLES 3 AND 4 OF THE UCC, IF BOTH THE BANK AND THE CUSTOMER WERE FOUND NEGLIGENT IN A CHECK FRAUD CASE, THE ENTIRE LOSS WOULD BE PLACED UPON THE BANK.

Now, however, under revised Articles 3 and 4, the principle of Comparative Negligence is introduced. Comparative Negligence basically means that both parties can be found liable for check fraud. How much depends on their relative degree of negligence or fault. Here's the definition of this concept: "Comparative Negligence requires the allocation of loss between the parties when both are negligent or when both have failed to exercise 'ordinary care.'The Comparative Negligence rule leaves it up to a trier of fact (a jury or a judge in a non-jury case) to reach something of a mathematical formula in allocating liability."

And here's an important point to consider: Under revised Articles 3 and 4 of the UCC, the burden is on the customer to establish that the bank failed to exercise ordinary care.

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Six Corporate Controls

By implementing the following controls, business owners can greatly minimize their exposure and risk to check fraud. And these controls, among other things, help demonstrate that Ordinary Care has been taken to protect a company's checks.

CONTROL #1 – Examine Bank Statements Promptly

It is essential to exercise reasonable promptness in examining bank statements. Here's an important rule: Let's say a situation occurs where a company's checks are used illegally because of a forged signature. If the bank establishes that the company failed to exercise reasonable promptness in examining its statement, and if the bank establishes that it suffered a loss because of that failure, the bank has no liability so long as it acted in good faith and was not negligent. Here's another important rule commonly known as the "Repeater Rule:" The rule takes force when a bank customer does not report a forged signature, and the same thief forges a signature on additional checks paid more than 30 days after the first forged check or bank statement was made available. In this case, the bank has no liability on the additional forged checks so long as it acted in good faith and was not negligent. More importantly, the bank does not have to establish that it suffered a loss.

CONTROL #2 – Report Losses Promptly

just as it is important to promptly examine bank statements, it is equally important to quickly report to the bank any unauthorized payments due to forgeries or alterations.

Regarding prompt reporting of a problem, here's an important rule: Bank customers are obligated to discover and report a forged signature on their checks within one year. If they fail to make the discovery and report it to the bank within one year, they are barred from making any claim against the bank. This rule applies even if the bank was somehow negligent.

CONTROL #3 – Maintain Adequate Security and Controls

One of the most important steps any business owner or executive can take is to assure that company checks are maintained in a safe and secure manner. Some of the safety steps include the following:

- Company checks should be kept in an area that's secure and locked, with access limited to those individuals with responsibilities for issuing checks.
- To maintain strong security, it is recommended that the keys or combination locks that safeguard the checks be changed on a regular basis.
- Always keep check boxes sealed until they are required for actual use.
- Mechanical signing equipment should be kept in a secure area away from blank checks.

CONTROL #4 - Segment Check Responsibilities

In order to minimize the odds of check fraud, it is important that different people within an organization have responsibility for check functions. For example, one person would be in charge of maintaining check stock custody and preparing checks for signature while another person would reconcile the monthly bank statements.

The following rule underscores the importance of minimizing check fraud by dividing check responsibilities:

Revised Articles 3 and 4 of the UCC provide that if an employer entrusts an employee with responsibility to sign, endorse or deposit checks, and if the employee forges the endorsement of the employer on a check payable to the employer, the endorsement is effective if it is made in the name of the employer. The bank does not have to establish any negligence on the part of the employer. So long as it acted in good faith and was not negligent, the bank is not liable for the forged check, and the check customer will be responsible for the financial loss.

CONTROL #5 - Institute Controls Over Accounts Payable And Payroll Functions

Another important deterrent is to have appropriate controls over the accounts payable and payroll functions.

Only authorized personnel should be allowed to add or change vendors to the company's computer system.

And controls should be in place to insure that only legitimate employees can be added to the system.

CONTROL #6 - Conduct Periodic Audits

It is important to conduct periodic audits of the various check control functions. This will help make sure the overall system is working as it should be.

Security Features and Ordinary Care

WHAT IS THE ROLE OF SECURITY FEATURES IN EXERCISING ORDINARY CARE? Legal experts agree that security features could well become an important aspect of Ordinary Care in the future. Brent Gorey, an attorney who specializes in the banking industry and the legal aspects of checking, says: "I believe that, in appropriate cases, a strong argument can be made that the failure by a business to use security features to protect its checks constitutes negligence."
According to the legal publication, The Law of Bank Deposits, Collections and Credit Cards: "One form of customer negligence that is beginning to attract attention is failure to use state-of-the-art security features in check paper stock ... If ABC Corporation could have used check stock with proven anti-forgery security features, but failed to use it, ABC has to that extent failed to exercise ordinary care in preventing the check forgery in the first place, particularly under revised UCC Article 3-406. Given the wide variety of check security features now available to companies at reasonable prices, it is foreseeable that this 'state of the art' defense will start appearing in check cases."

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Following are five case studies, each showing how respectable, honest businesses were the victims of check fraud.

Case Study #1: Eason Publications

Eason Publications had the misfortune of not knowing that its Comptroller was also an embezzler. For three years, the Comptroller forged the names of authorized signatories on Eason's corporate checking account and wrote checks to himself. To avoid bouncing any checks, he tapped into the company's line of credit with the bank. In a three year period, he embezzled nearly $1 million.

Case Study #2: A St. Louis Plastics Company

The St. Louis Business Journal reported on a plastics manufacturer in the St. Louis area. The company kept its blank checks in its computer room. Only a few employees had keys to the facility, so after hours the checks were safe. The problem was that during the day, a large number of people had access to the computer room. One of the employees obtained some blank checks and forged them for a total of almost $100,000.

On top of storing the checks in a relatively open area, the plastics company waited six months to reconcile its bank statement. As a result, the bank refused to refund the company for the already-paid forged checks. The company lost nearly $100,000.

Case Study #3: Best Legal Services

Best Legal Services provides various nonprofessional support services to attorneys and law firms. The company's receptionist, Lissa Grant, was eventually given the responsibility of bookkeeper. Unfortunately for the company, she intercepted 150 checks made out to Best. She deposited them in her personal account at Mellon Bank after printing "Pay to the Order of Lissa Grant" on the reverse side of the check, under which she forged the owner's endorsement. Mellon Bank accepted the checks for deposit and credited payment to Grant's account.

Because Grant was the bookkeeper, she was able to conceal her embezzlement for 20 months. Finally, another employee observed her entering a check payable to Best on a deposit slip to her personal account at Mellon Bank. During the 20 month period, the total amount of the stolen checks was $61,431.98.

In this case, the Third Circuit Court of Appeals ruled that the business owner was negligent as a matter of law and that he should bear the loss.

Case Study #4: Globe Motor Car Company

Globe Motor Car Company is an automobile dealership. Its day-to-day finances were handled mainly by the office manager, John Gallo. During a period of several years, Gallo embezzled over $1.5 million from his employer. On many occasions, he would simply retain vehicle purchase money for his own use. Other times, he would make himself payee on blank checks signed by the owner. He also forged the owner's signature to checks payable to himself. To conceal his activities, Gallo removed checks made out to him from the monthly checking account statement. He also made out fake certificates of deposit and falsified monthly bank reconciliations.

The court ruled that the dealership was responsible for the embezzled checks and should bear the financial loss. The court said that the employee's series of forgeries over a period of three years was in large part attributable to the carelessness of the dealership in failing to detect the forgeries when the canceled checks were returned.

Case Study #5: Georgia Auto Dealer

In the previous case studies, employers were victims of illegal actions by their employees. In this case study, provided to us by a Special Agent of the FBI, an automobile dealership in Georgia was the victim of a "scam" by two con artists.

Two women were part of a nationwide check fraud scheme. They had some work done on their car by the Georgia dealership. They overpaid their bill, and later received a refund check. The check became the centerpiece of the scam.

The two women found a vacant house in nearby Florida. They used this address to set up a personal phone line doing business as the Georgia auto dealer. Then, using a MICR machine they had obtained illegally, they used the refund check to make up counterfeit checks from the auto dealer. Next, they went to Oklahoma. Using a fake ID, birth certificate and stolen Social Security Card, one of the women went to a check cashing store. First, the clerk phoned the bank listed on the bogus check. Not suspecting any problems, the bank said the check was good. Then, the clerk phoned what he thought was the auto dealer. What happened was that the women put their new phone number on the check. Using call forwarding, the phone call was routed to a nearby phone booth, where the other con artist was waiting. She even had a toy telephone that rang in the background to make it sound as if it were the real car dealership.

The FBI Special Agent said this scam worked like a charm. The women netted $42,000 in a few days of work. They were later captured in suburban St. Louis.