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The Consequences of Bulk in Our Banking Diet: Bulk Filing of Checks and the Bank's Duty of Ordinary Care under the 1990 Revision to the Uniform Commercial Code When It Honors Forged Checks

Mark E. Budnitz

Georgia State University College of Law, mbudnitz@gsu.edu

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THE CONSEQUENCES OF BULK IN OUR BANKING DIET: BULK FILING OF CHECKS AND THE BANK'S DUTY OF ORDINARY CARE UNDER THE 1990 REVISION TO THE UNIFORM COMMERCIAL CODE WHEN IT HONORS FORGED CHECKS

*Mark E. Budnitz**

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* Associate Professor of Law, Georgia State University College of Law. B.A., Dartmouth College, 1966; J.D., Harvard Law School, 1969. The author gratefully acknowledges the research assistance of Cindy S. Stacey.

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INTRODUCTION

Recent changes approved by the sponsors of the Uniform Commercial Code ("UCC" or "Code") regarding customer liability for forged checks have made a bank's choice of its check processing procedures an important issue.¹ Over the years, banks increasingly have adopted automated methods to handle check processing, and the UCC revisions, in part, are intended to deal with such technological innovations.² The need for an adjustment to the present Code is demonstrated by the conceptual and analytical disarray among several recent

1. The text of the revisions is published in *UNIFORM COMMERCIAL CODE*, Revised Article 4 — Bank Deposits and Collections § 4-406 (Proposed Final Draft, Revised May 10, 1990), in *SELECTED COMMERCIAL STATUTES* app. VI (1990 ed.) [hereinafter Revision Draft — article 4] (includes Conforming and Miscellaneous Amendments to UCC). See *infra* note 340 for the text of relevant portions of revised § 4-406.

The sponsors of the UCC are the American Law Institute [hereinafter ALI] and the National Conference of Commissioners on Uniform State Laws [hereinafter NCCUSL]. Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the UCC*, 43 *BUS. LAW.* 621 (1988). The ALI approved a final draft of the revision to Articles 3 and 4 of the Code in May, 1990. 58 *U.S.L.W.* 2688 (May 29, 1990). The NCCUSL gave its approval to the revision in July, 1990. *Consumer Union Seeks More Protection for Consumers in UCC Articles 3 and 4*, 55 *Bank. Rep. (BNA)* 270 (Aug. 13, 1990). For a description of the drafting history of this project, see Rubin, *supra*. Prior to the initiation of work on the revisions, the sponsors had attempted to draft a comprehensive payments code covering all types of fund transfer systems. Scott, *Corporate Wire Transfers and the Uniform New Payments Code*, 83 *COLUM. L. REV.* 1664, 1665 & n.9 (1983).

The term "customer" as used in this article has the same meaning as the term "drawer" given in the UCC. That is, the drawer is the person who issues a check ordering the bank to pay a third person by signing the check in the lower right hand corner. D. EPSTEIN, J. MARTIN, W. HENNING & S. NICKLES, *BASIC UNIFORM COMMERCIAL CODE* 347, 354 (3d ed. 1988).

The term "bank" as used in this article has the same meaning as the definition given in U.C.C. § 1-201(4) (1989) ("Bank" means any person engaged in the business of banking"). The word "bank," therefore, includes commercial banks, thrifts, and credit unions.

2. Rubin, *supra* note 1, at 628-29.

court decisions interpreting the Code's requirement that banks exercise ordinary care.³ While the need for Code reform is apparent, the modifications proposed in the revised Code fail to address fundamental issues, create conceptual confusion, and, without justification, upset the balance of rights established under the present law.

Banks face a daunting task when processing checks. Experts estimate that each year financial institutions process more than forty billion checks, transferring approximately thirty trillion dollars.⁴ Speed is vital due to availability deadlines set by state⁵ and federal law.⁶ In response, most banks have turned to technology. In the past, all banks conducted sight review; each check was examined by a bank employee who compared the signature on the check with that on the bank's signature card. Skyrocketing labor costs and large increases in check volume induced many banks to convert to a procedure referred to as bulk filing.⁷ Under this system, checks are filed in bulk until the bank prepares its periodic account statement. At that time, machines automatically sort the unreviewed checks into each customer's file. Some banks, including most credit unions, do not conduct sight review of any checks.⁸ Some banks conduct sight review of checks over a certain amount, subjecting only the smaller checks to bulk filing.

Under the present Code, the customer who fails to report a forged signature promptly is liable for any loss, but can shift the loss to the bank if the customer can prove the bank failed to exercise ordinary care.⁹ The revised Code changes the definition of ordinary care, requires proof that the bank's failure to exercise

3. Compare *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 346, 546 N.E.2d 904, 906, 547 N.Y.S.2d 611, 613-14 (1989) (bank's inspection process failed to meet standard of ordinary care because procedures provided little chance to detect forged checks) and *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 189 (Tex. Ct. App. 1989) (standard of ordinary care not met where credit union failed to establish any signature verification process) with *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291 (1st Cir. 1988) (bank determined to have exercised ordinary care even though it did not examine the signature on every check) and *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 552 N.E.2d 783 (1990) (whether bank exercised ordinary care where it does not verify manually checks under \$1000 is a question of fact).

4. J. VERGARI & V. SHUE, CHECKS, PAYMENTS, AND ELECTRONIC BANKING 227 (1986).

5. U.C.C. § 4-301 (drawee banks must dishonor checks before its midnight deadline). All references to the UCC are to the official text unless otherwise stated.

6. 12 C.F.R. pt. 229 (1990) (regulation promulgated pursuant to the Expedited Funds Availability Act, 12 U.S.C. §§ 4001-4010 (1988), requiring banks to make funds accessible to depositors promptly).

7. A 1988 survey conducted by the Bank Administration Institute found that median productivity was four times higher under bulk filing. Ledford, *Check Fraud Cases Lead Courts to Scrutinize Bulk Filing, an Automated Processing Method*, MAG. OF BANK ADMIN., Aug. 1989, at 8.

8. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 186 (Tex. Ct. App. 1989).

9. U.C.C. § 4-406 (2)-(3). Section 4-406 provides in pertinent part:

(1) When a bank sends to its customer a statement of account . . . or otherwise in a reasonable manner makes the statement . . . available to the customer, the customer must exercise reasonable care and promptness to examine the statement . . . to discover his unauthorized signature . . . and must notify the bank promptly after discovery thereof.

(2) If the bank establishes that the customer failed . . . to comply with the duties imposed

ordinary care substantially contributed to the loss resulting from the forgery, and requires the finder of fact to allocate loss according to the principles of comparative negligence.¹⁰

This article examines the present Code scheme, and describes the confusion caused by the mixing of contract and tort concepts. The article next applies an economic theory of loss allocation to five recent cases. The revised Code is then critiqued in terms of this theory and these cases. Under this analysis, it becomes apparent that the new definition of ordinary care is a significant improvement. The introduction of comparative negligence as a method of loss allocation, however, is a step backward. Finally, the article proposes an alternative approach, which adopts the new definition of ordinary care, but also establishes the banks' duty to maintain some type of check review procedure that reasonably relates to the detection of forgeries. This restores the balance that exists under the present Code.

I. THE UNIFORM COMMERCIAL CODE SCHEME OF LOSS ALLOCATION FOR FORGED SIGNATURES: TORT OR CONTRACT?

A. *The Bank's Strict Liability for Paying Checks with Forged Signatures*

As a general rule, the bank incurs the loss when it pays a check bearing the customer's forged signature.¹¹ This system of loss allocation has contributed to making the check a safe, reliable, convenient, and comfortable payment device that has flourished despite the encroachment of attractive electronic payment systems.¹² Customers continue to use checks in increasing numbers because they know that they are protected from loss as long as they act in a non-negligent, reasonable manner.

Courts and commentators characterize this Code scheme as imposing strict

on the customer by subsection (1) the customer is precluded from asserting against the bank

(a) his unauthorized signature . . . if the bank also establishes that it suffered a loss by reason of such failure; and

(b) an unauthorized signature . . . by the same wrongdoer on any other item paid in good faith by the bank after the first item and statement was available to the customer for a reasonable period not exceeding fourteen calendar days and before the bank receives notification from the customer of any such unauthorized signature or alteration.

(3) The preclusion under subsection (2) does not apply if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).

10. Revision Draft — article 4, *supra* note 1.

11. Section 4-401 of the UCC authorizes a bank to pay only those checks that are "properly payable." A check containing a forged signature should not be deemed properly payable and cannot be charged against the depositor's account. U.C.C. § 3-404. *See also* Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust, 74 N.Y.2d 340, 345, 546 N.E.2d 904, 906, 547 N.Y.S.2d 611, 613 (1989) (check with forged signature not properly payable by the bank); McDonnell, *Bank Liability for Fraudulent Checks: The Clash of the Utilitarian and Paternalist Creeds Under the Uniform Commercial Code*, 73 GEO. L.J. 1399, 1404 (1985) (depositor protected by UCC provisions even if bank inspects the signature carefully).

12. G. MOEBS & E. MOEBS, PRICING FINANCIAL SERVICES 84-85 (1986) (Federal Reserve data indicate customers' use of checks is continuing to rise); *Paper Trail Not Abating*, PENSIONS & INVESTMENT AGE, Apr. 17, 1989, at 37 (volume of check use will increase substantially until 1993).

liability upon banks since the bank is liable to its customer for paying a check containing a forged signature regardless of how careful and reasonable its conduct.¹³ According to Professor McDonnell, the strict liability principle has a basis not only in the UCC, but also in the common law of contract.¹⁴ To better understand the legal relationship between the customer and the bank, it is necessary to determine the nature of the contract between these parties.

B. The Contractual Relationship between Customers and Banks

By depositing money in the bank, the customer becomes the creditor of the (debtor) bank.¹⁵ The depositor thus has acquired contract rights *vis-a-vis* the bank.¹⁶ Courts characterize the agreement between these parties as either an express or an implied contract.¹⁷ The account's signature card is not only a means of check verification, it is the express contract between the parties.¹⁸ The terms of the contract are gleaned from documents, such as the provisions of the signature card and those of the UCC, which is deemed to have codified the implied contract.¹⁹ These writings are to be construed according to the intentions of the bank and its customer.²⁰ UCC section 4-401 imposes upon the bank the

13. See, e.g., *Perini Corp. v. First Nat'l Bank*, 553 F.2d 398, 403-04 (5th Cir. 1977) (bank breaches contract with depositor and is held strictly liable when it pays on forged check); *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 345, 546 N.E.2d at 906, 547 N.Y.S.2d at 613 (bank generally held liable for forged check notwithstanding exercise of due care). See also E. RUBIN & R. COOTER, *THE PAYMENT SYSTEM* 478 (1989) (payor bank strictly liable for paying check with forged signature); McDonnell, *supra* note 11, at 1404 (bank liable even if forgery is perfect).

14. McDonnell, *supra* note 11, at 1404-05. McDonnell states: "The assumed contract operates to impose strict liability on the bank for paying any type of unauthorized order." *Id.*

15. 5A MICHIE ON BANKS AND BANKING ch. 9, § 1 at 1 (1983) [hereinafter MICHIE].

16. MICHIE, *supra* note 15, ch. 9, § 1 at 17; Symons, *The Bank-Customer Relation: Part 1 — The Relevance of Contract Doctrine*, 100 BANKING L.J. 220, 222 (1983).

17. See MICHIE, *supra* note 15, ch. 9, § 1 at 12-13, which states: "The express or implied contract between a bank and its depositor creates and regulates the relationship between them." *Id.* Implied in the debtor-creditor relationship is a contract, one of whose terms is the bank's promise that it will pay only checks containing authorized signatures. *K & K Mfg. v. Union Bank*, 129 Ariz. 7, 11, 628 P.2d 44, 48 (Ct. App. 1981); *Certified Grocers of Cal. v. San Gabriel Valley Bank*, 150 Cal. App. 3d 281, 286-87, 197 Cal. Rptr. 710, 714 (1983) (bank operates under implied contract with depositor when it accepts depositor's funds). The express terms of the agreement can be found in the deposit agreement, the signature card, and the checks the customer draws. *Federal Deposit Ins. Corp. v. West*, 244 Ga. 396, 399, 260 S.E.2d 89, 91 (1979).

18. *Perdue v. Crocker Nat'l Bank*, 38 Cal. 3d 913, 922, 702 P.2d 503, 509, 216 Cal. Rptr. 345, 551 (1985), *appeal dismissed*, 475 U.S. 1001 (1986). See also *Dietrich v. Chemical Bank*, 115 Misc. 2d 713, 713-14, 454 N.Y.S.2d 490, 491 (Sup. Ct. 1981) (depositor accepts rules and regulations of bank upon signing signature card), *aff'd*, 92 A.D.2d 786, 459 N.Y.S.2d 1016 (N.Y. App. Div. 1983). The signature card is the contract that creates the checking account. MICHIE, *supra* note 15, ch. 9, § 1, at 20. The signature card is the contract that establishes the relationship between the bank and the customer. R. SPEIDEL, R. SUMMERS, & J. WHITE, *COMMERCIAL PAPER TEACHING MATERIALS* 347 (1987). The signature card is an adhesion contract. *Id.*

19. *Taylor v. Equitable Trust Co.*, 269 Md. 149, 157, 304 A.2d 838, 842-43 (1973); *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 592-93, 676 P.2d 329, 333 (1984).

20. MICHIE, *supra* note 15, ch. 9, § 1, at 17-18; Symons, *supra* note 16, at 246.

contractual duty to pay only those checks that are "properly payable."²¹ Only checks containing authorized signatures are considered properly payable.²²

Courts agree that there is a contractual relationship between the bank and its customer, and that if the bank fails to comply with the Code's requirements in regard to paying its customers' checks, it is breaking that contract.²³ This consensus is helpful in developing a sound analytical framework for viewing the banks' obligations when they process checks. For if we agree that courts should proceed along the path of contractual analysis, we know we should look at factors relevant to that type of analysis — such as the expectations of the parties, commercial reasonableness, usage of trade — and to a scheme of damages significantly different from tort damages.²⁴ The Code, however, imposes on banks a standard of care derived from the law of torts. This blending of tort and contract doctrines makes clear and consistent analysis difficult.

C. *The Liability of the Negligent Customer*

Although the bank ordinarily is liable to the customer when it pays a check bearing a forged customer signature, there are two situations in which the Code shifts from a framework based on the bank's strict liability in contract²⁵ to one that focuses on the tort concept of the customer's negligence.²⁶ The first instance of potential customer liability for loss involves the preparation and issuance of the check. If the customer's conduct is negligent, and the "negligence substantially contributes . . . to the making of an unauthorized signature[.]" the loss falls on the customer.²⁷ For example, when the customer leaves a book of blank checks in an unlocked cabinet in an unused storeroom, and the checks are stolen, the customer's signature forged, and the checks cashed, the customer must bear the loss.²⁸

The second situation in which the loss may be shifted to the customer occurs after the customer's bank pays the check. The customer bears the loss if, after receiving the bank's periodic statement, he or she fails to "exercise reasonable care and promptness to examine" the statement, discover forgeries, and

21. *Taylor*, 269 Md. at 157, 304 A.2d at 842; *Medford Irrigation Dist.*, 66 Or. App. at 591, 676 P.2d at 333.

22. *Medford Irrigation Dist.*, 66 Or. App. at 592-93, 676 P.2d at 332.

23. See *supra* notes 17-21 and accompanying text for a discussion of the contractual relationship between the bank and customers and violations of that contract when the bank improperly pays checks.

24. Note, "Contort:" *Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts — Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510, 525 n.92 (1985).

25. 1 RESTATEMENT (SECOND) OF CONTRACTS introductory note at 309 (1979) [hereinafter 1 RESTATEMENT]. ("Contract liability is strict liability.")

26. See, e.g., *Perini Corp. v. First Nat'l Bank*, 553 F.2d 398, 405 (5th Cir. 1977) (fault occupies secondary role in UCC treatment of forgery losses).

27. U.C.C. § 3-406. The loss is on the bank, however, if it failed to pay the check in accordance with reasonable commercial standards. *Id.*

28. *Commercial Credit Equip. Corp. v. First Alabama Bank*, 636 F.2d 1051, 1053 (5th Cir. 1981).

"promptly" notify the bank.²⁹ If the same person forges his or her signature on more than one of the customer's checks, and the customer fails to report the forgeries to the bank within a reasonable period³⁰ after receiving from the bank the first forged check and the accompanying statement, the bank is not required to recredit the customer's account for anything more than the amount of the first check.³¹

D. Liability Reverts to Bank if it Fails to Exercise Ordinary Care

The loss allocation process does not stop with finding the customer negligent, however. Even if the customer fails to report promptly any forged signatures after receiving the bank's statement, the customer can shift the loss to the bank if he or she can establish the bank's "lack of ordinary care" in paying the check.³²

1. Ordinary Care in its "Normal Tort Meaning"

The comment to UCC section 4-103 points out that the Code does not define ordinary care, but also states the drafters' intention that courts use the term in its "normal tort meaning and not in any special sense related to bank collections."³³ The New York Court of Appeals utilized the language of the comment to support its conclusion that "a customer could prove a bank lacked ordinary care by presenting any type of proof that the bank failed to act reasonably."³⁴

Several objections can be made to the comment and to the New York court's interpretation of it. The comment is mistaken when it suggests that courts give ordinary care its "normal tort meaning" by judging the bank's conduct in processing checks without any regard to check collection. The classic tort approach is to determine whether negligence is present by deciding whether the conduct of the party charged with negligence is reasonable within the context of the circumstances in which the party acted.³⁵ Negligence involves a bal-

29. U.C.C. §§ 4-406(1)-(2). "Reasonable care" apparently has the same meaning as "ordinary care." See Mellinkoff, *The Language of the Uniform Commercial Code*, 77 YALE L.J. 185, 218 (1967) (whether drafters of UCC gave consideration to inherent ambiguity of language of standard of care uncertain). Professors Rubin and Cooter label this a *per se* negligence rule since the customer is deemed negligent as a matter of law. E. RUBIN & R. COOTER, *supra* note 13, at 527.

30. The reasonable period may not exceed fourteen calendar days. U.C.C. § 4-406(2)(b).

31. *Id.* See also *Flagship Bank v. Complete Interiors, Inc.*, 450 So. 2d 337, 339 (Fla. Dist. Ct. App. 1984); B. CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS* ¶ 8.02[4][b], at 8-27 (3d ed. 1990). But see *Winkler v. Commercial Nat'l Bank*, 42 Mich. App. 740, 745, 202 N.W.2d 468, 470-71 (1972) (whether customer reported within reasonable time second forged check that bank paid within fourteen days from time customer received first forged check and statement is question for trier of fact).

32. U.C.C. § 4-406(3).

33. U.C.C. § 4-103 comment 4.

34. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust*, 74 N.Y.2d 340, 345, 546 N.E.2d 904, 906, 547 N.Y.S.2d 611, 613 (1989). By showing that under the bank's procedures there was "no realistic opportunity to detect forged checks," the customer presented the required proof of unreasonableness. *Id.* at 346, 546 N.E.2d at 907, 547 N.Y.S.2d at 614.

35. W. KEETON, PROSSER & KEETON ON THE LAW OF TORTS § 37 (5th ed. 1984). Keeton states: "The question . . . is what the reasonable person would have done under the circumstances."

ancing of the risk taken by the party whose conduct is under question, and the "probability and extent of the harm," against the "social value of the interest" that party is promoting.³⁶ Ordinary care, therefore, cannot be judged in a vacuum. The reasonableness of the conduct must be determined in light of the situation presented. Consequently, ordinary care in the context of the bank collection process must include a consideration of the bank's conduct in that process.

Whereas the first paragraph of the comment to section 4-103 seeks to divorce ordinary care from its banking context, section 4-103(3) and the second paragraph of the comment take the opposite approach. Section 4-103(3) provides that action or nonaction consistent with a "general banking usage not disapproved by this Article, *prima facie* constitutes the exercise of ordinary care."³⁷ Moreover, the comment states that in determining bank usage, the court should consider the practices of other banks and suggests the appropriate geographical scope of what constitutes general banking usage.³⁸ The statement in the comment that ordinary care in its normal tort sense means that the bank's conduct should be considered without regard to the bank's check collection practices, therefore, is contrary to the accompanying statutory provision, other language in the same comment, and general tort law.³⁹

Id. Keeton further states: "[E]vidence of the usual and customary conduct of others under similar circumstances is normally relevant and admissible" *Id.* § 33. See generally J. HURST, *DEALING WITH STATUTES* 58 (1982) (legislatures should be presumed to intend that words have their ordinary meaning).

36. W. KEETON, *supra* note 35, § 31.

37. U.C.C. § 4-103(3). But see Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 375 (1952) (section 4-103 renders Article 4 of Code objectionable). The meaning of the phrase "usage not disapproved by this Article" is not apparent because the Code does not disapprove of any particular banking usage. 2 STATE OF N.Y. LAW REVISION COMMISSION REPORT, *STUDY OF THE UNIFORM COMMERCIAL CODE* 1264 (Reprint ed. 1980). Section 4-103's reference to general banking usage, standing alone, is consistent both with a tort and a contract theory of liability. What constitutes negligence is determined by the standards of conduct of the community where the activity occurred. It is, therefore, relevant to consider the "usual and customary conduct of others under similar circumstances." W. KEETON, *supra* note 35, § 33. Usage is also an integral element in contract analysis, 2 RESTATEMENT (SECOND) OF CONTRACTS § 220 (1979) [hereinafter 2 RESTATEMENT], and is incorporated in U.C.C. section 1-205 which applies to all transactions under the Code. That section provides that usage "give[s] particular meaning to and supplement[s] or qualif[ies] [the] terms of an agreement." U.C.C. § 1-205(3). Whereas this provision relates to contract interpretation, § 4-103(3)'s reference to general banking usage relates to the negligence concept of ordinary care. U.C.C. § 4-103(3).

38. General banking usage means the common practices engaged in by banks operating in the geographical area of the bank under consideration. U.C.C. § 4-103 comment 4. To be considered a general banking usage, more than two or three banks must engage in a practice, but a practice need not be country-wide. *Id.*

39. Professor Phillips suggests negligence under the Code may be somewhat narrower than the general standard of negligence. Phillips, *The Commercial Culpability Scale*, 92 YALE L.J. 228, 228 n.2 (1982). The focus of Professor Phillips' article is not on the situation where both parties are negligent, as in § 4-406 cases. *Id.* at 229 n.4.

2. Ordinary Care and the Morals of the Marketplace

Article 4's approach to ordinary care is similar to that used in the UCC's Article 2, which governs the sale of goods. Rather than providing detailed definitions of terms and carefully setting out the law, Article 2 requires parties' conduct to conform to the general standard of "commercial reasonableness."⁴⁰ Courts give meaning to the term by discovering what practices are considered reasonable by the business community.⁴¹ As a result, Article 2 reaffirms "the predominant morals of the marketplace."⁴²

Section 4-103(3) follows the same tack. It does not require any specific bank conduct. Neither ordinary care nor general banking usage is defined. To make out a *prima facie* case of ordinary care, the bank need only prove that its practices conform to the standards of current commerce.⁴³ The court will not automatically approve the "morals of the marketplace," however. The customer can prevail if he or she can establish that general banking practice is "unreasonable, arbitrary, or unfair."⁴⁴ As one court stated the test: the customer has the burden of showing that the "entire industry's practice is unreasonable."⁴⁵ Although the Code provides the customer with this thin reed, the entire thrust of section 4-103(3) is toward codifying whatever current practice may be.

Professor Danzig criticizes the Article 2 approach, not only because it is designed to further "the purposes of business instead of [being used] as a body of means toward general social ends,"⁴⁶ but also because, instead of achieving Llewellyn's goal of the regularization of the law, it has the opposite result of frustrating the Code's goals of simplification, clarification, and uniformity.⁴⁷ Since Article 2 often uses general terms, such as "commercial reasonableness," instead of spelling out what conduct is required, judges are free to "discover" that current practices are whatever conform to the judges' value systems.⁴⁸ As a result, the law is unpredictable, varying from case to case, depending upon whim. Likewise, because Article 4 fails to define ordinary care and general banking usage, acceptable bank practice varies from case to case, depending upon the predilections of the judge or jury and upon the facts and procedural posture of each case.⁴⁹

40. Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 626 (1975) (quoting K. LLEWELLYN, *THE COMMON LAW TRADITION* 122 (1960)).

41. *Id.*

42. *Id.* at 629.

43. U.C.C. § 4-103 comment 4.

44. *Id.*; Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp., 848 F.2d 291, 294 (1st Cir. 1988); McDowell v. Dallas Teachers Credit Union, 772 S.W.2d 183, 189 (Tex. Ct. App. 1989).

45. *Zapata Corp.*, 848 F.2d at 294 (emphasis added).

46. Danzig, *supra* note 40, at 630 (quoting Pound, *The Call for a Realist Jurisprudence*, 44 HARV. L. REV. 697, 708 (1931)).

47. U.C.C. § 1-102(2) (statement of goals of UCC).

48. Danzig, *supra* note 40, at 626.

49. See *infra* notes 174-94 and accompanying text for a discussion of varied factual contexts and procedural settings that have led to inconsistent interpretations of ordinary care.

3. General Banking Usage Contrasted with Usage of Trade

The meaning of "general banking usage" in Article 4 can be understood better by comparing it to another Code concept known as "usage of trade."⁵⁰ The entire focus of section 4-103 is on judging one bank's conduct by comparing it to what other banks do. In contrast, section 1-205 employs the concept of usage of trade to decide what constitutes the terms of the contract between the parties.⁵¹ As in general banking usage under section 4-103, usage of trade is determined by reference to how others in that line of business conduct themselves.⁵² Unlike section 4-103, however, what other businesses are doing is not the exclusive focus under section 1-205. Instead, the focus is on the parties to the contract. Where the contract is silent or ambiguous, the parties are bound by trade usage,⁵³ but only if the party who will be bound by the usage had either actual or constructive knowledge of the same.⁵⁴ Courts do not find constructive knowledge unless a usage has "general and universal application."⁵⁵ Moreover, a person who is a newcomer to the field cannot be charged with constructive knowledge.⁵⁶ Thus, usage of trade should not be read automatically into the terms of the contract, because there are occasions where a party cannot justifiably be expected to follow such usage.⁵⁷

Applying the trade usage standards of section 1-205 to bank practices for reviewing checks with forged signatures would produce results different from those produced if courts apply the general banking usage test of section 4-103. Because practices differ so greatly among banks,⁵⁸ it is not clear that there is indeed any usage of trade.⁵⁹ Banks do not disclose to the public their procedures for reviewing checks for forged signatures, apparently out of concern that

50. U.C.C. § 1-205(2) (defines "usage of trade").

51. U.C.C. § 1-205(5). Usage of trade is one factor employed to determine the "commercial meaning of the agreement" and to provide terms with respect to those issues that are not explicitly agreed upon. U.C.C. § 1-205 comment 4.

52. U.C.C. § 1-205 comment 5. The comment states: "[F]ull recognition" should be given to the practices of "the great majority of decent dealers." *Id.*

53. U.C.C. § 1-205(1). The parties may also be bound by course of dealing. *Id.* Course of dealing applies where the parties have engaged in similar transactions prior to their conduct under the instant contract. *Id.* comment 2.

54. *Heggblade-Marguleas-Tenneco, Inc. v. Sunshine Biscuit*, 59 Cal. App. 3d 948, 957, 131 Cal. Rptr. 183, 189 (1976).

55. *Id.*

56. *United States v. Haas & Haynie Corp.*, 577 F.2d 568, 574 (9th Cir. 1978).

57. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 785 (9th Cir. 1981); U.C.C. § 1-205(2) (usage of trade is practice so regular that it justifies "expectation that it will be observed").

58. *Compare Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 344, 546 N.E.2d 904, 905, 547 N.Y.S.2d 611, 612 (1989) (sight review of all checks) with *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 186 (Tex. Ct. App. 1989) (no review of any checks).

59. U.C.C. § 1-205(2) (practice must have "such regularity of observance" that one is justified in expecting it will be observed).

such disclosure would encourage wrongdoing.⁶⁰ Consequently, customers lack actual knowledge, and cannot be presumed to know of the usage unless it has "general and universal application."⁶¹ Because there is no uniformity, the bank's practices are not usage of trade and cannot be incorporated into the contract. In contrast, a bank may be able to prove its practices come within the meaning of general banking usage under section 4-103 if it can present testimony from an expert witness or bank officers that only some other banks use comparable procedures.⁶² The bank is not required to relate bank practices to the customer's knowledge and to the standard for determining trade usage under section 1-205.⁶³

4. Ordinary Care within a Contract Cause of Action

Section 4-406 is remarkable because it allows negligence to be asserted as a defense in a contract action. The bank's lack of due care does not give rise to an independent negligence claim. Instead, the Code injects the tort concept of ordinary care into a cause of action in contract. The bank breaches its contract with the customer when it pays a check bearing a forged signature.⁶⁴ If the customer is negligent by failing to report forged signatures, however, the customer is "precluded" from asserting the unauthorized signatures against the bank that pays the check.⁶⁵ Section 4-406 is based on the theory of estoppel.⁶⁶ The term "precluded" is meant to "recognize the possibility of an estoppel" against a person whose negligence should prevent that person from contesting the validity of a signature.⁶⁷ The customer's negligence is not in the nature of an independent tort. Rather, the underlying theory is contract:⁶⁸ the customer's negligence precludes the customer from obtaining a judgment that the bank is liable for breach of contract; it allows the bank to escape contractual liability.⁶⁹

The bank's failure to exercise ordinary care must be seen as a loss of this defense.⁷⁰ Under section 4-406(3), if the bank fails to exercise ordinary care, the preclusion no longer applies.⁷¹ In other words, the customer is no longer estopped; he or she can assert the bank's negligence in bringing an action on the

60. Murray, Price v. Neal in the Electronic Age: An Empirical Survey, 87 BANKING L.J. 686, 692 (1970).

61. Heggblade-Marguleas-Tenneco, Inc. v. Sunshine Biscuit, 59 Cal. App. 3d 948, 957-58, 131 Cal. Rptr. 183, 189 (1976).

62. Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp., 848 F.2d 291, 294 (1st Cir. 1988).

63. Compare U.C.C. § 4-103 (requirement for general banking usage test) with U.C.C. § 1-205 (sets forth trade usage standard).

64. U.C.C. § 3-404(1); B. CLARK, *supra* note 31, ¶8.02, at 8-5.

65. U.C.C. § 4-406(2).

66. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 689 (3d ed. 1988).

67. U.C.C. § 3-404 comment 4.

68. R. H. Kimball, Inc. v. Rhode Island Hosp. Nat'l Bank, 72 R.I. 144, 153, 48 A.2d 420, 426 (1946).

69. Stella Flour & Feed Corp. v. National City Bank, 285 A.D. 182, 186, 136 N.Y.S.2d 139, 144 (N.Y. App. Div. 1954), *aff'd*, 308 N.Y. 1023, 127 N.E.2d 864 (1955).

70. *Id.*

71. *Id.*

contract against the bank for paying the check and debiting the customer's account.⁷² The bank's negligence does not give the depositor an independent cause of action in tort. Instead, the customer's complaint should be phrased in terms of the bank negligently performing its duties under its contract with the customer.⁷³

The conclusion that the bank's negligence is properly viewed within the context of a contract violation is also supported by the Code's measure of damages. Under section 4-103(5), the customer who proves that the bank failed to exercise ordinary care is entitled to the amount of the check reduced by the amount that the customer would have lost even if the bank had exercised ordinary care.⁷⁴ At least one court has ruled that the customer must show it suffered loss as a result of the bank's breach of contract, but the customer is not required to show proximate cause as would be necessary if the bank's negligence gave rise to an independent cause of action in tort.⁷⁵ Thus, if the Code intended the bank's negligence to give rise to an independent tort, the customer would have to prove proximate cause and section 4-103(5) would authorize traditional tort damages.⁷⁶

At first blush, it would seem that finding the bank negligent within the confines of the parties' contract strengthens the bank's position in regard to reviewing checks for forgeries. Under a contract analysis, the bank is protected from the greater damages a tort action could bring.⁷⁷ In addition, the Code shifts the burdens of proof to the customer in favor of the bank. Before the UCC was enacted, the law of many states placed the burden on the bank to prove it exercised ordinary care before it could assert the customer's negligence as an affirmative defense.⁷⁸ Under section 4-406(3), the burden is on the customer to prove that the bank did not exercise ordinary care.⁷⁹ The shifting of the burden, as well as the way in which the Code uses general banking usage to determine ordinary care,⁸⁰ indicates that the purpose of the Code was to favor the bank's

72. *Id.*

73. *H.B.A. Fur Corp. v. Manufacturers Hanover Trust Co.*, 38 U.C.C. Rep. Serv. (Callaghan) 955, 956 (N.Y. Sup. Ct. 1984). *See also* *R. H. Kimball, Inc. v. Rhode Island Hosp. Nat'l Bank*, 72 R.I. 144, 153, 48 A.2d 420, 426 (1946) (contract serves as basis of liability, not bank's negligence); *Penney, Bank Statements, Cancelled Checks and Article Four in the Electronic Age*, 65 MICH. L. REV. 1341, 1350 (1967) (bank's liability based on breach of contractual obligation to customer).

74. U.C.C. § 4-103(5).

75. *Isaac v. American Heritage Bank & Trust Co.*, 675 P.2d 742, 747 (Colo. 1984).

76. Note, *supra* note 24, at 525 n.92. Damages in tort are designed to put injured persons in as good a position as they were in prior to being injured. *Id.* Tort remedies include consequential damages for negligence. *Philippine Airlines v. McDonnell Douglas Corp.*, 189 Cal. App. 3d 234, 239-40, 234 Cal. Rptr. 423, 425 (1987). Under § 4-103(5), the customer can recover consequential damages only if the bank acted in bad faith.

77. Note, *supra* note 24, at 525 n.92.

78. *R. H. Kimball, Inc. v. Rhode Island Hosp. Nat'l Bank*, 72 R.I. 144, 153, 48 A.2d 420, 426 (1946).

79. U.C.C. § 4-406(3). *See supra* note 9 for the relevant text of this section.

80. *See supra* notes 43-49 and accompanying text for a discussion of conduct that is consistent with general bank practices and that constitutes ordinary care under the UCC.

interests over those of the customer.⁸¹ It would be consistent with this purpose to apply the ordinary care standard in a manner that permits banks maximum flexibility in establishing procedures to review checks for forged signatures.

The pre-Code case law, however, did not emasculate the customer's rights when it characterized these actions as based on contract. Courts stressed the "high standard of contractual responsibility" imposed on banks when paying their customers' money.⁸² The Rhode Island Supreme Court seemed to believe this contractual obligation imposed stricter requirements upon banks than the duty to exercise due care.⁸³

The UCC does not purport to undermine this fundamental contractual relationship between the parties and the pre-Code cases which gave meaning to that relationship. To the contrary, the Code affirms freedom of contract⁸⁴ and provides that, unless displaced by the UCC, non-UCC concepts, such as estoppel, supplement the provisions of the Code.⁸⁵ The challenge facing the courts is how to apply the tort concept of negligence in a way that is consistent with its confusing Code treatment, while at the same time preserving the integrity of the contractual relationship between the bank and customer.

E. The Parties' Contract and the Bank's Duty to Verify Signatures

Case law stresses the primacy of the contract between the bank and the customer, and suggests that the tort concept of ordinary care be given meaning, not as an independent tort, but within the context of that contract.⁸⁶ It is appropriate, therefore, for courts to determine the contractual terms relating to the bank's duty to review the customer's signature,⁸⁷ and then to attempt to apply

81. Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334, 361-62 (1952) (drafters "sold out" to bank lobby for support of Code); Gilmore, *supra* note 37, at 374-75 (1952) (bank counsel drafted Article 4 to favor banking interests); Leary & Schmitt, *Some Bad News and Some Good News From Articles Three and Four*, 43 OHIO ST. L.J. 611, 613-14 (1982) (banks played active role in creation of UCC).

82. *Stella Flour & Feed Corp. v. National City Bank*, 285 A.D. 182, 184, 136 N.Y.S.2d 139, 142 (N.Y. App. Div. 1954), *aff'd*, 308 N.Y. 1023, 127 N.E.2d 864 (1955).

83. *R. H. Kimball, Inc. v. Rhode Island Nat'l Bank*, 72 R.I. 144, 153, 48 A.2d 420, 426 (1946). The Kimball court stated:

[S]pecial burdens are placed upon the bank in that regard because of the nature of the relationship and its primary duty under the contract. That contractual obligation is not to be confused with or transformed into a duty *merely* to use due care, or to be completely nullified by modifications.

Id. (emphasis added).

84. U.C.C. §§ 1-102(3) (parties may vary most provisions and standards by agreement); 4-103(1) (same).

85. U.C.C. § 1-103.

86. See *supra* notes 16-23 and accompanying text for a discussion of the contractual nature of the bank-customer relationship. See also *supra* notes 64-76 and accompanying text for a discussion of the contractual basis for the customer's cause of action where the bank fails to exercise ordinary care.

87. See generally J. VERGARI, *COMPUTERIZED PAYMENT OPERATIONS LAW* 113 (1989) (contract between bank and customer more important than ever in computerized check processing system).

the ordinary care standard in a manner that is both consistent with a contractual analysis and UCC section 4-103(3). Unfortunately, in a typical case, the court may have great difficulty construing the parties' contract.

Examination of the terms of a contract begins with the writing itself. However, most contracts governing checking accounts do not contain provisions specifically related to the bank's duty in regard to signature verification.⁸⁸ Nevertheless, the court should peruse the parties' written documents because they may spell out the bank's duty. But even if they do, the court cannot stop there, because the Code sets certain restrictions on the freedom of the parties to establish the bank's responsibilities.⁸⁹ Consequently, the provisions of the contract may not be enforceable.

If the parties' writings say nothing about signature verification, the court can look to the UCC for guidance on how to treat a contract that omits an important term. The contract is the "legal obligation which results from the parties' agreement."⁹⁰ The agreement consists of "the bargain of the parties in fact as found in their language or by implication from other circumstances including . . . usage of trade."⁹¹ Although contracts between banks and customers typically do not contain a specific provision relating to the bank's signature review procedure, the presence of the signature card, which constitutes one portion of the parties' contract, may constitute "other circumstances" from which a court could determine the parties' bargain in fact.⁹² Further, it is reasonable to assume that bank customers believe that the signature card is intended as a handwriting exemplar to be used by the bank to verify whether the signature on a check corresponds to the customer's signature.⁹³ This expectation is sup-

88. Cases in which signature verification was at issue do not mention any contract provisions pertaining to signature verification. See, e.g., *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 293 (1st Cir. 1988) (reasonable commercial standards are equivalent to ordinary care); *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 128, 552 N.E.2d 783, 787 (1990) (ordinary care standard applies); *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 346, 546 N.E.2d 904, 906, 547 N.Y.S.2d 611, 613 (1989) (customer must establish that bank acted without ordinary care); *Medford Irrigation District v. Western Bank*, 66 Or. App. 589, 591, 676 P.2d 329, 331 (1984) (reasonable commercial standards apply). Examples of deposit agreements and signature cards, none of which contains language relating to signature verification, may be found in 2 J. KUSNET & J. ANTROPOL, *MODERN BANKING FORMS* 8-10 to 8-13 (3d ed. 1981); T. QUINN & R. QUINN, *MODERN BANKING FORMS* 301-06 (1969); R. SPEIDEL, R. SUMMERS & J. WHITE, *supra* note 18, at 365-70; J. WHITE & R. SUMMERS, *supra* note 66, at 752 n.1, 753 n.2.

89. U.C.C. § 4-103(1). See *infra* note 100 and accompanying text for a discussion of U.C.C. § 4-103(1), as well as the prohibition against an agreement by which the bank may disclaim responsibility or limit damages for its negligence.

90. U.C.C. § 1-201(11).

91. U.C.C. § 1-201(3). 2 RESTATEMENT, *supra* note 37, § 204 provides that when the parties have not agreed with respect to an essential term, the court may supply a term that "is reasonable in the circumstances." Comment d accompanying § 204 further elucidates the standard by suggesting that the court supply a term that "comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process." *Id.* comment d.

92. See *supra* note 18 and accompanying text for a discussion of the means by which the contract terms are derived from various sources, including the signature card.

93. *Perdue v. Crocker Nat'l Bank*, 38 Cal. 3d 913, 922, 928, 702 P.2d 503, 509, 513, 216 Cal. Rptr. 345, 351, 355 (1985), *appeal dismissed*, 475 U.S. 1001 (1986).

ported by empirical evidence: a 1986 study conducted by the American Bankers Association found that 24% of the 3,400 banks surveyed with assets between \$100 million and \$500 million verified signatures on all checks before payment.⁹⁴

Do the customer's expectations concerning the meaning of the signature card become part of the parties' bargain, resulting in a bank's duty to verify signatures? Customers can argue that the meaning they attached to the signature card represents the public's common understanding of the function of the card. The bank may counter that it had no reason to know that the signature card would have that meaning to the customer. If the customer is a business, the bank can argue that it was reasonable for the bank to believe a business would be sophisticated enough to know that not all banks verify signatures. Contract law has developed doctrines addressing differing expectations of the parties. According to the Restatement (Second) of Contracts, if the customer had no reason to know the bank was attaching a meaning different from the customer's, and if the bank had reason to know the customer thought the signature card meant the bank would verify customer signatures, the contract should be interpreted in accordance with the customer's meaning.⁹⁵

Customers can claim that they never would have entered into the checking account agreement if they had realized it did not require the bank to examine signatures and that the bank would hold the customer responsible for losses if the customer did not promptly report forgeries. They can point to the structure of the UCC, which generally protects the customer and places the loss upon the bank if it pays a check with a forged signature.⁹⁶ They can contend that a primary reason for having a checking account, as opposed to using other methods of transferring money, is to obtain protection from the unauthorized use of their funds, and that a contract that is interpreted to free the bank from the duty to verify signatures is contrary to their expectations.

The bank can argue that it had no reason to believe the customer would have refused to sign the card if it had known the bank did not engage in signature verification. Moreover, the UCC does not protect the customer from all forgeries. If the customer is negligent within the terms of section 3-406 or 4-406(2), the loss falls on the customer, unless the bank also neglected to meet Code standards. Therefore, it is not reasonable for customers to regard such protection as the dominant purpose of a checking account.

Courts may be expected to shy away from determining the bank's duty to verify signatures on the basis of the above arguments because any determination requires the court to engage in such imponderables as deducing the common understanding of customers as to the function of the signature card. Further-

94. AMERICAN BANKERS ASSOCIATION, NATIONAL OPERATIONS/AUTOMATION SURVEY 1986, 119 Table 35E (1987) [hereinafter SURVEY] (many banks require handwriting exemplars for purposes of verifying signatures). See also Murray, *supra* note 60, at 700-01 (84 of 91 banks surveyed compare check signatures with signature card).

95. 2 RESTATEMENT, *supra* note 37, § 201(2)(b).

96. See *supra* notes 11-14 and accompanying text for a discussion of the bank's strict liability for forged checks.

more, these arguments force the court to conduct a subjective evaluation of what was in the minds of each customer when he or she signed the card and what the bank had reason to know.⁹⁷

Even if courts were to engage in a traditional contract analysis, however, barriers would remain to frustrate attempts to give meaning to the term "ordinary care." Assuming a court agreed with the customer's contentions, it must then determine how the bank can perform its contractual duty to verify signatures. At one extreme, the court could decide the contract requires the bank to engage in sight review of every check or bear the loss. At the other extreme, the court could decide the bank's contractual obligation is merely to verify signatures in over-the-counter transactions. The basic problem is that the rules for interpreting the impact of the signature card on the bank's contractual obligations do not provide sufficient guidance as to the meaning of ordinary care.⁹⁸

In addition, determining the bank's duty by focusing on each party's intentions, expectations, and the knowledge of the other party's expectations is inconsistent with the approach taken in section 4-103(3) and its accompanying comment. That section and its comment ignore contractual analysis and instead direct the court's attention to the bank's practices *vis-a-vis* other banks. Section 4-103(3) could be read as telling courts that if the parties have not clearly spelled out the bank's duties, courts should not read things into their agreement.⁹⁹

Banks could strengthen their position by the careful drafting of their contracts with customers. The agreement, for example, might provide that the bank has no duty to engage in sight review of all checks, or specify that the parties agree that the bank's practice of examining only those checks above a certain amount, to be determined by the bank, constitutes the exercise of ordinary care. The difficulty with this tactic is that the UCC provides that "no agreement can disclaim a bank's responsibility for its . . . failure to exercise ordinary care or can limit the measure of damages for such . . . failure."¹⁰⁰ The validity of such contractual terms, therefore, again depends upon what constitutes ordinary care. Unless courts determine what ordinary care requires, it is impossible to know if such contract provisions amount to a disclaimer of ordinary care.

This examination of the UCC's scheme of loss allocation demonstrates that the Code does a poor job of providing courts with guidance on how to determine what constitutes ordinary care in regard to signature verification under section

97. See generally G. GILMORE, *THE DEATH OF CONTRACT* 42 (1974) (if court uses parties' intentions and beliefs to construe contract, it must engage in thorough examination of facts).

98. U.C.C. § 1-201(3) provides another potential basis for determining the parties' bargain by stating that conduct that conforms to the "usage of the trade" constitutes an implied term of the contract where the contract is silent. *Id.* The concept of trade usage, however, does not substantially assist courts in deciding banks' duties in regard to signature verification. See *supra* notes 58-61 and accompanying text for a discussion of the difficulty in applying trade usage because of the varied bank practices in connection with signature verification.

99. U.C.C. § 4-103(3). Section 4-103(3) currently provides in pertinent part: "(3) Action or non-action approved by this Article . . . constitutes the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent with . . . a general banking usage not disapproved by this Article, prima facie constitutes the exercise of ordinary care."

100. U.C.C. § 4-103(1).

4-406(3). Examination of a proposed framework adapted from the field of economics will provide useful insights for a consideration of how courts confronted with section 4-406(3) disputes have interpreted and applied the Code, and for evaluating the revised UCC.

II. AN ECONOMIC THEORY OF LOSS ALLOCATION

Professors Cooter and Rubin have formulated a "modified economic analysis"¹⁰¹ that provides a useful additional perspective on the issues raised by section 4-406(3).¹⁰² Cooter and Rubin posit three operative principles—loss spreading, loss reduction, and loss imposition—and derive from them generally applicable rules.¹⁰³ Examination of these principles suggests that the UCC does not take into account all relevant factors in assigning liability for losses associated with improperly negotiated checks. The construction of viable legal rules, however, does not follow easily or ineluctably from an application of these principles.

A. The Loss Spreading Principle

According to the loss spreading principle, loss should be imposed upon the party that can bear the risk at the lowest cost.¹⁰⁴ Ability to bear the risk depends on the relative size of the loss—whether it is small or large in proportion to the party's total wealth, and whether that party can spread the loss by charging its customers a little more and still remain competitive.

No general rule of loss allocation can be derived from this principle. If the customer is a large corporation and the bank is small, as are many credit unions, or in a weak financial condition, as are many thrifts, or in a highly competitive market, the business customer may be better able to bear the risk. If the customer is a small business in a highly competitive market, however, the bank may be better able to bear the risk. Only if the customer is an individual consumer does this principle suggest a consistent answer. For individual consumers, the size of the loss is generally a much larger proportion of their wealth and they cannot spread the loss.¹⁰⁵ Also, if courts tried to apply the loss-spreading principle to business customers, they would have to engage in extensive fact-finding, such as examining financial statements, exploring the cost and availability of insurance, and determining the competitiveness of the customer's market as compared to the bank's. Inevitably, there would be close cases where, for exam-

101. Cooter & Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63, 66 (1987).

102. Although the Cooter-Rubin discussion is confined to transactions between consumers and banks, it provides a framework that may apply equally well to any customer lacking the bargaining power to protect itself through contract negotiations with the bank. *Id.* at 69 n.35. Individual customers and small businesses suffer from the same disproportionate negotiation costs and asymmetrical access to information. *Id.* at 69.

103. See *infra* notes 104-73 and accompanying text for a discussion of the rules developed within the Cooter-Rubin system of loss treatment.

104. Cooter & Rubin, *supra* note 101, at 71.

105. *Id.* at 72.

ple, both the customer and the bank are equally capable of bearing the loss. Banks and customers need a principle that results in a rule that is far more uniform and certain.

B. The Loss Reduction Principle

One objective of the law should be to prevent injury from occurring in the first place. The loss reduction principle seeks to accomplish this by assigning liability to the party who can reduce losses at the lowest cost.¹⁰⁶ According to Cooter and Rubin, this principle consists of four elements: precaution, technological innovation, responsiveness, and learning.¹⁰⁷

1. Taking Precautions

In analyzing the loss reduction principle, an initial consideration is which party can take precautions against the loss at the lowest cost.¹⁰⁸ This element is often considered by the courts.¹⁰⁹ In many cases, the customer can take precautions at the lowest cost. The customer has far fewer checks to review than the bank, and the customer knows its signature far better than does the bank. Business customers can greatly reduce the probability of forged customer signatures by having different employees prepare checks and reconcile the monthly statement.¹¹⁰ To prevent employees from conspiring to defraud the company, the company could institute random inspection of the books by one of the officers or occasional surprise visits by outside accountants.¹¹¹ A legal rule that provides incentives for careful review of the monthly statement results in better overall business practices.¹¹² Companies should review their statements for possible bank errors and check alterations in addition to possible forgeries.

Adopting precautionary procedures can be very costly for small businesses, however. Often the same person prepares the checks and reconciles the monthly statement because the business can afford to have only one person handling the bookkeeping.¹¹³ Time spent by the employer supervising the bookkeeper's work

106. *Id.* at 73.

107. *Id.*

108. *Id.* at 74.

109. *See, e.g.,* Sun Bank/Miami, N.A. v. First Nat'l Bank, 698 F. Supp. 1298, 1304 (D. Md. 1988) (UCC increases banking efficiency by placing burden on bank as party best situated to prevent fraud); Northpark Nat'l Bank v. Bankers Trust Co., 572 F. Supp. 524, 535 (S.D.N.Y. 1983) (UCC policy places fraud losses on party in best position to prevent them).

110. J. WILLINGHAM & D. CARMICHAEL, AUDITING CONCEPTS AND METHODS 217 (2d ed. 1975) (one person should not handle every aspect of transaction).

111. *See, e.g.,* Brief of Defendant-Respondent at 4, Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust, 74 N.Y.2d 340, 546 N.E.2d 940, 547 N.Y.S.2d 611 (1989) (No. 2290-86) (independent accountants inspected books on unscheduled basis).

112. J. WILLINGHAM & D. CARMICHAEL, *supra* note 110, at 216-17 (sound internal control procedures require segregation of duties).

113. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS 65 (1984) [hereinafter CODIFICATION OF STATEMENTS] (business not expected to adopt method of internal control methods costing more than anticipated benefits).

is time away from purchasing, producing, and selling. The huge number of small businesses that fail each year is an indication of the great demands on the time of managers, as well as small profit margins, and fierce competition.¹¹⁴

Upon initial consideration, it seems fair to impose liability on individual consumers since they are subject to lower costs when they take precautions. As a practical matter, however, it appears that many consumers do not reconcile their bank statements.¹¹⁵ We could conclude that the law should not adopt a paternalistic approach when it results in increased bank costs that are then passed on to even conscientious consumers.¹¹⁶ It is not quite that simple, however. Even if we ignore the difficulties faced by those who are unable to monitor satisfactorily their accounts, including, for example, those with limited math and reading skills, modern technological advances have made the task of reconciling statements much more difficult than it used to be. For example, if the consumer has electronic fund transfer services such as direct deposit and preauthorized bill paying, the statement will contain far more data than the statement of yesteryear.¹¹⁷

Even more problematic is the plight of the consumer whose checks are truncated.¹¹⁸ Truncation is the check processing system in which the customer does not receive cancelled checks with the bank statement. Instead, the checks or copies of them are retained by the customer's bank, the depository bank, or another bank or check servicing center. All federal credit union checks are truncated,¹¹⁹ and an increasing number of customers at thrifts and commercial banks also are agreeing to participate in this system.¹²⁰ The consumer with a truncated account never receives cancelled checks. He or she must examine the statement for discrepancies between it and the checkbook stub and carbonless copies of the checks written that month. Moreover, the customer still will not know if any discrepancy was caused by a forged customer's signature. That cannot be ascertained until the customer obtains a copy of the check from the bank. Because the bank may not have its own copy, it may have to obtain a copy from

114. *Bankruptcy Cases Up 33% for N. Georgia during 3rd Quarter*, Atlanta Const., Oct. 21, 1989, at E1, col. 5 (business bankruptcy filings in northern Georgia increased 70% over previous year).

115. See Mallory, *Many Can't Perform Checkbook-Balancing Act*, Atlanta J. & Const., Jan. 8, 1990, at C1, col. 3 (banker estimates 50% of customer bank statements never opened).

116. See McDonnell, *supra* note 11, at 1433 (paternalistic view advocates that all customers pay more rather than placing full cost of fraud on victim).

117. 12 C.F.R. § 205.9(b) (1990). See also D. BAKER & R. BRANDEL, *THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS* ¶4.05[4], at 4-10 to 4-11 (2d ed. 1988) (federal regulation requires information regarding preauthorized payments to be included in periodic statement).

118. D. BAKER & R. BRANDEL, *supra* note 117, ¶2.02[2][1], at 2-13.

119. Rubin, *supra* note 1, at 633.

120. D. BAKER & R. BRANDEL, *supra* note 117, ¶ 2.02[2][a]-[b], at 2-14 to 2-21 (truncation is clearly wave of future as demonstrated by increased use by financial institutions); B. CLARK, *supra* note 31, ¶ 12.02[1], at 12-3 (same). It is unclear whether truncated checks are governed by U.C.C. § 4-406. See *Florida Fed. Sav. & Loan v. Martin*, 400 So. 2d 151 (Fla. Dist. Ct. App. 1981) (bank defense under U.C.C. § 4-406 unavailable when checks not dispatched for customer inspection); B. CLARK, *supra* note 31, ¶ 12.02[2], at 12-3 to 12-5 (effect of widespread check truncation practice uncertain).

whomever is storing the check.¹²¹ While section 4-406 requires the customer to report unauthorized signatures promptly,¹²² presumably courts will find that customers meet that requirement if the customer promptly notifies the bank that something is wrong, even if it will be impossible to know the cause of the problem until the cancelled checks are retrieved.

While a strong argument can be made that even customers whose checks are truncated can take precautions at a lower cost than banks, recent technological developments may alter that assessment. A "static signature verification" system that uses electronic equipment to discover discrepancies between the customer's signature on file and signatures on the customer's checks presently is being marketed to banks.¹²³ If the system is available at a reasonable price, the bank may become the party that can take precautions at a lower overall cost. Under the Code, when the customer reports forgeries promptly, the bank is liable for those checks it pays.¹²⁴ Even if the customer is negligent in failing to report forged signatures promptly, the bank is liable for the first check.¹²⁵ The static signature verification system would enable the bank to identify those forgeries for which it would be responsible in any event. Presumably, the bank would alert its customer who would take steps to prevent further forgeries. The amount banks might save by employing this "early warning system" could be greater than the cost of the equipment.

Cooter and Rubin recognize that in some situations both parties can take precautions.¹²⁶ For example, in some section 4-406 scenarios, the customer can take the precaution of reviewing cancelled checks, and the bank can verify the customer's signature by comparing it to the signature card. Where both can take precautions, Cooter and Rubin recommend that the law adopt a standard that will motivate both parties to do so.¹²⁷ Contributory and comparative negligence are appropriate legal doctrines to accomplish this. While some lower courts have found comparative negligence to be the correct solution, this approach is not in the UCC, and has been rejected by courts that have found it is inconsistent with the Code's provisions.¹²⁸

2. Technological Innovation

The goal of the second element of the loss reduction principle is to allocate

121. See D. BAKER & R. BRANDEL, *supra* note 117, ¶ 2.02[2][b], at 2-20 to 2-21 (transfer of information from "keeper" institution to "payor" institution can be accomplished via automated clearinghouse).

122. U.C.C. § 4-406(1).

123. Kutler, *Enhanced Static System Uses Less Computer Power*, Am. Banker, May 25, 1988, at 6, col. 1.

124. U.C.C. § 4-406(1).

125. U.C.C. § 4-406(2). See *supra* note 31 and accompanying text for a discussion of the requirement that the bank recredit a customer's account for the first check in a series of forgeries.

126. See generally Cooter & Rubin, *supra* note 101.

127. *Id.* at 90.

128. Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co., 74 N.Y.2d 340, 348, 546 N.E.2d 904, 908, 547 N.Y.S.2d 611, 615 (1989) (trial court erred by importing comparative negligence concepts into the UCC).

liability in a manner that creates an incentive for developing innovations "that reduce both the cost of precaution and the frequency of losses."¹²⁹ Therefore, liability should be imposed upon the party "most likely to develop innovative methods of precaution."¹³⁰ The most promising innovation in the area of forged signatures is the "static signature verification device."¹³¹ To use these machines, banks obtain several signature samples from each authorized check signatory. A computer analyzes several characteristics of each person's signature.¹³² When the customer's checks are returned to the bank for processing, the device scans for signatures that do not match the characteristics obtained from the samples. Detection of the forgery by scanning is less likely if the forgery closely resembles the authorized signature.¹³³

The existence of static signature verification equipment presents an attractive solution to the loss allocation problem. Banks contend that they should not have to verify signatures because such a slow, labor-intensive, and expensive process eviscerates the gains made by high-speed check processing technology.¹³⁴ Computer signature verification offers the possibility that banks will be able to examine signatures for forgeries far more efficiently. This technology would result in overall loss reduction because banks would be able to spot forgeries soon after the wrongdoer begins his or her thefts.¹³⁵ Consequently, courts and legislatures may be tempted to define ordinary care as requiring banks to use state of the art technology, such as signature verification equipment.

Adopting a state of the art standard of ordinary care, however, creates several problems. Unless these machines are relatively inexpensive, smaller or financially-strapped banks may be unable to purchase the equipment at a price that is reasonable in proportion to the size of their overall check processing operation. Wealthier banks would be advantaged. By proving in court that they used the equipment, these banks could easily make out a *prima facie* case of ordinary care.¹³⁶ Banks that could not afford the equipment would have a more difficult time proving that their practices met the standard.¹³⁷

129. Cooter & Rubin, *supra* note 101, at 75.

130. *Id.*

131. Kutler, *supra* note 123, at 6, col. 1.

132. Bradshaw, *Signature Scanner To Be Launched in US*, Financial Times, Sept. 28, 1988, § I, at 11.

133. *Signature Verification System*, ABA BANKING J., July 1988, at 85.

134. American Bankers Association Brief as Amicus Curiae at 9-10, *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 552 N.E.2d 783 (1990) (No. 67709). See generally SURVEY, *supra* note 94, at 15-16.

135. In most reported cases involving forged signatures, a bookkeeper writes many checks with forged signatures over a long period of time for small amounts in order to escape detection. See, e.g., *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 552 N.E.2d 783, 784 (1990) (42 forged checks negotiated over six month period, all for less than \$1,000); Brief for Appellee at 3-4, *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291 (1st Cir. 1988) (No. 87-1890) (224 forged checks negotiated over four month period, all for \$800 or less); Murray, *supra* note 60, at 711 (average forgery claim of \$223 over 41 banks).

136. U.C.C. § 4-103(3). See *supra* note 99 for the relevant text of this section.

137. But see generally SURVEY, *supra* note 94, at 16, 112 Table 1E (13.9% of banks with assets under \$100 million use service companies to process their checks). These service companies may be

Another foreseeable problem in equating "ordinary care" with "state of the art" is the rapidity of technological progress. Assume affordable signature verification devices are available and virtually every bank buys them. A few years later more sophisticated machines with significantly greater accuracy are developed, but are much more expensive. To meet a state of the art ordinary care standard, would banks have to purchase the new equipment without regard to cost?

A third problem that arises from equating ordinary care with state of the art is availability. If a court were to rule that henceforth banks in its jurisdiction would be subject to a state of the art ordinary care standard, would banks immediately have to purchase the machines? Would sufficient numbers of them be available shortly after the ruling?

A major concern of banks might be whether employment of the equipment would slow check processing. Under the Expedited Funds Availability Act,¹³⁸ banks are required to make funds available to customers promptly after they deposit checks.¹³⁹ As a consequence, banks are under tremendous pressure to process checks speedily to stay within the guidelines set by the statute and the regulations issued by the Federal Reserve Board.¹⁴⁰ The demand for speed is related to another issue: to comply with a state of the art ordinary care standard, would banks have to use the device to scan every check, or could they employ procedures already used by many banks, in which they review the signatures of all checks drawn for a large amount, randomly review checks in an intermediate range, but don't examine small checks at all?¹⁴¹ If banks could meet the ordinary care standard by using the verification device to examine only the relatively small number of checks drawn for large amounts that are subjected to their present procedures, many of their concerns might be satisfied. This approach would have little effect in detecting forgeries, however, because most checks with forged signatures are drawn for small amounts.¹⁴²

Loss allocation rules that encourage banks to take advantage of technological innovations seem both to protect customers and provide banks with an alternative to reverting to outmoded human sight review or facing liability. The development of signature verification machines, however, illustrates that this solution raises possible problems for banks.

3. Responsiveness and Learning

The third and fourth principles of the loss reduction theory are responsiveness and learning. The loss reduction principle can be justified only to the extent that it actually influences the parties' conduct. A loss allocation rule that en-

able to take advantage of economies of scale to purchase advanced technology and charge banks an affordable fee. Therefore, cost may not, in fact, be a major impediment for the many small banks that contract with a service company to process the banks' checks.

138. 12 U.S.C. §§ 4001-4010 (Supp. I 1989).

139. *Id.* § 4002.

140. 12 C.F.R. pt. 229 (1990).

141. SURVEY, *supra* note 94, at 119 Table 36E.

142. See generally *supra* note 135 (most cases involve checks in small amounts).

courages the taking of precautions and the development and adoption of innovative technology must be designed to ensure that the party who can undertake these measures at the lowest cost responds to the rule's incentives.¹⁴³ Further, only to the extent that the parties learn of the rules governing loss allocation will they be responsive to those rules.¹⁴⁴

Because the UCC does not provide specific guidance on what a bank must do in regard to signature verification in order to exercise ordinary care as required by section 4-406(3), it is difficult for both banks and customers to have adequate knowledge of the rules of loss allocation. Unless courts in the bank's jurisdiction have decided the issue, reference to case law will provide little assistance, since the courts have taken such a wide variety of positions.¹⁴⁵

If the courts in a bank's jurisdiction have articulated clearly what a bank must do to exercise ordinary care, knowledge of this standard of conduct may still vary with the type of party. Banks and large companies employing well-trained and highly educated financial officers with access to in-house or outside counsel should have little difficulty understanding and complying with the bank's duty. Small companies are more likely to be less knowledgeable. Their financial employees often are bookkeepers; attorneys are consulted on an ad hoc basis only when a problem arises. Since the current version of the UCC does not define the bank's duty beyond stating that the bank must exercise ordinary care,¹⁴⁶ a business would have to hire an attorney to conduct research into the case law to determine how much risk it was taking in not carefully supervising the person or persons who prepare the checks and reconcile the statement. Unless there was a case decided in the company's jurisdiction, the attorney could do little more than guess at what the bank's duty might be, given the variety of stances taken by the courts.

Silence in the UCC, coupled with the lack of clear answers in the case law, and the lay person's general lack of access to statutory and case law, results in little knowledge among consumers of the bank's duty in regard to signature verification under section 4-406(3). Adding to the consumer's ignorance of the law is the confusion generated by the bank's requirement of a signature affixed to a signature card accompanied by a deposit agreement that says nothing about the function of the card.¹⁴⁷ Consumers may reasonably assume that the inclusion of the signature card means the bank engages in some form of signature verification.

143. Cooter & Rubin, *supra* note 101, at 75.

144. *Id.* at 76.

145. See *infra* notes 195-286 and accompanying text for a discussion of the varied approaches adopted by courts. These approaches include requiring banks to establish a procedure designed to detect forgeries or requiring only that a bank's procedure is comparable to those of other banks. If the highest court in the jurisdiction has decided merely that ordinary care is a question for the factfinder, the parties' knowledge will remain inadequate.

146. U.C.C. § 4-406(2)-(3). See *supra* note 9 for the relevant text of these two sections.

147. See *supra* note 88 and accompanying text for a discussion of the problem arising from the fact that most checking account contracts are silent on the matter of the bank's duty to verify signatures.

The ability of a party to respond to the UCC's system of loss allocation is limited by the party's knowledge of that system. Because small businesses and individual consumers may have limited knowledge, the Code's rules and the interpretation of them by the courts probably have little or no effect on the behavior of these customers. One way to overcome this difficulty is to clarify the bank's duty by spelling it out in the Code. Banks could be required to inform customers of their responsibilities and of the customers' need to take precautions to avoid liability. Customers may not understand the message of the disclosure, however, unless it is given in a conspicuous fashion and in plain English.¹⁴⁸ Even then, consumers in particular may not respond to this notice because of "information overload."¹⁴⁹ Without disclosure, however, it is unreasonable to expect consumers to acquire information about the Code's rules.

Even if a party has the requisite knowledge, he or she may not respond by taking precautions or adopting innovative technology. Whether banks respond to a court's definition of ordinary care, which requires the bank to adopt a rigorous procedure of signature verification, depends upon whether the bank predicts the cost of taking precautions such as sight review or buying state of the art equipment is greater than the loss it would suffer if it were found liable. The bank's ability to spread losses to others should be part of the calculation as well.

Even if courts define ordinary care to mean that a bank can behave however it wants, as long as its conduct conforms to that of other banks,¹⁵⁰ and customers are aware of these rulings, if customers fail to report forged signatures promptly, it will be nearly impossible to shift liability back to the bank under section 4-406(3). Customers' responsiveness to this loss allocation rule likely will vary. Larger companies might respond by having different persons prepare checks and reconcile the statement. Companies required to file reports with the Securities and Exchange Commission should adopt procedures such as this at any rate to be in compliance with the Exchange Act.¹⁵¹ Smaller companies may not respond, however, because the cost may be too high,¹⁵² and they may predict their risk is low. Individual consumers may not respond to a loss allocation rule that puts a premium on their ability to reconcile bank statements because of deficiencies in math or language skills.¹⁵³ In light of the time and effort required to acquire those skills and an individual's calculation of the risk, he or she may not believe it is worthwhile to respond. Consumers faced with statements littered with data related to noncheck transactions and those whose checks are

148. See generally Davis, *Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer Credit Contracts*, 63 VA. L. REV. 841, 850-56 (1977) (lack of readability, coupled with conceptual difficulty, impact negatively on consumer comprehension).

149. *Id.* at 847-50.

150. See *supra* notes 38-45 and accompanying text for a discussion of conduct deemed to be consistent with general banking usage and the exercise of ordinary care.

151. 15 U.S.C. § 78m(b)(2) (1988).

152. See *infra* note 182 and accompanying text for a discussion of how small companies, including nonprofit institutions, depend upon volunteers to handle accounting procedures.

153. See *supra* note 117 and accompanying text for a discussion of the increasing complexity of modern bank statements.

truncated may also decide it is not worth their time to be responsive to legal rules on loss allocation.¹⁵⁴

The loss reduction principle seeks to assign liability in a way that encourages conduct designed to minimize economic injury. Achieving this worthy goal, however, is elusive because application of the principle does not place the loss consistently on either the customer or the bank. The party to bear the loss is dependent upon whether the focus is on taking precautions, on adopting innovative technology, on obtaining knowledge of the law or on being responsive to the rules of loss allocation. Individual characteristics of the bank and the customer should also effect who bears the loss.

C. The Loss Imposition Principle

The objective of the loss imposition principle is to make enforcement of the liability assigned by the law as efficient as possible.¹⁵⁵ Efficiency can be achieved by fashioning rules that allow the party suffering the loss to bring a lawsuit at a cost that is low enough to make litigation feasible. The first way to achieve this result is to establish rules that prevent the filing of lawsuits the plaintiff is likely to lose. Second, plaintiffs filing meritorious lawsuits need rules to resolve issues as simply and quickly as possible. Otherwise, unless the loss is very large, the cost of litigation and the risk of not obtaining a judgment or favorable settlement make it irrational to sue. The type of rules that achieve these objectives are those that are "simple, clear and decisive."¹⁵⁶ Examples of such rules are: "strict liability rather than fault-based liability, single factor standards rather than multiple factor standards, [and] objective rather than subjective tests. . . ."¹⁵⁷

The UCC scheme for allocating loss due to forged signatures generally conforms to this model. The bank is strictly liable for paying a check bearing a forged signature.¹⁵⁸ A *per se* negligence standard attaches to customers who fail to report checks with unauthorized signatures soon after they receive their bank statement.¹⁵⁹ The duty of ordinary care imposed on banks pursuant to section 4-406(3), however, violates the loss imposition principle. Although the UCC allocates the loss to the bank if the bank fails to exercise ordinary care, the loss initially is always on the customer because the bank has paid the check and charged the customer's account. A lawsuit is therefore required to put the ultimate loss on the party whom the Code designates as the appropriate one to bear it, unless the bank agrees to recredit the customer's account. Not only is the burden on the customer to file a lawsuit, but the burden is also on the customer

154. See *supra* notes 118-22 and accompanying text for a discussion of the meaning and ramifications of the truncated account.

155. Cooter & Rubin, *supra* note 101, at 78.

156. *Id.*

157. *Id.*

158. See *supra* note 11 and accompanying text stating that the UCC allows the bank to pay only checks that are properly payable.

159. U.C.C. § 4-406(1)-(2). See *supra* note 9 for the relevant text of these two sections.

to establish the bank's lack of ordinary care.¹⁶⁰ The customer appears to be the logical party to have this burden because ordinarily it will be the plaintiff in the lawsuit.

The scheme described above, though rational, is contrary to the objectives of the loss imposition principle. The ordinary care standard, unlike strict liability, is based on fault. It is not a "simple, clear and decisive" standard since it requires a fact-intensive inquiry. Not only is the burden on the customer, but that burden is to prove something that is within the exclusive knowledge of the bank. When a bank pays checks containing forged signatures and the customer fails to report promptly, the customer has no way to know whether it can bring a successful lawsuit against the bank under section 4-406(3). Unless the bank voluntarily discloses its signature verification procedures, the customer is forced to file a lawsuit and engage in discovery to learn the bank's practices.¹⁶¹ It is only after the customer has this information that it can evaluate the merits of its lawsuit. Thus, the UCC's scheme does not prevent the plaintiff from filing lawsuits it is likely to lose.

Furthermore, the UCC's scheme does not lend itself to simple and quick resolution of the issues. In addition to the need to engage in discovery, the customer probably will need expert testimony. Under section 4-103(3), "action or non-action consistent with general banking usage . . . prima facie constitutes the exercise of ordinary care."¹⁶² Once the bank offers proof that its signature verification practices are similar to those of other banks,¹⁶³ the customer must prove either that the bank's practices are not similar to those of other banks, or that the practices of the banks are "unreasonable, arbitrary or unfair."¹⁶⁴ It is difficult to imagine customers overcoming the bank's *prima facie* case without expert testimony, unless a court is willing to rule that a bank's practice constitutes a lack of ordinary care as a matter of law, an issue on which the courts are divided.¹⁶⁵

Because the UCC requires customers to engage in expensive litigation to shift the loss to the bank, rational customers will not litigate these cases unless a substantial amount of money is at stake.¹⁶⁶ The practical effect of the UCC

160. U.C.C. § 4-406(3). See *supra* note 9 for the relevant text of this section.

161. See, e.g., Appellant's Brief and Abstract of Record at A-12, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. A-26603) (alternative methods of reviewing drawer's signature must meet standard of ordinary care).

162. U.C.C. § 4-103(3).

163. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 347, 546 N.E.2d 904, 907, 547 N.Y.S.2d 611, 614 (1989) (section 4-103(3) does not specify who has burden of proving general banking usage; at least one court has held this burden is on bank).

164. U.C.C. § 4-103 comment 4. See also *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 189 (Tex. Ct. App. 1989) (burden of proof on depositor when credit union shows compliance with industry standards) (citing *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 294 (1st Cir. 1988)).

165. Compare *McDowell*, 772 S.W.2d at 191 (court held bank failed to exercise ordinary care as matter of law) with *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 131, 552 N.E.2d 783, 787 (1990) (court declined to rule that bank failed to exercise ordinary care as matter of law).

166. Cooter & Rubin, *supra* note 101, at 79-80; Dow & Ellis, *The Proposed Uniform New Pay-*

scheme is that, regardless of the explicit rules on loss allocation, the loss remains on the customer unless the total amount of the loss exceeds the transaction costs of litigation by a sum large enough to make it worth the cost, time, and effort required to litigate. This means individual consumers will bear the loss in almost all cases,¹⁶⁷ and business customers will bear the loss in all cases in which the wrongdoer, through fear or discretion, has kept the amount of theft small enough to make it infeasible for the customer to sue the bank. While this will be a manageable loss to bear for some businesses, it may be an onerous burden for many other small businesses.

Although the UCC's use of an ordinary care standard violates the loss imposition principle, it remedies one of its disadvantages. While a rule of strict liability would be consistent with the loss imposition principle and would result in greater certainty and less costly litigation, it also would remove the element of flexibility.¹⁶⁸ Flexibility enables the courts to apply legal standards to changing commercial practices in a reasonable fashion.¹⁶⁹ The Code's nebulous ordinary care standard permits flexibility. In addition, the ordinary care standard is consistent with the precaution element of the loss reduction principle.¹⁷⁰ Assigning liability to provide incentives for parties to take precautions typically involves considering who is regarded as being at fault.¹⁷¹

While it may be reasonable to impose upon business customers a loss allocation scheme that precludes many lawsuits even though the bank failed to exercise ordinary care, the scheme has an unreasonable impact upon individual consumers, who will be precluded in almost all cases from bringing a claim. Consequently, special consumer legislation may be warranted. Cooter and Rubin propose a statute that would encourage both banks and consumers to take precautions, and would make it attractive for banks to adopt innovative technology, by apportioning liability.¹⁷² In addition, this legislation could make litigation feasible by providing for an award of attorney's fees and minimum statutory damages.¹⁷³

Consideration of the economic principles proposed by Cooter and Rubin does not provide a clear resolution to the questions raised by section 4-406(3). Applying these principles to that section, however, does lead to a better understanding of its operation. In addition, these principles provide insights for an

ments Code: Allocation of Losses Resulting From Forged Drawers' Signatures, 22 HARV. J. ON LEGIS. 399, 415 (1985). In one case, the jury found it cost the customer \$26,700 in reasonable attorney fees to get through the trial stage of the case, would cost an additional \$15,000 for an appeal to the intermediate court of appeals, and \$10,000 for an appeal to the state's highest court. *McDowell*, 772 S.W.2d at 187.

167. Cooter & Rubin, *supra* note 101, at 79 n.70, 85; Dow & Ellis, *supra* note 166, at 415.

168. Cooter & Rubin, *supra* note 101, at 79.

169. See U.C.C. §§ 1-102(2)(b), 4-103 comment 1.

170. See *supra* notes 108-28 for a discussion of the application of the precaution element of the loss reduction principle.

171. Cooter & Rubin, *supra* note 101, at 85.

172. *Id.* at 90.

173. See, e.g., 15 U.S.C. § 1640(a) (1990) (Truth in Lending Act provides for attorney's fees and statutory minimum damages).

examination of the case law under section 4-406(3) and the proposed revision of that section, and guidance for a proposal to improve that revision.

III. SIGHT REVIEW V. BLIND BULK PROCESSING: THE CASE LAW

The five principal cases concerning forged signatures decided in the 1980s have little uniformity or consistency of analysis, even among decisions holding for the same party. This is a natural outgrowth of the failure of the UCC to provide one set of consistent goals and objectives and a framework of analysis. Application of the Code should yield uniform and sound results, but also should allow flexible response to accommodate varying fact situations.

A. Fact Scenarios — Variability Contributes to a Confusing Body of Law

One reason the forged-check case law of the 1980s lacks consistency is because each court has addressed different bank procedures. At the two extremes, one bank conducted sight review of all checks¹⁷⁴ while another was fully automated, reviewing no checks for forged signatures.¹⁷⁵ Other banks were partially automated; checks over a certain amount were subject to sight review, the rest were not.¹⁷⁶ Some banks even had a variation on this procedure, subjecting those checks over a certain amount to sight review, excluding checks in small amounts from any review, but conducting a random review of all checks in an intermediate range.¹⁷⁷ Some banks did not do any check processing themselves; it was contracted out to service providers.¹⁷⁸ Some banks sent no cancelled checks to customers; checks were truncated and stored by a third party so even the customer's bank did not have direct access to the cancelled checks.¹⁷⁹

The five cases analyzed below are uniform in that all involve commercial customers and in each case the wrongdoer was an employee who forged an authorized signature. All five cases involved employees who forged in small amounts over several months until the aggregate forgery involved large sums.¹⁸⁰

While the customers obviously failed to supervise their bookkeepers adequately,¹⁸¹ it would be wrong to assume that all customers are equally culpable.

174. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 344, 546 N.E.2d 904, 905, 547 N.Y.S.2d 611, 612 (1989).

175. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 186-87 (Tex. Ct. App. 1989).

176. *See, e.g., Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 127, 552 N.E.2d 783, 785 (1990) (automatic sorting and payment of checks less than \$1000 and manual signature verification on those greater than \$1000).

177. *See, e.g., Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 294 (1st Cir. 1988) (bank examined all checks over \$1000, checks from \$100-\$1000 if problems suspected, and random 1% of checks from \$100-\$1000).

178. *See, e.g., McDowell*, 772 S.W.2d at 186 (check processing undertaken by third party).

179. *Id.*

180. In *Zapata*, almost all of the checks were in amounts of \$150 to \$800. *Zapata Corp.*, 848 F.2d at 292. The wrongdoer in *Putnam* continued her forgeries for approximately 10 months. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 343, 546 N.E.2d 904, 905, 547 N.Y.S.2d 611, 612 (1989).

181. J. WILLINGHAM & D. CARMICHAEL, *supra* note 110, at 216-17. The American Institute

Cases have involved small nonprofit institutions depending on volunteers to do the bookkeeping,¹⁸² or employees who were honest for many years.¹⁸³ In one case, the wrongdoing occurred while management was involved in a major reorganization and was changing over to a new computer system.¹⁸⁴

Another factor that influenced the decisions was the procedural posture of the case. One case was decided on a motion for summary judgment.¹⁸⁵ One case went to a jury.¹⁸⁶ Further, evidence establishing general bank usage varied greatly. In one case the bank put on expert witnesses to present evidence of general banking usage.¹⁸⁷ In a case that was decided on a motion for summary judgment, the bank merely presented an affidavit of one of its own officers asserting its views on general usage.¹⁸⁸ In one case that went to trial the bank presented no evidence whatsoever on this usage.¹⁸⁹ In no case did the customer present evidence of general bank usage.

This disparity in facts allowed the parties in some cases to make successful arguments that would not apply in other cases. For example, since a credit union in one case reviewed no checks,¹⁹⁰ the customer was able to argue that the credit union could not be exercising ordinary care, because it was exercising no care.¹⁹¹ This should be contrasted with those cases in which banks review only checks over a certain amount. Customers there have argued that the bank exercised no care because the bank did not review checks in the amount of those forged.¹⁹² This argument raises the issue of whether the court should use as its frame of reference the bank's overall procedure for reviewing checks, or whether the court should instead focus on the bank's procedure for reviewing the checks in the amount of the particular check involved.

The lack of trials at which both sides used expert witnesses to develop the

of Certified Public Accountants' Committee on Auditing Procedure has suggested that a satisfactory organizational structure segregates duties so no one person handles all stages of a transaction. The cost of such an internal control should not exceed the expected benefits. CODIFICATION OF STATEMENTS, *supra* note 113, at 65.

182. *Jackson v. First Nat'l Bank*, 55 Tenn. App. 545, 403 S.W.2d 109 (1966), *overruled*, *Vending Chattanooga Inc. v. American Nat'l Bank & Trust Co.*, 730 S.W.2d 624 (Tenn. 1987).

183. *K & K Mfg. v. Union Bank*, 129 Ariz. 7, 10-11, 628 P.2d 44, 47-48 (1981) (misplaced confidence in employee will not excuse duty of depositor).

184. Appellants' Brief at 2, *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291 (1st Cir. 1988) (No. 87-1890).

185. *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 552 N.E.2d 783 (1990).

186. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183 (Tex. Ct. App. 1989). The jury found the bank exercised ordinary care. *Id.* at 187.

187. *Zapata Corp.*, 848 F.2d at 294.

188. *Wilder Binding Co.*, 135 Ill. 2d at 127, 552 N.E.2d at 785.

189. See, e.g., *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 546 N.E.2d 904, 547 N.Y.S.2d 611 (1989).

190. See, e.g., *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183 (Tex. Ct. App. 1989).

191. Appellant's Brief at 16, *McDowell* (No. 05-88-00652).

192. Brief of Plaintiff-Appellee at 24, *Wilder Binding Co.* (No. 67709); Appellants' Brief at 11, *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291 (1st Cir. 1988) (No. 87-1890).

issue of general banking usage has left many questions unanswered. UCC Section 4-103 comment 4 provides:

The term 'general banking usage' is not defined but should be taken to mean a general usage common to banks in the area concerned . . . the intention is to require a usage broader than a mere practice between two or three banks but it is not intended to require anything as broad as a country-wide usage. A usage followed generally throughout a state, . . . a metropolitan area or the like would certainly be sufficient.¹⁹³

The comment was written at a time when only commercial banks provided regular checking services. Today thrifts offer NOW accounts and credit unions offer share drafts. This creates issues such as whether a credit union can meet its burden under section 4-103 by proving its practice is consistent with those of other credit unions rather than banks. In the alternative, and more in keeping with the geographical focus of the comment, perhaps the credit union must show its practices are consistent not only with those of other credit unions in its community, but also with those of thrifts and commercial banks in that area.¹⁹⁴

B. Legal Analysis — Whether To Focus On the Customer or Other Banks and "Efficiency"

The decisions rendered in the five principal forged-signature cases of the last ten years provide little guidance for banks and customers. The crucial difference between outcomes favoring customers and those favoring banks is whether the court focused on the reasonableness of the banks' practices from the perspective of the relationship between the customer and the bank, or compared the banks' internal operations to those of other banks. Another major factor in determining the outcome of these cases is the analytical framework employed by the courts.

In *McDowell v. Dallas Teachers Credit Union*,¹⁹⁵ the court held that under the UCC, the bank (which in this case was a credit union) is "conclusively presumed to know the signature of [its] depositor;"¹⁹⁶ therefore, the bank has a "duty to signature-verify."¹⁹⁷ To fulfill that duty, the bank must establish some "process" to verify signatures.¹⁹⁸ Although the bank made out a *prima facie* case of ordinary care by showing its practice (no procedure whatsoever) was common among credit unions, the court found, as a matter of law, that this absence of procedure was "unreasonable, arbitrary, and unfair."¹⁹⁹ The bank

193. U.C.C. § 4-103 comment 4.

194. See *supra* notes 118-22 and accompanying text for a discussion of the problems associated with assessing ordinary care where financial institutions, such as credit unions, truncate their checks. Arguably, different rules should apply in that situation since customers are not sent their cancelled checks with their bank statements.

195. 772 S.W.2d 183 (Tex. Ct. App. 1989).

196. *Id.* at 188.

197. *Id.* at 191.

198. *Id.* at 189.

199. *Id.* The requirement of showing that the bank's practice is unreasonable, arbitrary, or unfair is contained not in the Code itself, but in a comment. U.C.C. § 4-103 comment 4. The

apparently had demonstrated that its policy of not verifying signatures was efficient.²⁰⁰ But rather than discussing the role a cost-benefit analysis might take in this type of case, the court summarily dismissed the evidence, stating that the adoption of an efficient operation cannot authorize a bank to "set its own uncontrolled standard."²⁰¹ Not only did the court decline to provide any guidance beyond requiring that banks employ some procedure, but it specifically declared that its holding should not be interpreted to give approval or disapproval to any particular procedure.²⁰²

Whereas in *McDowell* the bank adopted the most automated techniques, examined no signatures, and introduced evidence that this was consistent with industry practices, the bank in *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*²⁰³ still employed manual sight review of every check, and presented no evidence of general banking usage. It would seem logical that a bank would easily meet the standard of ordinary care when it examines the signature of each check. The court in *Putnam*, however, apparently agreed with the trier of fact who found that "allowing at most four seconds to inspect each check"²⁰⁴ was a procedure "so superficial as to offer no realistic opportunity to detect forged checks."²⁰⁵ In addition, the bank's failure to show that its procedures were followed by other banks may have influenced the court's decision that the bank was negligent. The court's fundamental approach may have been determinative, however. The court noted that the loss allocation scheme prior to enactment of the UCC was based on the theory that the bank-customer relationship was defined by the contract between the parties.²⁰⁶ The court further believed that the UCC approach was in "accord" with that theory.²⁰⁷ This interpretation of the meaning of ordinary care is consistent with a focus on the customer as a creditor to whom the bank owes contractual duties. The *Putnam* court also seized upon the statement in a Code comment that ordinary care is used "with its normal tort meaning and not in any special sense relating to bank collections."²⁰⁸ However, the court failed to acknowledge that this declaration of tort law is problematic because ordinary care in the normal tort case is always defined by the context in which the conduct took place²⁰⁹ and is inconsistent with the next paragraph of the same comment and the Code provision tying

McDowell court was also impressed by the fact that the bank processed and paid checks that contained no signatures. *McDowell*, 722 S.W.2d at 189.

200. *McDowell*, 722 S.W.2d at 191.

201. *Id.*

202. *Id.* at 191 n.5.

203. 74 N.Y.2d 340, 546 N.E.2d 904, 547 N.Y.S.2d 611 (1989).

204. *Id.* at 344, 546 N.E.2d at 905, 547 N.Y.S.2d at 612.

205. *Id.* at 346, 546 N.E.2d at 906-07, 547 N.Y.S.2d at 613-14.

206. *Id.* at 345, 546 N.E.2d at 906, 547 N.Y.S.2d at 613. See also *supra* notes 15-16 and accompanying text for a discussion of the proposition that the customer's deposit creates the debtor-creditor relationship.

207. *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 345, 546 N.E.2d at 906, 547 N.Y.S.2d at 613.

208. See U.C.C. § 4-103 comment 4.

209. See *supra* notes 35-36 and accompanying text for a discussion of the proposition that conduct is negligent if it is unreasonable under the circumstances.

ordinary care to general banking usage.²¹⁰ Instead, the court interpreted the reference to the "normal tort meaning" as inviting the customer to show its "bank lacked ordinary care by presenting any type of proof that the bank failed to act reasonably."²¹¹ Besides giving customers a relatively free rein to show the bank's negligence, the court also believed that this tort was to be considered within the broader context of the UCC, which has objectives fundamentally different from those of tort law.²¹² Consequently, the court of appeals in *Putnam* held that the trial court erred in pursuing the tort theory beyond the explicit provisions of the Code and in applying a comparative negligence principle.²¹³

Putnam provides little guidance for customers and banks. The trier of fact decided that inspecting checks for no longer than four seconds was not ordinary care.²¹⁴ Perhaps that trier of fact would have found ten seconds adequate; possibly a different trier of fact would have found as little as two seconds satisfied the standard. *Putnam* represents a warning that even sight review of every check may not pass muster. It shows how a court can use the "normal tort meaning" language in the comment as a powerful tool.

It is unclear, however, how the *Putnam* case would have been decided if the bank had presented evidence of general banking practice. The court declared that one of the Code's objectives is "efficiency in dispute resolution."²¹⁵ By making ordinary care a matter of fact rather than law and establishing no standards, the court promoted an inefficient system of dispute resolution in violation of the loss imposition principle.²¹⁶ After *Putnam*, customers contemplating lawsuits in New York will have difficulty gauging their chance of success, and banks will have difficulty determining what types of cases justify prompt settlement.

The signature review procedure employed by the bank in *Medford Irrigation District v. Western Bank*²¹⁷ was mid-way between the two extremes of *Putnam* (every check examined) and *McDowell* (no checks reviewed). The bank in *Medford* reviewed the signatures of checks in the amount of \$5,000 and over. Those under \$5,000 were processed by computer.²¹⁸ The court rejected the bank's cost-benefit argument²¹⁹ and held that "as a matter of law" the bank failed to exercise ordinary care.²²⁰ Consistent with its view that ordinary care

210. U.C.C. § 4-103(3); § 4-103(3) comment 4.

211. *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 346, 546 N.E.2d at 906, 547 N.Y.S.2d at 613. The court found proper the admission of evidence that the bank also paid checks containing one instead of the required two signatures, since this showed the bank operated its check processing system in an unsafe condition. *Id.* at 346, 546 N.E.2d at 907, 547 N.Y.S.2d at 614.

212. *Id.* at 349, 546 N.E.2d at 908, 547 N.Y.S.2d at 615. The *Putnam* court stated: "Unlike tort law, the UCC has the objective of promoting certainty and predictability in commercial transactions." *Id.* Liability is based on who is best able to prevent loss rather than on fault. *Id.*

213. *Id.*, 546 N.E.2d at 908, 547 N.Y.S.2d at 615.

214. *Id.* at 346, 546 N.E.2d at 906, 547 N.Y.S.2d at 613.

215. *Id.* at 349, 546 N.E.2d at 908, 547 N.Y.S.2d at 615.

216. See *supra* notes 155-57 and accompanying text for a discussion of the argument that efficient adjudication requires clear rules that resolve disputes quickly and simply.

217. 66 Or. App. 589, 676 P.2d 329 (1984).

218. *Id.* at 592, 676 P.2d at 331.

219. *Id.*, 676 P.2d at 332.

220. *Id.* at 594, 676 P.2d at 333.

and commercially reasonable procedures amount to the same standard,²²¹ the court also held that the bank's procedures were not reasonable commercial practices.²²²

The *Medford* court's analysis focused on the contractual relationship between the bank and its customer rather than on the bank's practices *vis-a-vis* other banks.²²³ The decision assumed there was a contract (albeit implied), and that this contract obligated the bank to pay only those checks containing authorized signatures.²²⁴ The court also cited a state court of appeals dissent that attacked the majority opinion "for proceeding on negligence principles when the relationship between the bank and its depositor is one of contract,"²²⁵ and quoted from a commentator who asserts that the strict liability scheme of loss allocation is "'born of an implied contract between bank and depositor.'"²²⁶

The importance of the contractual focus is illustrated by the court's treatment of general banking usage. In *Medford*, the bank argued that its procedures were similar to those of other banks.²²⁷ Neither party, however, cited UCC section 4-103(3) in its brief.²²⁸ The court nevertheless seemed to concede that the bank's procedure was in conformity with industry standards. That alone could not save the procedure from successful attack, however, because the "reasonableness of commercial banking standards must be analyzed in the context of a bank's duty in relation to the depositor's account" and the implied contract between the parties, not solely in comparison with the practices of other banks.²²⁹

221. *Id.* at 593, 676 P.2d at 332.

222. *Id.* at 594, 676 P.2d at 333.

223. The legal underpinning of the *McDowell* case, by contrast, was the duty imposed by the UCC to verify signatures. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d at 186, 188, 191 (Tex. Ct. App. 1989). The *Putnam* case also focused on the Code-imposed duty, noting that this was consistent with pre-Code "theory" that there was a contractual relationship between the customer and the bank. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 345, 546 N.E.2d 904, 906, 547 N.Y.S.2d 611, 613 (1989). The *McDowell* opinion's silence about the contractual relationship makes one wonder whether the court thought there was none, or that such relationship was irrelevant. The *Putnam* court speaks of the contract as something that was relevant in the past; it is unclear whether the court believed it still played a role.

224. *Medford Irrigation Dist.*, 66 Or. App. at 592, 676 P.2d at 332. In its brief, the customer pointed out that its action was based on the bank's breach of contractual duty, not on negligence or conversion. Respondent's Brief and Supplemental Abstract of Record at 36, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603).

225. *Medford Irrigation Dist.*, 66 Or. App. at 595, 676 P.2d at 333 (citing 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)).

226. *Id.* at 595-96, 676 P.2d at 334 (quoting B. CLARKE, *THE LAW OF BANK DEPOSITS* (Supp. 1982)).

227. Appellant's Brief and Abstract of Record at 26, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603).

228. See, e.g., Appellant's Brief and Abstract of Record, Table of Citations at vi, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603); Appellant's Reply Brief, Table of Citations at iii, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603); Respondent's Brief, Index of Authorities at v, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603).

229. *Medford Irrigation Dist.*, 66 Or. App. at 592, 676 P.2d at 332.

The *Medford* court also rejected the bank's cost-benefit argument. In its brief, the bank had presented the results of a study it conducted comparing forgery losses incurred under sight review to those incurred after converting to computer processing.²³⁰ The bank interpreted the data as showing that "there had been no significant increase or decrease in forgery losses" as a result of conversion to computer processing.²³¹ The bank explained the results by asserting that most forgeries are so well done that it is impossible to identify them.²³² Moreover, the bank estimated it was saving \$142,000 by converting from sight review to computer processing.²³³ Based on this data, the bank contended that a standard of ordinary care that required sight review would cost the bank money and would be passed on to customers in increased service charges, but would result in no greater protection.²³⁴ Those higher service charges would require customers who are careful in reviewing their statements and cancelled checks to "subsidize" the cost for implementing sight review in order to benefit customers who are negligent.²³⁵ In addition to being less costly, the computerized procedure allowed the bank to prepare and distribute statements more promptly.²³⁶

The court in *Medford* did not dispute the bank's contentions that computer processing is efficient, less costly, a "prudent business decision," and the procedure adopted by most banks.²³⁷ Nevertheless, it rejected the bank's analysis. First, the court emphasized that it was not requiring banks to engage in sight review to meet the ordinary care and commercial reasonableness standard.²³⁸ Rather, the bank can adopt any procedure it wishes, as long as it reasonably relates to the detection of unauthorized signatures.²³⁹ Second, according to the court, the Code imposes certain responsibilities upon banks, and banks cannot necessarily meet those responsibilities simply by showing that their procedures are efficient.²⁴⁰ In other words, efficiency may not necessarily lead to findings of commercial reasonableness and non-negligence. This derogation of efficiency is consistent with the court's contractual focus. It is in sharp contrast to the analysis urged by the bank, which requested the court to focus on two other factors to determine ordinary care. According to the bank, a procedure that was efficient, and comparable to those of other banks, was non-negligent.²⁴¹ Consequently, it

230. Appellant's Brief and Abstract of Record at 10, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603). This information was available to the trial court in the form of depositions and affidavits. *Id.*

231. *Id.* It is not clear how the bank made its calculations. For the period covering the checks involved in *Medford*, the bank reported forgery losses totalling \$12,616.44. *Id.* The bank admitted, however, that the losses from the *Medford* forgeries alone amounted to \$68,751.56. *Id.* at 7.

232. *Id.* at 11.

233. *Id.*

234. *Id.*

235. *Id.* at 4.

236. *Id.* at 11.

237. *Medford Irrigation Dist.*, 66 Or. App. at 593, 676 P.2d at 332.

238. *Id.*

239. *Id.*

240. *Id.*

241. See *supra* notes 227-36 and accompanying text for a discussion of the bank's arguments concerning efficiency and trade practice.

fulfilled the bank's responsibilities to the customer. The court rejected this approach because it would permit the bank to shift the loss to the customer, while employing a procedure that does not reasonably relate to forgery detection.

As discussed below, the *Medford* court had a sound basis for dismissing the bank's cost-benefit argument.²⁴² The bank, however, is left with no guidance from the court as to the procedure that might satisfy the court. The procedure used by the bank in *Medford* was found lacking even though it was superior to that used in *McDowell*, and despite the court's statement that sight review of every check is not required.²⁴³ Presumably, the court would approve a procedure more stringent than that used by the bank in *Medford*, even though it was not as thorough as sight review of all checks. Banks cannot be certain what procedure within that range might be acceptable, especially since even sight review of all checks may fail to constitute ordinary care under certain circumstances.²⁴⁴

The case of *Wilder Binding Co. v. Oak Park Trust & Savings Bank*²⁴⁵ presented an opportunity for clarification of the ordinary care standard, but both the appellate court of Illinois and the Illinois Supreme Court failed to provide guidance to customers and banks. The *Medford* court had found that a procedure of reviewing checks in the amount of \$5,000 or more did not constitute the exercise of ordinary care. The bank in *Wilder* had a procedure designed to detect many more forgeries. It reviewed all checks in the amount of \$1,000 or more.²⁴⁶ Unfortunately, each of the forty-two checks containing forged signatures was made out for less than \$1,000.

The Illinois Appellate Court in *Wilder*, purporting to follow *Medford* and other cases,²⁴⁷ held that the bank's procedures demonstrated a failure to exercise ordinary care as a matter of law, because "forgery-detection procedures are non-existent."²⁴⁸ It therefore affirmed the trial court's grant of the customer's motion for summary judgment. In order to provide ordinary care, the court would require the bank to establish a procedure designed to detect forgeries on checks under as well as over \$1,000.²⁴⁹ The court apparently believed the bank could satisfy this requirement by employing either sight review or random review.²⁵⁰ The judges dismissed the bank's contention that its procedure conformed to general banking usage, arguing that such conformity cannot "magically insulate"

242. See *infra* notes 291-329 and accompanying text for a discussion of the numerous grounds upon which cost-benefit analysis can be attacked.

243. *Medford Irrigation Dist.*, 66 Or. App. at 593, 676 P.2d at 332.

244. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 346, 546 N.E.2d 904, 906-07, 547 N.Y.S.2d 611, 613-14 (1989).

245. 135 Ill. 2d 121, 552 N.E.2d 783 (1990).

246. *Id.* at 124, 552 N.E.2d at 785.

247. *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 173 Ill. App. 3d 34, 41, 527 N.E.2d 354, 358 (1988), *rev'd*, 135 Ill. 2d 121, 552 N.E.2d 783 (1990).

248. *Id.* at 42, 527 N.E.2d at 359.

249. *Id.* at 40-41, 527 N.E.2d at 358.

250. *Id.* at 42, 527 N.E.2d at 358-59 (as cost of doing business, banks may examine each draft against signature, use some form of random check, or use automatic sorters, absorbing expense of occasional forgeries).

banks; they must have a procedure that will detect forgeries, regardless of what other banks are doing.²⁵¹ Finally, the court rejected the bank's cost-benefit argument, asserting that banks adopting an automated system that cannot detect forgeries should incur liability as a "cost of doing business."²⁵²

The *Wilder* court's holding was grounded on its conclusion that the UCC imposes on the bank "an absolute duty not to pay unauthorized drafts,"²⁵³ and the resulting requirement that the bank employ a procedure involving some form of signature review of all checks. In contrast, the dissent stressed the tort concept of section 4-103 and its comment which was "virtually ignored by the majority."²⁵⁴ Dissenting Judge Jiganti criticized what he regarded as the majority's failure to take into consideration the efficiencies effectuated by computers, a consideration that was appropriate given the Code's intention to be flexible enough to accommodate new technology, and given the tort concept the Code uses to weigh bank conduct.²⁵⁵

The bank appealed and was supported by briefs filed on behalf of the American Bankers Association, the Illinois Bankers Association, and the Chicago Clearinghouse Association.²⁵⁶ The participation of these organizations demonstrates the importance of the issue. The Illinois Public Action Council supported the customer.²⁵⁷ The briefs presented the *Wilder* court with the wide variety of analytical approaches, contentions, and policy choices that previous courts had considered. The Illinois Bankers Association decried the "devastating impact [of the lower court decision and cases such as *Medford*] upon the efficient operation of our banking system."²⁵⁸ The Chicago Clearinghouse urged the Illinois Supreme Court to engage in a cost-benefit analysis.²⁵⁹ The American Bankers Association described the increased volume of checks banks confronted, and the technological innovations developed to handle that volume.²⁶⁰ According to the American Bankers Association, the Code drafters specifically "anticipated and accommodated" these developments "by incorporating such flexible concepts as 'ordinary care' into the Code."²⁶¹ The brief filed by the bank contended, *inter alia*, that tort concepts controlled²⁶² and that, conse-

251. *Id.* at 41, 527 N.E.2d at 358.

252. *Id.* at 42, 527 N.E.2d at 358.

253. *Id.* at 41, 527 N.E.2d at 358.

254. *Id.* at 44, 527 N.E.2d at 360 (Jiganti, J., dissenting).

255. *Id.* at 45, 527 N.E.2d at 360-61 (Jiganti, J., dissenting).

256. *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 124, 552 N.E.2d 783, 784 (1990).

257. *Id.*

258. Brief of Amicus Curiae, The Illinois Bankers Association, on Behalf of Defendant-Appellant, Oak Park Trust and Savings Bank, an Illinois Banking Corporation at 6-7, *Wilder Binding Co.* (No. 67709).

259. Brief of Amicus Curiae, Chicago Clearing House Association, in Support of the Appeal of Oak Park Trust and Savings Bank at 7-9, *Wilder Binding Co.* (No. 67709).

260. Motion for Leave to File a Brief and Brief of The American Bankers Association as Amicus Curiae at 5-10, *Wilder Binding Co.* (No. 67709).

261. *Id.* at 7.

262. Brief of Defendant-Appellant, Oak Park Trust and Savings Bank at 37-41, *Wilder Binding Co.* (No. 67709).

quently, the lower court erred in deciding the case as a matter of law since "negligence is a question of fact."²⁶³ The bank also denied that it had no procedures designed to detect forgeries on checks under \$1,000. It claimed its practice of mailing statements to customers constituted "one of the most effective means of detecting an ongoing pattern of forgery by the same wrongdoer."²⁶⁴ The customer relied on *Medford* and on cases holding that the bank is required to know its customer's signature as support for its position.²⁶⁵ The brief of the Illinois Public Action Council attacked the argument that banks can fulfill their ordinary care obligations by relying on the customer to conduct its own sight review.²⁶⁶ It charged that the cost-benefit analysis urged by the bank and its allies improperly weighed the risk to the customer against a benefit to the bank.²⁶⁷

The lower court opinion, coupled with the briefs filed with the court, set out for the Illinois Supreme Court in *Wilder* the full array of issues, questions, policies, and possibilities. Based on this information, the supreme court had the opportunity to articulate an analytical framework that would provide the guidance lacking in other decisions. Instead, the *Wilder* court decided the case on very narrow grounds, reversing the trial court, which had granted summary judgment in favor of the customer.²⁶⁸ The supreme court held that the requirements for summary judgment were not met because "a genuine issue of material fact exists regarding whether defendant exercised ordinary care."²⁶⁹ The trier of fact should determine whether the bank's procedure "is 'consistent with general banking usage' and, accordingly, 'prima facie constitutes the exercise of ordinary care.'"²⁷⁰ The court, therefore, rejected the lower court's holding that a bank which has no procedure to review checks under \$1,000 fails to exercise ordinary care as a matter of law.

The Illinois Supreme Court in *Wilder* also left several other questions unanswered. For example, is it the province of the trier of fact to decide whether a bank's "procedure" can consist of relying on its customers to conduct sight review of ninety-three percent of all of the bank's checks?²⁷¹ If that is proper, then is ordinary care solely a question for the trier of fact if the bank's procedure is to review no checks and to rely on the customer to sight review 100% of the checks, as in *McDowell*? Is it still solely a question of fact when, as in *McDowell*, not only does the bank review no checks, but the customer receives no checks

263. *Id.* at 38.

264. *Id.* at 61.

265. Brief of Plaintiff-Appellee, *Wilder Binding Company* at 11-26, *Wilder Binding Co.* (No. 67709).

266. Brief and Argument of Amicus Curiae, Illinois Public Action Council at 12, *Wilder Binding Co.* (No. 67709).

267. *Id.* at 8.

268. The Illinois trial court decision in *Wilder* had been affirmed by the Illinois Appellate Court in *Wilder Binding Co. v. Oak Park Trust & Savings Bank*, 173 Ill. App. 3d 34, 527 N.E.2d 354 (1988), before reversal by the Illinois Supreme Court.

269. *Wilder Binding Co.*, 135 Ill. 2d at 131, 552 N.E.2d at 787.

270. *Id.*

271. *Id.* at 136, 552 N.E.2d at 789 (Calvo, J., dissenting) (only seven percent of checks in *Wilder* subject to sight review by bank).

with its statement because they are truncated? Is the court holding that ordinary care is always a question of fact regardless of the bank's procedure?

The Illinois Supreme Court in *Wilder* similarly provides no guidance on the question of establishing a *prima facie* case of ordinary care. The applicable UCC comment states that to qualify as a "general" banking usage, "[a] usage followed generally throughout . . . a metropolitan area . . . would certainly be sufficient."²⁷² Can the bank meet this test by presenting testimony of the bank's officers that "more than two or three banks in the metropolitan Chicago area . . . automatically pay checks drawn for less than a designated amount without manually verifying the signatures on those checks?"²⁷³ Is the practice of two or three banks representative of the nature of practice throughout Chicago? Does the bank have to show those two or three banks are comparable to the defendant bank in size and type of financial institution? Is general banking usage established by showing other banks automatically pay checks for less than some unspecified amount, as the bank's affidavit in *Wilder* stated, or does the bank have to show the other banks use a cut-off point comparable to the defendant bank's in terms of dollar amount or percentage of checks not subject to any review? Can the bank make its *prima facie* case through the testimony of its own employees, or must it present evidence from an independent source? Upon whom is the burden placed to show whether the bank's practice conforms to bank usage?²⁷⁴

Furthermore, in remanding the case, the Illinois Supreme Court in *Wilder* said the trial court should allow the trier of fact to determine whether the bank had presented a *prima facie* case by showing its procedure was consistent with general banking usage.²⁷⁵ The majority, unmoved by the dissents' apparent concern, seemed to accept that a mere showing that other banks engage in similar practices might be sufficient to avoid liability, even if these practices fall below the ordinary care standard.²⁷⁶ The court failed to address the question of what the customer must show in order to overcome the *prima facie* case. The Code is also silent on this matter.²⁷⁷

Another issue that the Illinois Supreme Court in *Wilder* avoided was the role of cost-benefit analysis. The First Circuit confronted that issue head-on in *Rhode Island Hospital Trust National Bank v. Zapata Corp.*²⁷⁸ The bank in *Zapata* employed the random signature detection procedure for smaller checks

272. U.C.C. § 4-103 comment 4.

273. *Wilder Binding Co.*, 135 Ill. 2d at 129, 552 N.E.2d at 786.

274. See *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 347-48, 546 N.E.2d 904, 907-08, 547 N.Y.S.2d 611, 614-15 (1989) (burden of showing bank's practice conforms to banking standard discussed).

275. *Wilder Binding Co.*, 135 Ill. 2d at 131, 552 N.E.2d at 787.

276. *Id.* at 134, 552 N.E.2d at 788 (Calvo, J., dissenting) (industry cannot set own uncontrolled standard).

277. U.C.C. § 4-103. Comment 4 states that the customer must establish that the procedure is "unreasonable, arbitrary or unfair."

278. 848 F.2d 291 (1st Cir. 1988).

suggested by the dissent in *Wilder*.²⁷⁹ Like the bank in *Wilder*, it conducted sight review of all checks over \$1,000. In addition, one percent of checks between \$100 and \$1,000 were subject to random review.²⁸⁰ Unlike *Medford* and *Putnam*, the court never mentioned a contractual relationship between the parties. There is no reference to signature cards. The court ignored the requirement of *Medford* and *McDowell* that the bank's procedure reasonably relate to the bank's duty to detect forgeries.²⁸¹

Instead, the court in *Zapata* concentrated on a cost-benefit analysis of the bank's practices. The bank presented expert testimony that changing from sight review to its current procedure saved \$125,000 each year and resulted in "no significant increase in the number of forgeries that went undetected."²⁸² The court approved the procedure, concluding 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.'"²⁸³ The court went on to state that even if there were an increased number of undetected forgeries, the customer could not prevail unless it demonstrated that the increased loss due to more forged checks being paid was "unreasonable in light of the costs that the new practice would save."²⁸⁴ Finally, the court explained why it attached so much importance to costs and benefits. The issue was whether the bank was negligent. Negligence is judged by what is reasonable conduct. What is reasonable "is often a matter of costs of prevention compared with correlative risks of loss."²⁸⁵ The court seemed to be saying, in effect, that the bank's former system of sight review constituted ordinary care.²⁸⁶ Since the new procedure is just as effective and costs the bank less money, it also must constitute ordinary care.

As the above analysis demonstrates, the five recent cases concerning check forgery detection procedures lack a clear and consistent analytical perspective. To remedy this situation, the legal community should directly acknowledge and confront the fundamental differences in approach among the cases, and admit that such differences involve a social policy choice, not a question of correct legal application of the UCC. The legal community should then decide what approach to follow, and determine how best to incorporate that approach into legal rules.

279. *Wilder Binding Co.*, 135 Ill. 2d at 136-37, 552 N.E.2d at 789 (Calvo, J., dissenting) (bank procedure utilized in *Zapata* approved).

280. *Zapata Corp.*, 848 F.2d at 294.

281. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 191 (Tex. Ct. App. 1989); *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 593, 676 P.2d 329, 332 (1984).

282. *Zapata Corp.*, 848 F.2d at 294. One of the bank's experts testified that under both the sight review system and the automated system, the bank's loss through forgeries was \$10,000 to \$15,000 per year. *Id.* The court never questioned this data even though the losses from the *Zapata* forgeries alone totalled \$109,247.16. *Id.* at 292.

283. *Id.* at 295.

284. *Id.*

285. *Id.*

286. As the *Putnam* case shows, this is not necessarily true.

C. The Role of Cost-Benefit Analysis

One of the consequences of the Code's injection of the tort concept of ordinary care as the standard for judging the bank's conduct is to make relevant a cost-benefit analysis of the bank's practices.²⁸⁷ Courts typically conduct such an analysis by applying Judge Learned Hand's negligence test, which has been summarized as follows: the "failure to take precautions constitutes negligence only when the burden of the accident, assessed in terms of the accident, assessed in terms of its magnitude and probability of occurrence, exceeds the burden of taking precautions."²⁸⁸ Hand's formulation has gained a wide audience in recent years as law and economics aficionados, such as Judge Posner, have used it as a foundation for their efficiency theories.²⁸⁹ Advocates of these theories seek to quantify every element in the cost-benefit formula.²⁹⁰

Not all authorities are so enamored of cost-benefit analysis, however. Some, such as Professor Vandall, contend not only that some elements cannot be quantified,²⁹¹ but also that a wholesale attempt to quantify everything to determine negligence is contrary to the traditional concept of negligence, and was specifically rejected by Judge Hand.²⁹² Professor Waldron points out that the critical concept of Posner's theory, "efficiency," is an ambiguous term.²⁹³ Professor White debunks the belief that cost-benefit analysis can be objective merely because it involves numerical calculations. She believes that deciding what constitutes a cost or benefit often involves making value judgments,²⁹⁴ as does quantifying them.²⁹⁵ Vandall also points out that efficiency theory is founded on numerous questionable assumptions. For example, the theory assumes that persons alleging injury have perfect information; consequently they know the risks and evaluate them before entering into a transaction.²⁹⁶

Professor White also questions the way in which cost-benefit analysis is

287. *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 173 Ill. App. 3d 34, 45, 527 N.E.2d 354, 360-61 (1988) (Jiganti, J., dissenting).

288. McDonnell, *supra* note 11, at 1400. See also White, *Risk-Utility Analysis and the Learned Hand Formula: A Hand that Helps or a Hand that Hides?*, 32 ARIZ. L. REV. 77, 104-05 (1990). Professor White expresses the test as one involving weighing and balancing:

On one side of the scale is the risk of harm, calculated by the harm's severity adjusted for its probability of occurring . . . often referred to as 'expected harm.' Balanced against the 'expected harm' on the other side of the scale, is the cost to avoid the harm . . . If the scale tilts towards the expected harm, then the cost to avoid harm . . . is less than the expected harm . . . in such a case the defendant is obligated to undertake those precautions, and in failing to do so, should be liable for any consequential harms.

Id.

289. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 32-34 (1972).

290. Vandall, *Judge Posner's Negligence-Efficiency Theory: A Critique*, 35 EMORY L.J. 383, 409 (1986).

291. *Id.*

292. *Id.* at 413 (quoting Hand's opinion in *Conway v. O'Brien*, 111 F.2d 611, 612 (2d Cir. 1940), *rev'd*, 312 U.S. 492 (1941)).

293. Waldron, *Book Review*, 99 YALE L.J. 1441, 1443 (1990).

294. White, *supra* note 288, at 113.

295. *Id.* at 114.

296. Vandall, *supra* note 290, at 399.

used. According to White, even if we can objectively analyze a party's conduct and agree that the cost of that party taking preventative measures outweighs the benefits, society may nevertheless decide to impose liability on that party.²⁹⁷ In other words, taking an economically efficient course of action should not always guarantee a party protection from liability; other loss allocation schemes may exist that also promote "economically efficient levels of precaution," such as the policy of assigning liability to the party who could have avoided the harmful occurrence at the least cost.²⁹⁸

Professor Vandall also questions the applicability of the entire cost-benefit analysis to a determination of whether ordinary care exists. He says the goal of law should not be efficiency, or wealth maximization, but justice; the definition of ordinary care should reflect a decision as to "which direction society should take."²⁹⁹ According to this theory, defining ordinary care is a value-laden public policy decision not susceptible to mere number-crunching.³⁰⁰

Despite the trenchant criticisms of cost-benefit analysis, it remains an alluring construct for determining whether a bank's signature verification system constitutes a failure to exercise ordinary care. The *Medford* case illustrates how banks have argued that costs of intensive check review exceed benefits. The bank presented data comparing its forgery losses under its former sight review procedure to those under its current procedure.³⁰¹ The bank contended that there was "no significant increase or decrease in forgery losses" as a result of converting from sight review to bulk filing all checks under \$5,000.³⁰² In addition, the bank estimated that it saved approximately \$142,000 each year by abandoning sight review.³⁰³ The bank in *Zapata* presented comparable evidence; switching from sight review to bulk filing resulted in savings of \$125,000 annually and no significant increase in undetected forgeries.³⁰⁴

The type of cost-benefit analysis used in *Medford* and *Zapata* is questionable in several respects. First, it is erroneous to assume that the only relevant basis of comparison of cost and benefit is between sight review and the bank's

297. See White, *supra* note 288, at 126 (not requiring party to undertake every conceivable preventative measure does not mean victim must absorb full costs).

298. *Id.*

299. Vandall, *supra* note 290, at 398. See also White, *Coase and the Courts: Economics for the Common Man*, 72 IOWA L. REV. 577, 612 (1987) (choice about what is best for society must be based on society's morals, ethics, and legal principles, none of which market prices accurately reflect).

300. See also Peller, *The Metaphysics of American Law*, 73 CALIF. L. REV. 1151, 1272 (1985) (notion that social world can be expressed meaningfully according to costs and benefits excludes other ways of perceiving and communicating about social world).

301. Appellant's Brief and Abstract of Record at 10, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603) (total number of checks cleared annually compared to number and percentage of forged checks; total deposits compared to dollar amount of losses due to forgery; percentage of forgery loss compared to total deposits). See also *Medford Irrigation Dist.*, 66 Or. App. at 592, 676 P.2d at 331 (checks for \$5000 or more reviewed).

302. Appellant's Brief and Abstract of Record at 10-13, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603).

303. *Id.* at 11.

304. *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 294 (1st Cir. 1988).

current system of bulk filing. Even courts that find the bank did not exercise ordinary care do not require sight review of every check.³⁰⁵ Instead, some courts have set out the more general requirement that banks employ a procedure that "reasonably relate[s] to the duty the bank has to detect unauthorized signatures."³⁰⁶ Under that test, banks may be able to meet the ordinary care standard by using procedures less costly than sight review of all checks—for example, sight review of checks over a certain amount and random review of other checks.³⁰⁷ Another possible alternative to sight review is utilization of electronic equipment, such as a static signature verification system, to scan checks for forgeries.³⁰⁸ If such machines are available at reasonable cost and do not significantly slow check processing, they may be a viable choice.³⁰⁹ Consequently, it is erroneous for a court merely to compare the cost of sight review of all checks to a bank's current automated method.

The cost-benefit analyses employed by the banks in *Medford* and *Zapata* also were flawed because the courts used the bank's former sight review procedures as the benchmark, and implicitly assumed that those procedures satisfied the ordinary care standard. As *Putnam* shows, a bank's sight review procedure may be so perfunctory that it amounts to negligence.³¹⁰ Dr. Lipis, testifying in *Zapata* for the bank, provided reasons why sight review tends to be a poor procedure: "[S]ignature verification is very tedious, very difficult, and not a function that is liked by anybody who does it."³¹¹ Absent evidence to demonstrate the reliability of its sight review procedure, a bank cannot properly contend its current automated procedure is non-negligent merely because it detects as many forgeries as sight review.

Even if the bank's sight review procedure is facially adequate to meet the ordinary care standard, the bank's personnel may not follow that procedure. For example, in *Vending Chattanooga, Inc. v. American National Bank & Trust Co.*, the bank's policy was to have two full-time and one half-time employees

305. See, e.g., *Medford Irrigation Dist.*, 66 Or. App. at 593, 676 P.2d at 332 (bank not required to adopt particular procedure). But cf. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 191 n.5 (Tex. Ct. App. 1989) (whether bank must review all checks not addressed by court).

306. *McDowell*, 772 S.W.2d at 191. Accord *Medford*, 66 Or. App. at 593, 676 P.2d at 332.

307. See *Zapata Corp.*, 848 F.2d at 294 (sight review of checks over \$1000; random review of one percent of checks between \$100-\$1000 conducted by bank). The court in *McDowell* distinguished *Zapata* by noting that in *McDowell* the bank had no procedure to verify any checks whatsoever, whereas the bank in *Zapata* at least employed some type of process to verify signatures. *McDowell*, 772 S.W.2d at 190. The implication is that the *McDowell* court might well have found the practice in *Zapata* constituted ordinary care if the bank also produced evidence that such a practice was commercially reasonable. See *id.*

308. Kutler, *supra* note 123, at 6.

309. These machines possibly could be used in conjunction with other procedures. For example, a bank might conduct sight review of large checks and use a static verification system to review a percentage of smaller checks if it is more efficient than a random review of checks.

310. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust*, 74 N.Y.2d 340, 346, 546 N.E.2d 904, 905, 547 N.Y.S.2d 611, 612 (1989).

311. *Zapata Corp.*, 848 F.2d at 294.

engaged in sight review each day for a total of twenty-one hours per day.³¹² During the period the forged checks were being processed, however, the person responsible for sight review was absent so frequently that she eventually was fired.³¹³ Consequently, the bank was using only sixty percent of the work force it had determined was needed to detect forgeries satisfactorily. In addition, bank employees testified they did not follow the sight review procedures. As the head teller said, "rules are made to be broken."³¹⁴ Courts should not find that banks fulfill their duty of ordinary care when a cost-benefit analysis is based on comparing two procedures, one of which often is not followed.

A third problem with the use of a cost-benefit analysis in check forgery cases relates to the allocation of costs and benefits between the parties. Banks argue that if they had to return to sight review in order to avoid liability, the increased costs would be passed on to customers, requiring non-negligent customers to subsidize negligent ones.³¹⁵ In addition, the bank would have to purchase additional insurance, the cost of which would be passed on to customers.³¹⁶ Even assuming, *arguendo*, that sight review is the bank's only alternative to automated processing,³¹⁷ the bank's warnings about the increased costs of a return to sight processing raises the question of who receives the benefits of automated check processing.³¹⁸ In *Medford*, the bank claimed annual savings of \$142,000.³¹⁹ In *Zapata*, the savings were \$125,000.³²⁰ Nowhere do the banks claim these savings were passed on to the customers.³²¹ Presumably, whether customers benefited from the savings depended upon the bank's competitive position in the marketplace. Thus, a relevant question is: when a court looks at costs and benefits, whose costs and whose benefits are relevant? A cost-benefit approach in which customers ultimately pay all the costs of increased protection and banks receive all the benefits of providing less protection does not appear

312. (Tenn. Ct. App. Dec. 6, 1985) (WESTLAW, States Library, Tenn. file, at 6), *rev'd*, 730 S.W.2d 624 (Tenn. 1987).

313. *Id.*

314. *Id.* Other examples of employees' failure to follow forged-check procedures in this case include the payment of eight checks containing both forgeries and no dates, and the payment of checks containing no signatures, even after the account had been identified as a problem account. *Id.*

315. Appellant's Brief and Abstract of Record at 4, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603).

316. *Id.* at 11.

317. See *infra* note 349 and accompanying text for a discussion of courts allowing banks to establish alternative procedures.

318. See generally G. MOEBS & E. MOEBS, *supra* note 12, at 77 (cost efficiency can be passed to customer or can contribute to profitability).

319. Appellant's Brief and Abstract of Record at 11, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603).

320. Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp., 848 F.2d 291, 294 (1st Cir. 1988).

321. Brief of Defendant-Appellant Oak Park Trust and Savings Bank, Wilder Binding Co. v. Oak Park Trust & Sav. Bank, 135 Ill. 2d 121, 552 N.E.2d 783 (1990) (No. 67709); Appellant's Brief and Abstract of Record, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603); Brief for Appellee, *Zapata Corp.* (No. 87-1890).

fair. Some assurance that customers will enjoy lower-cost services in return for less protection would make cost-benefit analysis seem more just.

Another problem with using a cost-benefit analysis to determine ordinary care in check forgery cases is how to measure the severity of the harm. The amount of loss in the five principal cases ranged from \$25,254.78³²² to \$109,247.16.³²³ The average loss was \$60,720³²⁴ and the median loss was \$67,250.23. Assuming these amounts are typical, how is a court to determine whether or not this constitutes "serious" harm to either party? In *Medford*, the bank submitted data comparing total forgery losses to total deposits.³²⁵ The loss was very small when viewed from this perspective. To a large, prosperous business customer the loss also would be small. But to a small, struggling business customer, or to a typical individual consumer, the loss could be devastating. As Professor White points out in discussing cost-benefit analysis generally, determining how to quantify costs and benefits involves making value judgments.³²⁶ The question here is whether, in using a cost-benefit analysis to determine ordinary care, the courts or legislature should take into consideration the disparate impact forgery losses have on different types of customers. This is a social policy judgment that cost-benefit analysis alone cannot resolve.³²⁷

A further defect in the cost-benefit approach is its reliance on questionable assumptions. For example, the cost-benefit approach, as refined by Judge Posner, assumes that victims have adequate knowledge of the risks involved in a transaction.³²⁸ This assumption is false; customers cannot evaluate the risks of check transactions because most banks do not disclose their signature verification procedures,³²⁹ and, as the five principal cases illustrate, bank practice varies considerably.

In general, however, the *Zapata* decision demonstrates that banks have a strong argument for using a cost-benefit analysis to justify their choice of procedures when they present evidence that converting from sight review to bulk filing does not result in a significant increase in the number of forgeries detected.³³⁰ It is difficult to justify labeling a bank's bulk filing system a negli-

322. *Wilder Binding Co.*, 135 Ill. 2d at 125, 552 N.E.2d at 784.

323. *Zapata Corp.*, 848 F.2d at 292.

324. See Appellant's Brief and Abstract of Record at 7, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603) (claimed loss of \$68,751.56); *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 343, 546 N.E.2d 904, 905, 547 N.Y.S.2d 611, 612 (loss of \$48,094); *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 186 (Tex. Ct. App. 1989) (loss of \$52,255.02).

325. Appellant's Brief and Abstract of Record at 10-11, *Medford Irrigation Dist.* (No. 81-1914-J-1; A-26603).

326. White, *supra* note 288, at 113.

327. See generally Vandall, *supra* note 290, at 398.

328. Vandall, *supra* note 290, at 399.

329. See McDonnell, *supra* note 11, at 1427 (customers unlikely to guard against forgery); Murray, *supra* note 60, at 692 (customer knowledge of bank procedure may encourage forgery).

330. See *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 294 (1st Cir. 1988) (evidence that bulk filing did not lead to significant increase in undetected forgeries uncontradicted); Appellant's Brief and Abstract of Record at 10, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603) (conversion led to no significant

gent practice if it detects forgeries just as well as sight review. Courts should not, however, seize upon the bank's evidence as decisive in proving their cost-benefit argument. First, the court should determine whether the bank's sight review procedure met the ordinary care standard.³³¹ Second, the court should hear evidence on whether bank personnel followed that procedure.³³² Third, if the bank's sight review procedure was not negligent and was generally followed, the court should review critically the bank's data.³³³

Finally, the *Medford* statistics raise the question of how great a burden it would be to fashion a definition of ordinary care that imposed loss on the bank unless it had an effective state of the art system to detect forgeries. The bank in *Medford* presented data which showed that forgery losses were "infinitesimal,"³³⁴ as measured by the number of checks involved³³⁵ and by the amount of each check.³³⁶ Credit unions also have experienced "an extremely low loss ratio."³³⁷ While evidence that a bank pays few checks containing forged signatures tends to show either that the bank's system is sound or that few forgeries occur, it also indicates that banks don't face a high risk of substantial losses if they are held liable under section 4-406(3). Conversely, if many forged checks totalling a substantial sum are paid, one must question whether the bank's procedure meets the ordinary care standard.

Even if a bank can show that its sight review or bulk filing procedure is efficient because the cost of taking further preventative measures outweighs the benefits, it does not necessarily follow that the customer should bear the loss. As Professors Cooter and Rubin have shown, cost-benefit analysis does not take into account many economic, social, and legal considerations of the allocation of loss.³³⁸ While courts and legislatures ordinarily should not craft rules of loss allocation that put the loss on an efficient bank, other matters also should be considered, such as the disparate impact forgery losses have on different types of

change in forgeries detection); Murray, *supra* note 60, at 708 (banks report no increase in forgery claims after adopting electronic processing of checks).

331. See *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 191 (Tex. Ct. App. 1989) (Code sets standard; industry cannot set own standard).

332. See *supra* notes 312-14 and accompanying text for a discussion of a case in which bank personnel testified they did not follow the bank's rules.

333. See *supra* note 231 and accompanying text for a discussion of discrepancies in the data presented in the *Medford* brief making evaluation of that data difficult.

334. Appellant's Brief and Abstract of Record at 25, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603).

335. *Id.* at 10.

336. *Id.* at 11.

337. Siebold & Kessler, *Credit Unions and Check Truncation*, 44 BUS. LAW. 1096, 1098 (1989).

338. See *supra* notes 102-73, 297-98 and accompanying text for a discussion of how cost-benefit analysis ignores many significant factors in dispute resolution that are considered when the analytical framework includes the principles of loss spreading, loss reduction, and loss imposition. See also Waldron, *supra* note 293, at 1450 (reliance on single overarching principle rejected); White, *supra* note 288, at 126 (assigning liability to party who can avoid result at least cost is alternative to cost-benefit analysis and promotes efficiency). Waldron believes tort law is "extremely complex and . . . resists simple analysis." Waldron, *supra* note 293, at 1450 (quoting J. Coleman, *Markets, Morals and the Law* 189 (1989)).

customers, the appropriateness of encouraging banks to develop innovative technology (which may eventually allow them to take precautions at the lower cost in most instances) and the need to have a reliable national financial services industry. A court taking all of these factors into consideration may allocate loss to the same party as a court taking into account only the limited type of cost-benefit analysis urged by some banks. It is important, nevertheless, for a court to recognize the complexity of the issues before it and not to rely exclusively on a superficial cost-benefit approach.

IV. THE NEW, IMPROVED (?) SECTION 4-406

The foregoing review of the statutory scheme and case law relating to section 4-406, and an analysis of an economic theory of loss allocation, demonstrates the inadequacy of the current UCC formulation. Courts attempting to apply the concept of ordinary care to the bank's practices not only reach conflicting results, but also employ very different modes of analysis. Banks and customers need a new version of section 4-406 that provides courts with greater guidance as to what constitutes acceptable bank conduct in regard to signature verification. The project of the American Law Institute and the National Conference of Commissioners on Uniform State Laws to revise Article 4 presented the opportunity to accomplish this objective.³³⁹

Revised section 4-406's treatment of liability for a series of checks with forged signatures is similar to current section 4-406; the customer is precluded from holding the bank liable for a forged check if he or she fails to promptly notify the bank of "relevant facts."³⁴⁰ If the "customer proves that the bank

339. Rubin, *supra* note 1, at 621.

340. Revision Draft — article 4, *supra* note 1, at § 4-406. The relevant portions of revised § 4-406 provide:

Section 4-406. Customer's Duty To Discover and Report Unauthorized Signature or Alteration

(1) A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return to the customer the items paid or provide information in the statement of account sufficient to allow the customer to identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount, and date of payment.

(2) If the items are not returned to the customer, the person retaining the items shall either retain the items or, if the items are destroyed, maintain the capacity to furnish legible copies of the items until the expiration of seven years after receipt of the items. A customer may request an item from the bank that paid the item, and that bank must provide in a reasonable time either the item or, if the item has been destroyed or is not otherwise obtainable, a legible copy of the item.

(3) If a bank sends or makes available a statement of account or items pursuant to subsection (1), the customer shall exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized. If, based on the statement or items provided, the customer should reasonably have discovered the unauthorized payment, the customer has a duty to give prompt notification to the bank of the relevant facts.

(4) If the bank proves that the customer failed with respect to an item to comply with

failed to exercise ordinary care in paying the item and that the failure substantially contributed to loss," a comparative negligence scheme allocates loss between the parties. If the customer proves that the bank did not pay the check in good faith, the preclusion does not apply and the customer may demand that the bank credit his or her account.

A. *The New Definition of Ordinary Care*

New definitions of key terms are crucial to the operation of the revised section. As in the present section 4-406, "ordinary care" remains a critical standard of conduct in the revised Code. The revision, however, treats ordinary care in a strikingly different manner than the present Code. While the present Code contains no definition of ordinary care,³⁴¹ the revision, in sharp contrast, not only contains a definition in Article 3, which deals generally with negotiable instruments, but also makes a specific reference to ordinary care as it applies to a bank's check examination procedure under Article 4.

Revised Article 3 defines ordinary care solely as it applies to "a person engaged in business."³⁴² For such a person, ordinary care means the "observance of reasonable commercial standards, prevailing in the area in which that person is located, with respect to the business in which that person is engaged."³⁴³ Ordinary care, therefore, is equated with reasonable commercial standards. This treatment is consistent with cases applying section 4-406 in which the two terms also were equated.³⁴⁴

The word "tort" is not used in Revised Article 3's definitional section or in

the duties imposed on the customer by subsection (3) the customer is precluded from asserting against the bank

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

(b) the customer's unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notification from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time in which to examine the item or statement of account and notify the bank. "Reasonable period of time" is presumed to be 14 calendar days after the item or statement pursuant to subsection (1) was received by or made available to the customer.

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

341. U.C.C. § 4-103 comment 4 provides: "The term 'ordinary care' is not defined and is used here with its normal tort meaning and not in any special sense relating to bank collections. No attempt is made in the Article to define *in toto* what constitutes ordinary care or lack of it."

342. UNIFORM COMMERCIAL CODE, Revised Article 3 — Negotiable Instruments § 3-103(a)(7) (Proposed Final Draft, Revised May 10, 1990), in *SELECTED COMMERCIAL STATUTES* app. VI (1990 ed.) [hereinafter *Revision Draft* — article 3] (includes Conforming and Miscellaneous Amendments to UCC).

343. *Id.*

344. *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 293 (1st Cir. 1988);

its commentary. Moreover, tort is not mentioned in revised section 4-406 or its commentary. The revision consequently avoids the confusion engendered by the present commentary, which both rejects and adopts the view that ordinary care is a tort concept that requires evaluating the bank's conduct by relating it to bank check processing.³⁴⁵ By tying ordinary care to commercial reasonableness, and in no longer describing ordinary care in tort terms, the revision, when examined in light of the present Code, appears to have rejected the tort concept altogether. This rejection simplifies analysis of section 4-406 since courts no longer need to interpret the tort concept of ordinary care within the general context of the contractual relationship between the parties.³⁴⁶

B. Sight Review is not Required

The revision of section 4-406 also focuses on banks' check collection procedures. While it does not prescribe what conduct meets the standard of commercial reasonableness, it does provide that if the bank uses automated methods to process checks, the requirement to comply with the commercial reasonableness standard "do[es] 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 [3] or Article 4."³⁴⁷ One of the comments to revised section 4-406 states that the drafters' intent is to reject those cases that hold that failure to use sight reviews constitutes lack of ordinary care as a matter of law.³⁴⁸

The comment does not reflect accurately the status of current case law, however. As discussed previously, although courts are divided, those considering this issue in the last decade have not required sight review. The courts have pointed out that other procedures, such as random examination of a small percentage of checks within a given dollar range, may fulfill the bank's duty.³⁴⁹ Courts that have found that the bank failed to exercise ordinary care have done so only in cases where the bank had no procedure for examining checks in the amount at issue.

The revision of section 4-406 also fails to provide guidance in resolving the "reasonably related" issue. Courts that have found the bank negligent have re-

Medford Irrigation Dist. v. Western Bank, 66 Or. App. 589, 592-93, 676 P.2d 329, 332 (1984); McDowell v. Dallas Teachers Credit Union, 772 S.W.2d 183, 192 (Tex. Ct. App. 1989).

345. U.C.C. § 4-103 comment 4. See *supra* notes 33, 37 and accompanying text for a discussion of whether the meaning of ordinary care should take bank collections into account and whether general banking usage is *prima facie* ordinary care.

346. See *supra* notes 64-73 and accompanying text for a discussion of action against a negligent bank under U.C.C. article 4, *vis-a-vis* an independent tort action.

347. Revision Draft — article 3, *supra* note 342, at § 3-103(a)(7).

348. See Revision Draft — article 4, *supra* note 1, at § 4-406 comment 4 (intent is to allow banks to employ procedure other than sight examination if procedure is reasonable and is generally followed by similar banks in area).

349. See *supra* notes 238-39 and accompanying text for a discussion of procedures that reasonably relate to the detection of forgeries. The revision and comment provide guidance to courts in future cases that might otherwise hold that failure to engage in sight review is negligent. Revision Draft — article 4, *supra* note 1, at § 4-406 & comment.

quired it to establish a procedure that "reasonably relate[s] to the duty the bank has to detect unauthorized signatures."³⁵⁰ These decisions do not provide banks or customers with guidance on what procedures are acceptable. The revised section is of no help. The definition of ordinary care states that the bank is not required "to examine the instrument if the failure to examine does not violate the bank's prescribed procedures."³⁵¹ But the revision goes on to require that the bank's procedures "not vary unreasonably from general banking usage not disapproved by this Article [3] or Article 4."³⁵² This merely tells the bank, in effect, to draft procedures that do not require examination of checks as long as those procedures are not totally out of line with the practices of other banks.

C. General Banking Usage Standard Fails to Address the Fundamental Issue

The current Code explains in a comment that general banking usage is determined by looking at bank practices within the bank's geographical area.³⁵³ The Code is silent on whether small credit unions must show their practices are similar to those of other small credit unions in the area, or whether all financial institutions of any size or type must show their procedures are similar to those of all other financial institutions within that locality. The revision of section 4-406, like the current Code,³⁵⁴ allows the bank to prove that its conduct constitutes ordinary care by showing it is consistent with general banking usage. The revision, however, includes a comment that provides helpful guidelines on how to apply the concept of general banking usage; it provides that the proper focus of sight review is on whether that practice "is commonly followed by other comparable banks in the area."³⁵⁵

The problem with the revision is that it avoids entirely the central issue of the bank's duty in regard to detecting forged signatures. The revision retains the current Code's basic scheme, holding the bank liable for paying forged checks. It requires not only that the bank that paid a forged check have a procedure that is similar to those of other banks, but also that the practices of these other banks are those "not disapproved" by the Code.³⁵⁶ This language puts banks and customers right back where they started. Although the revised Code makes clear in a comment that when a customer fails to report forgeries promptly the bank is not liable simply because it did not employ sight review,³⁵⁷ the revision does not address the question of whether the bank still has some type of duty in the detection of forgeries. It states that the bank is not required to examine checks if it

350. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 191 (Tex. Ct. App. 1989).
Accord Medford Irrigation Dist. v. Western Bank, 66 Or. App. 589, 593, 676 P.2d 329, 332 (1984).

351. Revision Draft — article 3, *supra* note 342, at § 3-103(a)(7).

352. *Id.*

353. U.C.C. § 4-103 comment 4.

354. *Id.* at § 4-103(3). See *supra* note 99 for the relevant text of current section 4-103(3).

355. Revision Draft — article 4, *supra* note 1, at § 4-406 comment 4. Presumably, courts can extend the "comparable bank" standard to all types of bank practices; there is no apparent reason to confine it to sight review.

356. Revision Draft — article 3, *supra* note 342, at § 3-103(a)(7).

357. Revision Draft — article 4, *supra* note 1, at § 4-406 comment 4.

conforms to general banking usage and if that usage is not disapproved by the Code. Does that mean the procedure utilized by the credit union in *McDowell* constitutes ordinary care because there is no specific disapproval of it in the Code?³⁵⁸ Or does the Code's loss allocation scheme, which generally imposes liability on the bank for forgeries, mean that the Code disapproves of a procedure that contains no forgery examination of any checks? The failure to answer these questions leaves us with a revised Code which, like the present Code, violates the loss imposition principle because it does not reduce the probability of using litigation to clarify this legal question.

D. Proving the Bank's Negligence Substantially Contributed to the Loss

Under the revised UCC, not only must customers prove the bank failed to exercise ordinary care, but they also must prove that "the failure substantially contributed to loss."³⁵⁹ The addition of language requiring proof of causation creates uncertainty and increases the likelihood that customers will not be able to escape full liability even though they can prove the bank has failed to exercise ordinary care.

Current section 4-406(3) is silent on the issue of causation. The *Medford* court, interpreting this section to impose strict liability on the bank once the customer proved the bank's negligence, stated: "There is thus no issue as to the causal relationship between the bank's lack of due care and the customer's loss if the loss is established."³⁶⁰ Other courts have required proof of causation despite the silence of section 4-406(3).³⁶¹

Revised section 4-406 resolves the conflict among the courts by explicitly requiring proof of causation. The confusion with—and litigation resulting from—the issue of causation will not cease, however, because the drafters chose the same language for revised section 4-406 as that used in current section 3-406; such language engendered substantial case law as the courts have attempted to apply the ambiguous standard to a variety of fact patterns.³⁶² The comment to

358. See *McDowell v. Dallas Teachers Credit Union*, 772 S.W. 2d 183, 186 (Tex. Ct. App. 1989) (credit union employed no mechanism for reviewing signatures).

359. Revision Draft — article 4, *supra* note 1, at § 4-406(5). See *supra* note 340 for the text of revised section 4-406(5).

360. *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 595, 676 P.2d 329, 333 (1989).

361. See, e.g., *American Heritage Bank & Trust Co. v. Isaac*, 636 P.2d 1296, 1298 (Colo. Ct. App. 1981), *aff'd*, 675 P.2d 742 (Colo. 1984); *Vending Chattanooga Inc. v. American Nat'l Bank & Trust Co.*, 730 S.W.2d 624, 629 (Tenn. 1987). The *American Heritage* court found justification for requiring proof of causation from U.C.C. § 4-103(5) and comment 6 to that section. 636 P.2d at 1298. These provide that the measure of damages for failure to exercise ordinary care is the amount of the check minus the amount which would have been lost even if the bank had exercised ordinary care. U.C.C. § 4-103(5) & comment 6. In other words, unless the customer can establish a causal link between the bank's negligence and the loss, the customer cannot prove any damages. See B. CLARK, *supra* note 31, ¶ 8.02 [4][c], at 8-1.

362. Compare *Thompson Maple Prod. v. Citizens Nat'l Bank*, 211 Pa. Super. 42, 47, 234 A.2d 32, 36 (1967) (section 3-406 changes pre-Code law by shortening causal chain) and *Insurance Co. of North Am. v. Purdue Nat'l Bank*, 401 N.E.2d 708 (Ind. Ct. App. 1980) with *Commonwealth v. National Bank & Trust Co.*, 469 Pa. 188, 364 A.2d 1331 (1976) (section 3-406 did not change pre-

revised section 3-406 attempts to clarify the "substantially contributes" test by explaining that it "is meant to be less stringent than a 'direct and proximate' test."³⁶³ The comment even sets out three hypothetical situations to provide guidance.³⁶⁴ Even if the comment will assist the parties and the courts when they confront actual situations governed by section 3-406,³⁶⁵ it is not likely to help them resolve controversies raised under section 4-406; section 3-406 applies the "substantially contributes" test to the customer's negligence in storing and preparing checks, whereas section 4-406 applies the test to the bank's negligence in processing checks, an altogether different situation. Therefore, it is likely that uncertainty over the meaning of the "substantially contributes" test will result in expensive litigation, thus violating the loss imposition principle.

Revised section 4-406's requirement that the customer prove the failure to exercise ordinary care substantially contributed to the loss would protect the bank from liability in cases involving "perfect forgeries." That is, if the bank can show that the forgery was so well done that it would have paid the check even if it had exercised ordinary care, for example, by employing a reasonable system of sight review, the bank would escape liability. Upon initial consideration, this sounds reasonable. Why should the bank be penalized for negligent procedures if the same harm would have occurred if the bank had exercised care?

Case law is split on the question of whether the bank is liable for "perfect forgeries." As a general rule, the bank is liable for paying any check containing an unauthorized signature, including a forgery.³⁶⁶ This is so whether or not the bank could have detected the forgery.³⁶⁷ Some courts apply this strict liability rule in finding a bank negligent for check processing under section 4-406 and hold that the bank cannot meet its duty of ordinary care by claiming the forgery was so "artistic" that it could not be spotted.³⁶⁸ Other courts reach a different result under section 4-406 when there is a perfect forgery.³⁶⁹ Once the customer fails to report forged signatures promptly, the bank is liable only if it fails to

Code law). See also *National Bank v. Commonwealth*, 9 Pa. Commw. 358, 305 A.2d 769 (1973), *rev'd*, 469 Pa. 188, 364 A.2d 1331 (1976).

363. Revision Draft — article 3, *supra* note 342, at § 3-406 comment 2.

364. *Id.* comment 3.

365. See J. WHITE & R. SUMMERS, *supra* note 66, at 692 (case law involves "similar but often distinctively elaborate factual webs"). The cases do not develop any principles, however. *Id.* at 693.

366. See U.C.C. § 3-404(1) (unauthorized signature wholly inoperative as customer signature); *id.* § 1-201(43) (unauthorized signature includes forgery); *id.* § 4-401(1) (bank may only charge "properly payable" checks against customer account).

367. See generally B. CLARK, *supra* note 31, ¶ 8.02[2], at 8-9 (under doctrine of *Price v. Neal*, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762), drawee bank cannot shift liability to party transferring check where check contains forged signature and bank paid, even when forgery was so skillful that bank could not detect it).

368. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 188 (Tex. Ct. App. 1989); *First Nat'l Bank v. Hackworth*, 673 S.W.2d 218, 223 (Tex. Ct. App. 1984).

369. *Industrial Systems v. American Nat'l Bank*, 376 So. 2d 742, 745 (Ala. Civ. App. 1979); *K & K Mfg. v. Union Bank*, 129 Ariz. 7, 9-10, 628 P.2d 44, 48 (Ariz. Ct. App. 1981); *Ossip-Harris Ins. v. Barnett Bank*, 428 So. 2d 363, 366 (Fla. Dist. Ct. App. 1983); *Zenith Syndicate, Inc. v. Marine Midland Bank*, 23 U.C.C. Rep. Serv. (Callaghan) 1267, 1269 (N.Y. Civ. Ct. 1978).

exercise ordinary care. That means the bank is not liable for detecting "perfect forgeries." In fact, the bank need not utilize procedures designed to detect especially skillful forgeries, such as employing handwriting experts, because ordinary care sets a lower standard. Shielding the bank from liability when the exercise of ordinary care would not have resulted in detecting the forgery also is consistent with the damages scheme of section 4-103(5).³⁷⁰ The revised code apparently resolves this conflict by requiring proof of causation.

Assuming this is a fair resolution, two problems with revised section 4-406's requirement of proof of causation remain. First, imposing a causation requirement on the customer at best encourages swearing contests between experts at trial. The customer's expert will testify that the forgery was not very skillful; if the bank had used an acceptable detection procedure, the forgery would have been spotted. The bank's expert will swear that the forgery is nearly perfect and that no reasonable procedure would have caught it. This battle of experts makes the case costly for both sides;³⁷¹ ultimately the finder of fact must decide the case based on which expert is more credible or based on the finder of fact's own judgment as to the quality of the forgery. This approach violates the loss imposition principle, prevents customers from filing potentially meritorious claims because of expense, and results in law that is not certain or predictable.

Second, where a perfect forgery is not involved, it is unclear what the customer must prove under revised section 4-406 to show causation. The difficulties in interpreting and applying the "substantially contributes" test are illustrated by situations in which a bank employs a random examination procedure and fails to meet the ordinary care standard. This may happen, for example, where the bank randomly examines only one-tenth of one percent of all checks and the customer proves it is not a high enough percentage to meet the standard.³⁷² Under the revised Code, the customer must then prove this failure substantially contributed to the loss resulting from the forgery. It is not clear what the customer must do to satisfy this requirement. If a bank uses random review, causation is always proved because there is a significant likelihood the customer's check will not be examined. Consequently, the bank contributes to the loss by not detecting the forgery and by not refusing to pay the check. Once the customer proves that the bank's random review procedure does not meet minimal ordinary care standards, the customer logically would not have to show anything else to establish causation.

370. U.C.C. § 4-103(5). Section 4-103(5) currently provides in pertinent part: "The measure of damages for failure to exercise ordinary care . . . is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care, and where there is bad faith . . . other damages . . . suffered . . . as a proximate consequence."

371. *First Nat'l Bank v. Hackworth*, 673 S.W.2d 218, 221-22 (Tex. Ct. App. 1984) (much time at trial spent on expert testimony about quality of forged signatures).

372. Another example is a bank's use of a static signature verification system that fails to detect forgeries in a large percentage of cases. See *supra* notes 131-33 and accompanying text for a discussion of the use of static signature verification systems to detect forgeries.

E. The Comparative Negligence Conundrum

Revised section 4-406 adopts a comparative negligence approach to loss allocation.³⁷³ Comparative negligence may be more fair than contributory negligence in traditional tort cases.³⁷⁴ In the section 4-406 context, however, it violates the loss imposition principle, is contrary to several Code objectives, and obfuscates any conceptual clarity gained by defining ordinary care in terms of commercial reasonableness rather than tort.

1. The Pros and Cons of Comparative Negligence

Dissatisfaction with contributory negligence schemes in the context of automobile accident cases has led most states to adopt the doctrine of comparative negligence.³⁷⁵ Advocates of comparative negligence believe it is a fairer system since it is unjust to allocate loss solely to the plaintiff where both sides are at fault.³⁷⁶ The unfairness is most pronounced where the degree of the plaintiff's culpability is slight and that of the defendant is great.³⁷⁷

If the degree of negligence of each party is roughly the same, however, apportionment of loss becomes problematic. States have adopted different types of comparative negligence schemes. Several states have adopted "pure" comparative negligence, in which the plaintiff's damages are reduced in accordance with his or her degree of fault.³⁷⁸ Most states have enacted one of two different modified forms of comparative negligence. Under the first approach, the plaintiff can recover only if less than fifty percent of the fault can be attributed to him or her.³⁷⁹ The other form of modified comparative negligence allows the plaintiff to recover as long as he or she is not more than fifty percent culpable.³⁸⁰ Under both types of modified comparative negligence, if the plaintiff's negligence exceeds the acceptable quantum, the plaintiff is precluded from recovering anything. In effect, the contributory negligence approach applies at that point.³⁸¹ Two states adopt a third regime, whereby the comparative negligence allocation takes effect only if the plaintiff's damages are "slight" compared to the defendant's.³⁸²

While comparative negligence appears fairer than the one-side-take-all approach of contributory negligence, it has been criticized on several grounds. Commentators deride the notion that juries can determine degree of fault with

373. Revision Draft — article 4, *supra* note 1, at § 4-406(5).

374. Mutter, *Moving to Comparative Negligence in an Era of Tort Reform: Decisions for Tennessee*, 57 TENN. L. REV. 199, 230-32 (1990).

375. *Id.* at 228.

376. Keeton, *Comments on Maki v. Frelk — Comparative v. Contributory Negligence: Should the Court or Legislature Decide?*, 21 VAND. L. REV. 889, 912-13 (1968); Mutter, *supra* note 374, at 231.

377. Mutter, *supra* note 374, at 231.

378. *Id.* at 228-29.

379. *Id.*

380. *Id.*

381. *Id.* at 230.

382. *Id.*

the precision required by the percentage limits.³⁸³ Under any form of comparative negligence, "the apportionment of fault among culpable parties is a highly intuitive undertaking."³⁸⁴ As a result, there is little consistency among the cases and it is difficult to discern "definite guidelines."³⁸⁵ Finally, while comparative negligence may be ideally suited to automobile accident cases, it is inappropriate in many other contexts.³⁸⁶

2. Revised Code's Approach to Comparative Negligence

Despite both the reservations expressed by critics about the operation of comparative negligence in the traditional tort context and the disagreement among state legislatures over which form of comparative negligence is superior, the revised Code adopts use of the "pure" approach. This is distinctly a minority position, having been adopted by only thirteen of the forty-four states that have enacted comparative negligence to govern loss allocation in tort cases.³⁸⁷ Revised section 4-406 provides that if the customer proves that the bank failed to exercise ordinary care and it "substantially contributes" to the loss, the loss is then 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."³⁸⁸ Although this represents a radical departure from the the stance of the current Code, the comment to revised section 4-406 is completely silent on the introduction of comparative negligence; no explanation of or justification for the substantially increased burden placed upon the customer is offered.

3. Arguments Opposing Comparative Negligence in the Section 4-406 Context

Although a recent federal banking regulation adopts comparative negligence in transactions between banks,³⁸⁹ courts have refused to apply this doctrine in section 4-406 cases.³⁹⁰ The New York Court of Appeals in *Putnam* provided two rationales for reversing the lower court's application of comparative negligence. First, the court found that the Code's scheme of loss allocation

383. *Id.* at 234.

384. *Id.* at 235.

385. *Id.*

386. Malone, *Comments on Maki v. Frelk — Comparative v. Contributory Negligence: Should the Court or Legislature Decide?*, 21 VAND. L. REV. 889, 934 (1968).

387. Mutter, *supra* note 374, at 228-29.

388. Revision Draft — article 4, *supra* note 1, at § 4-406(5).

389. Regulation CC, promulgated pursuant to the Expedited Funds Availability Act, 12 U.S.C. §§ 4001-4010, incorporates a scheme of comparative negligence as between banks under certain circumstances. 12 C.F.R. § 229.38 (c)(1990). See generally B. CLARK, *supra* note 31, ¶ 7.14[2][k], at 7-53.

390. See *Five Towns College v. Citibank*, 108 A.D.2d 420, 489 N.Y.S.2d 338 (N.Y. App. Div. 1985) (comparative fault considerations alter rights under U.C.C. § 4-406); *Vending Chattanooga v. American Nat'l Bank*, 730 S.W.2d 624, 629 (Tenn. 1987) (no comparative fault under code); *Behring Int'l v. Greater Houston Bank*, 662 S.W.2d 642 (Tex. Ct. App. 1983) (comparative negligence inapplicable in breach of contract suit).

represents a "carefully drawn balance,"³⁹¹ which comparative negligence principles would upset. The revised Code upsets the same balance without explanation. Possibly the drafters believed the present Code makes it too easy for customers to prevail despite the *prima facie* rule of section 4-103(3). If so, this belief must be based on something other than published modern case law, for, during the past ten years, customers have prevailed under section 4-103(3) in few cases.³⁹² Perhaps the drafters believed that the Code's loss allocation scheme as a whole unduly favors customers and that section 4-406(3) is an appropriate vehicle for correcting that imbalance. The conclusion that Article 4 has a pro-customer bias in need of correction would certainly represent startling revisionism, however, since, at the time it was proposed, Article 4 was acknowledged universally to have been written by the banks and for the banks.³⁹³ Whatever the motivation, comparative negligence weights the balance far more heavily on the side of the bank, as explained below.

The second rationale given by the *Putnam* court in rejecting comparative negligence was that the objective of the Code is different from that of tort law.³⁹⁴ Tort law imposes liability on the basis of fault. Liability varies from case to case depending on the facts. The UCC promotes "certainty and predictability" as well as "efficiency in dispute resolution."³⁹⁵ The current Code is consistent with these objectives; once the customer proves the bank failed to exercise ordinary care, loss shifts to the bank. Under the revision, however, the amorphous process of assigning liability under comparative negligence leaves it unclear whether the bank or the customer ultimately bears the loss, even after the customer proves that the bank lacked ordinary care and that the bank's conduct substantially contributed to the loss. In addition, as the *Putnam* court pointed out, comparative negligence is contrary to efficient dispute resolution because of the fact-intensive issues the court is required to hear, evaluate, and rule on.³⁹⁶ The *Putnam* court's concern with efficient dispute resolution echoes the economist's disfavor of legal rules that violate the loss imposition principle.³⁹⁷

391. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust*, 74 N.Y.2d 340, 349, 546 N.E.2d 904, 908, 547 N.Y.S.2d 611, 615 (1989). See also *Five Towns College*, 108 A.D.2d at 429-30, 489 N.Y.S.2d at 345 (Code's rules on loss allocation represent attempt to be equitable).

392. See *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 348-49, 546 N.E.2d at 906-07, 547 N.Y.S.2d at 615 (bank liable if failed to exercise ordinary care); *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 593-97, 676 P.2d 329, 332-34 (1984) (bank liable if failed to follow reasonable commercial banking practice); *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 191 (Tex. Ct. App. 1989) (credit union liable for failure to exercise ordinary care).

393. Beutel, *supra* note 81, at 361-62; Gilmore, *supra* note 37, at 374-75; Leary & Schmitt, *supra* note 81, at 613-14.

394. See *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 349, 546 N.E.2d at 908, 547 N.Y.S.2d at 615 (UCC promotes certainty and predictability).

395. *Id.*

396. See *id.* (Code's goals not advanced by fact inquiries required under comparative negligence).

397. *Id.* The *Putnam* court also states that one of the Code's goals is "allocating responsibility to the party best able to prevent the loss by the exercise of care." 74 N.Y.2d at 349, 546 N.E.2d at 908, 547 N.Y.S.2d at 615. See *supra* notes 156-57 and accompanying text for a discussion of efficient

4. Problems in Applying the Revised Code's Comparative Negligence

While the revised Code's definition of ordinary care fits much more comfortably within the contractual context of customer-bank relations by eliminating confusing references to tort law, revised section 4-406(5) reintroduces tort with a vengeance by invoking comparative negligence, and, in the process, creates great conceptual confusion. Under revised section 4-406(5), the customer must prove the bank failed to exercise ordinary care; ordinary care is defined as commercially reasonable conduct.³⁹⁸ But if the customer proves that the bank failed to exercise ordinary care, and that the failure substantially contributed to the loss,³⁹⁹ the loss is allocated according to how much each party's failure to exercise ordinary care "contributed to the loss."⁴⁰⁰ In other words, to determine loss, the court must look at both the customer's lack of ordinary care in failing to report promptly, and the bank's lack of ordinary care in processing the forged check. The definition of ordinary care is stripped of tort baggage, but then applied within the tort framework of comparative negligence. Thus, tort concepts are eased out the back door and welcomed back in through the front.

It will be a challenge for the court to instruct the jury on how to apply the concept of ordinary care, which is no longer defined in tort terms, in a comparative negligence scheme. Ordinarily, juries apportion losses in comparative negligence cases according to the relative fault of each party.⁴⁰¹ Is the jury supposed to apportion loss under revised section 4-406 according to which party is the most commercially unreasonable?

The difficulties go even beyond that, however. Revised section 3-103(a)(7) defines ordinary care as it applies to "a person engaged in business." There is no definition of ordinary care for those customers who are individual consumers. Arguably, since the drafters were so precise in defining ordinary care in revised section 3-103(a)(7), they did not intend it to apply to consumers. Presumably, the customary tort definition of ordinary care is applicable.⁴⁰² If these assumptions are correct, an individual consumer's portion of the loss is judged on the basis of his or her culpability, and the bank's portion of the loss is determined based on its lack of commercial reasonableness. While juries may be able to "do the right thing," it is conceptually awkward and probably confusing for juries to use two different standards of ordinary care in apportioning loss.⁴⁰³

An examination of the facts in some of the commercial cases illustrates the difficulty of applying comparative negligence. Despite the fact that every section 4-406(3) case involves a customer deemed negligent by its failure to report

rules, such as strict liability; *supra* notes 106-28 and accompanying text for a discussion of the development of new bank practices and technology as placing additional burdens on customers.

398. Revision Draft — article 3, *supra* note 342, at § 3-103(a)(7).

399. Revision Draft — article 4, *supra* note 1, at § 4-406(5).

400. *Id.*

401. W. KEETON, *supra* note 35, at 472.

402. See U.C.C. § 1-103 (unless displaced by Code, general principles of law apply).

403. See *infra* notes 440-42 and accompanying text for a discussion of further difficulties that the revision creates in consumer cases; for example, the revision fails to require notice to consumers of their rights and obligations under the law or to provide an error resolution procedure.

promptly, the degree of negligence varies considerably. In *Medford*, the wrongdoer's conduct involved only nine checks⁴⁰⁴ amounting to almost \$69,000, forged over a period of a mere three weeks.⁴⁰⁵ In *Zapata*, the thief forged 224 checks⁴⁰⁶ totalling over \$109,000 over a period of five months.⁴⁰⁷ In *McDowell*, the bank alleged the officers never examined the bank statement,⁴⁰⁸ but in *Putnam*, the customer claimed its officers reviewed the statement and their accountant made "periodic 'surprise' reconciliations" of the checkbook.⁴⁰⁹ Fact finders may sympathize with customers such as Wilder Binding, which have few employees,⁴¹⁰ and where it is relatively more burdensome to closely monitor the bookkeeper.⁴¹¹ The customer also may appear less blameworthy in the eyes of the finder of fact when the case involves fewer forged checks, a smaller amount of money, a short period of time before discovery, a small firm, or a more sophisticated forgery scheme.

Likewise, bank conduct that falls below the ordinary care standard may take many forms. Finders of fact may consider banks that conduct sight review⁴¹² less negligent than banks that engage in no review of any kind, such as the credit union in *McDowell*.⁴¹³ Some finders of fact may be influenced by the bank's failure to heed suspicious circumstances. In *Medford*, for example, two bank employees testified that the forged signatures were noticeably different from those on the signature card⁴¹⁴ and two of the forged checks caused overdrafts of \$22,000 and over \$19,000.⁴¹⁵ While the Code specifically authorizes banks to pay checks even if they cause overdrafts,⁴¹⁶ if the customer never had

404. Respondents' Brief and Supplemental Abstract of Record at 7, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603).

405. *Medford Irrigation Dist.*, 66 Or. App. at 591, 676 P.2d at 331.

406. Brief for Appellee at 3, *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291 (1st Cir. 1988) (No. 87-1890).

407. *Zapata Corp.*, 848 F.2d at 292.

408. Brief of Appellee at 33, *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183 (Tex. Ct. App. 1989) (No. 05-88-00652-CV).

409. Brief of Defendant-Respondent Manufacturers Hanover Trust Company at 4, *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust*, 74 N.Y.2d 340, 546 N.E.2d 904, 547 N.Y.S.2d 611 (1989) (No. 2290-86).

410. Brief of Plaintiff-Appellee, *Wilder Binding Company* at 7, *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 552 N.E.2d 783 (1990) (No. 67709).

411. *Id.* The customer in *Zapata*, however, tried to garner sympathy despite its size by explaining that its failure to discover the forgeries was caused by the confusion surrounding a massive corporate restructuring, office relocations, and difficulties encountered in computerizing its accounting and payroll reconciliation procedure. Appellants' Brief at 2, *Zapata Corp.* (No. 87-1890).

412. See SURVEY, *supra* note 94, at 119 Table 35E (52.4% of responding banks with assets less than \$100 million verified all signatures before payment, 24.1% of banks with assets between \$100 and \$500 million verified all signatures, 13.2% of banks with assets between \$500 million and \$1 billion verified all signatures, and 7.2% of remainder verified all signatures).

413. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 186 (Tex. Ct. App. 1989).

414. Respondents' Brief and Supplemental Abstract of Record at 6-7, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603).

415. *Id.* at 5.

416. U.C.C. § 4-401. Section 4-401 provides that a bank may charge against a customer's account "any item which is otherwise properly payable from that account even though the charge creates an overdraft." *Id.*

an overdraft before, if the amounts of the overdrafts were significant in relation to the customer's normal balance, and if the signatures on the checks causing the overdrafts were obvious forgeries, the finder of fact may regard payment of the overdraft unfavorably in allocating blame between the parties.

Finders of fact also may take into consideration the failure of the bank to follow the express terms of its contract with the customer (where such failure may have encouraged the thefts), and its failure to maintain even minimal identification procedures (which permitted the thefts to continue). For example, the trial court in *Putnam* took into consideration the bank's previous payment of five checks containing only one signature⁴¹⁷ despite its obligation under contract to pay only checks containing two authorized signatures.⁴¹⁸ The customer suggested that the embezzling bookkeeper may have taken the bank's payment of these improperly signed checks as an indication that the bank would honor her forged checks as well.⁴¹⁹ The bank in *McDowell* failed to establish any procedure to verify signatures on checks presented for payment over the counter at the bank's branches.⁴²⁰ If the wrongdoer had tried to cash the checks at the main office, the bank's procedure required the teller to compare the check's signature with that on the signature card.⁴²¹ None of the branches had signature cards or copies of the cards; consequently, the bookkeeper was able to cash the checks and continue to forge additional checks because the bank's procedures foreclosed any opportunity for the bank to detect forgeries at branches. A finder of fact might find such a procedure particularly egregious given the ease with which the bank could have made signature cards or their copies available to branches⁴²² and because the bank also had a policy not to examine any checks which were not presented to the bank in person.

Despite the variety of fact patterns present in these cases, they are far less complicated than many others in which finders of fact are called upon to apply comparative negligence. Policy questions arise, however, because the conduct of customers and banks in section 4-406(3) situations cannot be quantified. How is the finder of fact supposed to compare degrees of culpability in the *Putnam* case? The customer failed to detect the forgeries in thirty-seven checks for ten months. The officers and their accountant, however, periodically reviewed the bookkeeper's work, but failed to discover the thief's scheme, which was designed to avoid easy detection.⁴²³ The bank was careful enough to employ sight review.

417. Reply Brief of Plaintiff-Appellant at 5, *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust Co.*, 74 N.Y.2d 340, 546 N.E.2d 904, 547 N.Y.S.2d 611 (1989) (No. 2290-86).

418. *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 343-44, 546 N.E.2d at 905, 547 N.Y.S.2d at 612.

419. Brief for Plaintiff-Appellant at 6, *Putnam Rolling Ladder Co.* (No. 2290-86).

420. Appellants' Brief at 8-9, *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183 (Tex. Ct. App. 1989) (No. 05-88-00652-CV).

421. *Id.* at 9.

422. See Violano, *The High-Tech Future of Foiling Fraud and Forgery*, BANKERS MONTHLY 35, 36 (April 1989) (many banks now use computers that allow teller to retrieve image of signature in less than two seconds).

423. Brief of Defendant-Respondent Manufacturers Hanover Trust Company at 4, *Putnam Rolling Ladder Co.* (No. 2290-86).

On the other hand, each check was examined for no more than four seconds.⁴²⁴ The system obviously did not work very well, since thirty-seven forgeries went undetected, and checks containing only one signature instead of the required two also were not spotted.⁴²⁵ Many finders of fact may follow the example of the *Putnam* trial court. It applied comparative negligence and ruled that each side was equally at fault, thereby reducing the customer's award by 50%.⁴²⁶ Because of the impossibility of precision, other finders of fact considering identical facts might consider the customer far more negligent because so many forgeries involving so much money went undetected for so long. Still others might be more influenced by what they regard as the bank's failure to adopt a procedure that had a reasonable chance of detecting any forgeries and find the bank the overwhelmingly negligent party.

Because of the variety of fact patterns present and the impracticability of quantifying instances of negligent conduct, it is likely that the comparative negligence scheme will encourage extensive discovery and fact-intensive trials, thus violating the loss imposition principle. In addition, the incorporation of comparative negligence will make the results in a given case unpredictable, even when the customer can prove lack of ordinary care and causation. This violates the commercial law's objectives of predictability and stability. Allocating loss based on comparative negligence pushes a commercial transaction arising out of a contract for financial services into a loss allocation scheme designed to govern accidental injury.

F. Does the Revised Code Strike the Proper Balance?

The revised Code upsets the balance established under the present Code by making it more difficult and costly for the customer to shift the loss for the forged check back to the bank.⁴²⁷ This change is proposed despite the drafters' failure to substantiate any undue burden imposed upon banks by the current Code.⁴²⁸ Supporters of the revised Code can justify tipping the balance further against customers by contending that the customer is the party who can avoid the loss at the least cost by taking precautions to prevent forgeries and by promptly detecting and reporting any forgeries that occur. Although this is a powerful argument, other factors should be taken into account as well, such as whether customers will be able to bear the risk at a lower cost than banks, whether banks will have sufficient incentives to develop technological innova-

424. *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 344, 546 N.E.2d at 905, 547 N.Y.S.2d at 612.

425. Brief for Plaintiff-Appellant at 5, *Putnam Rolling Ladder Co.* (No. 2290-86).

426. *Putnam Rolling Ladder Co.*, 74 N.Y.2d at 344, 546 N.E.2d at 905, 547 N.Y.S.2d at 612.

See generally Kalven, *Comments on Maki v. Frelk — Comparative v. Contributory Negligence: Should the Court or Legislature Decide?* 21 VAND. L. REV. 889, 901 (the best parties can do is divide loss equally).

427. See *supra* notes 362, 398-426 and accompanying text for a discussion of the revision requiring buyers to prove causation and adopting a comparative negligence scheme to allocate damages.

428. The comment to revised section 4-406 contains no justification for the change. See *Five Towns College v. Citibank*, 108 A.D.2d 420, 429-30, 489 N.Y.S.2d 338, 345 (N.Y. App. Div. 1985) (UCC's balance of rights in article 4 is attempt to be fair and equitable).

tions to prevent and detect forgeries, and whether customers will find it financially feasible to enforce their rights.⁴²⁹ In addition, this justification loses much of its force when the customer's checks are truncated and when the customer is an individual consumer.

1. Truncation

The drafters of the revised Code specifically have placed truncated checks within the governance of section 4-406. The bank has the choice of either returning the checks to the customer or withholding the checks, but if it withholds the checks, it must provide a statement with information that is "sufficient to allow the customer to identify the items paid."⁴³⁰ Revised section 4-406 then sets out the items of information that are deemed to be sufficient; these include the check number, the amount of the check, and the date when the check was paid. As the comment explains, these items were chosen because computers can retrieve such information automatically; no human review is required. The comment acknowledges that the revised Code does not require two other items that would greatly facilitate the customer's ability to determine if there is a problem: the name of the payee and the date written on the check. The drafters do not require banks to disclose this information on the statement because such inclusion would require check examination by humans, thereby greatly increasing the cost of truncation. The comment explains: "These costs will inhibit the growth of truncation plans."⁴³¹

If the bank chooses to truncate, it must either retain the original checks or "maintain the capacity to furnish legible copies" of the checks for seven years.⁴³² In other words, if someone other than the customer's bank is storing the check or copies of it, the customer's bank must be able to obtain a copy. If the customer wants a copy, he or she can request it from the customer's bank, which is required to provide it in a "reasonable time."⁴³³ If the bank that truncates the checks provides a statement containing sufficient information, the customer must promptly examine the statement and report unauthorized payments if "the customer should reasonably have discovered" that payment based on the statement or based on the items provided pursuant to the customer's request.⁴³⁴

The revised Code provides needed clarification by authorizing truncation

429. See *supra* notes 101-73 and accompanying text for a discussion of the application of Cooter and Rubin's principles as casting doubt on the proposition that it is appropriate to make it more difficult for the customer to shift the loss to the bank.

430. Revision Draft — article 4, *supra* note 1, at § 4-406(1). The comment states that the method the bank chooses "is a matter for bank-customer agreement." *Id.* comment 1. If the written contract between the parties is silent on this issue, perhaps the customer who receives a statement but no checks and does not object is considered to have agreed to truncation. Given the novelty of truncation, the better course may be to require banks wishing to truncate to enter into a written contract with the customer in which the customer explicitly agrees to truncation, and the customer's duties are set out and fees for copies disclosed.

431. *Id.* § 4-406 comment 1.

432. *Id.* § 4-406(2).

433. *Id.*

434. *Id.* § 4-406(3).

and by stating precisely what information a statement must contain to meet minimal standards of section 4-406. The revision enables banks to automate their operation to a considerable extent, which should benefit them and their customers; truncation is more efficient and should lead to lower costs for those customers choosing this option.⁴³⁵

It is less clear, however, whether banks that truncate checks should gain the advantages the revised Code provides. The current loss allocation scheme is justified in part by the assumption that the customer is the one who can prevent the loss at the lowest cost. Truncation, however, makes it far more costly for the customer to discover forgeries,⁴³⁶ and the revised Code exacerbates the difficulty of spotting forgeries by permitting the bank to issue a statement that omits information the customer needs, especially the name of the payee. This added expense substantially undermines the justification that the customer is the party who can prevent loss at the least cost.⁴³⁷

To gain a true perspective of the revised Code's allocation of loss in a truncated environment, one must add the increased costs of forgery detection to the customer under truncation to the increased burdens the revised Code imposes on all check customers trying to shift the loss to the bank.⁴³⁸ In addition, factors other than which party can take precautions at the least cost also should be considered.⁴³⁹ When all of these elements are taken into account, it is reason-

435. See *id.* § 4-406 comments (assumption is that banks will differentiate charges on basis of whether customer wishes return of checks).

436. J. WHITE & R. SUMMERS, *supra* note 66, at 697-98. To detect forgeries, a customer must carefully reconcile the balance shown on the statement with the balance shown by his or her calculations in the customer's checkbook, taking into account all deposits and withdrawals, preauthorized payments of recurring bills, fees for services such as stop payment, and use of ATM's monthly service charges, etc. The checks listed on the statement should be individually compared with the record on the check stub and the carbonless copies of the checks, which banks often provide. Even if a discrepancy is found, the customer still does not know if it was caused by a forgery unless he or she takes several steps. First, the customer should request a copy of the checks that the customer believes may be questionable. The bank likely will impose a charge for each check requested. To be certain not to miss anything, the customer would be well advised to request all checks received by the bank, or whoever is retaining them, during the period covered by the statement. See Appellants' Brief at 8, *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183 (Tex. Ct. App. 1989) (No. 05-88-00652-CV) (claims customer cost would run \$55 to \$80 monthly to obtain copies of cancelled checks during period checks were forged). Second, the customer should pray that the bank will send originals or legible copies. Once the documents are received, the customer must examine the checks for forgeries, and report any forgeries to the bank. Finally, the customer must be prepared to argue that, if UCC § 4-406 applies, the court also should take all of the above steps into consideration in construing the prompt reporting requirement. The court should not find the customer took too long to notify the bank of forgeries even though many weeks or months have elapsed between receipt of the statement and the reporting of forgeries in a truncated environment.

437. If low cost, high speed signature verification equipment becomes available, this difference will be reduced further, if not eliminated.

438. See *supra* notes 359-72, 398-426 and accompanying text for a discussion of the revised Code requiring the customer to prove the bank's negligence substantially contributed to the loss and a discussion of the comparative negligence standard making it more difficult for customers to resolve disputes satisfactorily.

439. See *supra* notes 102-73 and accompanying text for a discussion of whether consideration

able to question whether the revised Code has struck the correct balance when checks are truncated.

2. Individual Consumers

Finally, concerns about the appropriateness of the balance struck by the revised Code arise when the customers are individual consumers. The UCC approach starkly contrasts with modern federal consumer banking law. For example, federal law has established elaborate error resolution procedures to ensure that consumers have necessary safeguards when an unauthorized electronic fund transfer payment occurs.⁴⁴⁰ Federal lawmakers recognize that when a statute is enacted, consumers rarely know their rights and responsibilities under the new law. Therefore, unlike the revised UCC, which assumes customers can discover the contents of the new law on their own, federal law requires banks to notify consumers of what the law provides.⁴⁴¹

The drafters of the revised Code decided not to adopt any special provisions to protect the individual consumer. That course of action has been left to the discretion of federal and state legislators. In light of the increased burdens that the revised Code places on customers, further action by lawmakers may be warranted.⁴⁴² In the absence of consumer legislation, the revised Code should ensure that consumers know the new ground rules and are not under the erroneous impression that check transaction disputes are covered by a protective procedure comparable to that which governs other types of payment systems. The revised Code should require banks to notify consumers of their responsibility to report forgeries promptly. The notice should describe the new requirements the revised Code imposes upon them if they seek to shift the loss for a forged check to the bank. In addition, individual consumers using truncation services may benefit from a notice that both explains the additional steps truncation requires a consumer to take to identify forgeries and discloses the cost of obtaining copies of their checks.

V. A BETTER APPROACH

A. Possible Approaches

Many approaches to bank responsibilities for check forgery are possible. At

also should be given to issues arising from the application of the principles of loss spreading, loss reduction, and loss imposition.

440. See, e.g., 12 C.F.R. § 205.7(a)(10) (1990) (banks shall disclose notice containing detailed electronic funds transfer error resolution procedure and customer's rights under it); 12 C.F.R. § 205.11 (1990) (creditors in credit card transactions shall follow mandated billing error resolution procedure).

441. See, e.g., 12 C.F.R. § 205.7(a)(10) (notice required to consumers of error resolution procedure that banks and consumers required to follow); 12 C.F.R. § 226.6(d) (1990) (creditors in credit card transactions required to disclose mandated billing error resolution procedure); 12 C.F.R. §§ 229.15(b), 229.17 (1990) (notice required to consumers of when banks must have funds deposited by check available to consumer).

442. See Cooter & Rubin, *supra* note 101, at 90-92 (consumers should be strictly liable for losses, but only up to fixed and low maximum in situations where both parties can take precautions).

one extreme, the law could retire from the battlefield entirely, and allow a bank to adopt any procedure it desires. Society could rely upon the forces of competition in a free market to provide customers both with adequate information about bank practices and with an array of satisfactory choices. At the other extreme, the law could impose liability on any bank that failed to establish a system in which every check was subject to meaningful sight review. The first alternative conflicts with the national policy, in force ever since the widespread failure of the banking system in the Depression, to ensure by law a minimum level of performance standards for the national payments system.⁴⁴³ It also is contrary to the UCC, which requires "good faith, diligence, reasonableness and care" generally,⁴⁴⁴ and "ordinary care" specifically in regard to check processing.⁴⁴⁵ The second alternative is unacceptable because it is too rigid. Many banks could not meet the check processing deadlines set by law⁴⁴⁶ and keep costs at a reasonable level if they had to carefully examine every check. Consequently, banks would continue bulk filing, and bear the loss for all forged signatures. Such a result removes from customers the incentive to take reasonable precautions.

In between these two extremes are countless other options. The revised Code adopts the bank protectionist approach. The revision is consistent with the current Code's objective of facilitating flexibility to allow banks to develop technology and improve the speed and efficiency of check processing.⁴⁴⁷ The revision also probably places loss on the party able to prevent loss at the least cost, the customer. On balance, however, the revised Code's approach is objectionable because it violates the loss imposition principle by making litigation by customers excessively burdensome. It also violates the loss spreading principle because banks can better spread the loss. The revision provides no incentives for banks to take precautions or to promote the development of technological innovations that improve forgery detection, such as static signature verification. Further, the revision is contrary to the Code's objectives of stability and predictability. Finally, the revised Code continues the confusion engendered by injecting tort principles into an essentially commercial contract context.

An alternative to the revised Code approach would retain the revised Code's provisions, but also would require the bank to send a notice containing necessary information to every customer if it does not conduct sight review. The notice would inform the customer that, contrary to the impression the customer may have from signing a signature card, the bank does not examine the signature on every check. Consequently, to protect itself, the customer must take adequate precautions or face liability if forgeries are not promptly reported and the customer cannot prove the bank failed to exercise ordinary care and the failure substantially contributed to the loss that occurred. This notice could

443. See W. LOVETT, *BANKING AND FINANCIAL INSTITUTIONS LAW* 14-18 (1984) (national policy in force since depression-era failure of bank system).

444. U.C.C. § 1-102(3).

445. *Id.* § 4-103(1).

446. See, e.g., 12 C.F.R. pt. 229 (depositors' prompt access to funds required); U.C.C. §§ 4-301, 4-302 (bank must act within prescribed time limit, else customer has remedies).

447. U.C.C. § 4-103 comment 1.

easily be printed on the statement or inserted with the merchandising solicitations which accompany the statement.

B. A Proposal to Improve the Revised Code

A better approach is to resolve the fundamental issue of whether banks have a duty to know their customers' signatures despite the customers' failure to report forgeries promptly and to modify the revised Code in a manner consistent with that resolution. The modification proposed below removes some of the confusion caused by the present and revised Codes. It does not dictate customers' and banks' actions completely, however. Some lack of clarity is the necessary cost of providing banks the requisite flexibility to adopt new practices.

Some courts have held that the bank has a duty to know its customer's signature even on checks it pays after the customer's reporting deadline has passed. Courts have derived this duty from the Code and from the parties' contractual relationship; this duty was the underpinning of the decisions in *Medford*⁴⁴⁸ and *Putnam*.⁴⁴⁹ If the bank has this duty, then the bank must adopt a procedure that reasonably relates to the detection of forgeries to meet the ordinary care standard.⁴⁵⁰ While the meaning of the phrase "reasonably relates" is vague, it is clear that the practice of the bank in *McDowell* would not pass muster because it had no procedure at all. More problematic are the procedures of banks that conduct sight review only of checks over a certain amount or that combine a sight review of some checks with random review of others. Reasonable people can disagree substantially over what might be the appropriate amount above which the bank should conduct sight review, or the proper percentage of checks that should be subject to random review. The "reasonably relates" test, however, gives banks and customers some standard for judging the bank's procedure.

The courts deciding *Wilder* and *Zapata* appear to have believed that the bank's duty to know its customer's signature undergoes a radical transformation once the bank proves the customer failed to report promptly. Those opinions concentrate on section 4-103(3)'s provision that the bank makes out a *prima facie* case by showing its practice conforms to general banking usage.⁴⁵¹ The *Wilder* and *Zapata* courts assume the bank's procedure meets the requirements of ordinary care as long as it is consistent with general banking practice.⁴⁵² The Code and contract origins of the bank's duty to know its customer's signature are ignored. Implicit in these decisions is the courts' assumption that the cus-

448. *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 592-95, 676 P.2d 329, 332-33 (1984).

449. *Putnam Rolling Ladder Co. v. Manufacturers Hanover Trust*, 74 N.Y.2d 340, 345, 546 N.E.2d 904, 906, 547 N.Y.S.2d 611, 613 (1989). See also *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183, 188 (Tex. Ct. App. 1989) (Code basis for duty owed).

450. *Medford Irrigation Dist.*, 66 Or. App. at 593, 676 P.2d at 332.

451. *Rhode Island Hosp. Trust Nat'l Bank v. Zapata Corp.*, 848 F.2d 291, 294 (1st Cir. 1988); *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 131, 552 N.E.2d 783, 787 (1990).

452. See generally B. CLARK, *supra* note 31, ¶ 8.02[4][c], at 8-39.

tomers' negligence in not promptly reporting wipes out the bank's duty to know its customer's signature.

The revised Code does not directly address whether the bank has a duty to detect forged signatures after the customer fails to report promptly. Instead, the revision states that sight review is not required if the failure to employ sight review "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 [3] or Article 4."⁴⁵³ No guidance is provided regarding other methods of check processing except the general provision that ordinary care "means observance of reasonable commercial standards."⁴⁵⁴ One determines relevant reasonable commercial standards by comparing the business's practices with those which prevail "in the area" where the business is located.⁴⁵⁵

The revised Code does not provide guidance to banks, such as the credit union in *McDowell*, that employ no review procedure of any kind, or to banks such as the one in *Zapata*, that have a procedure combining sight review with random review and no review, depending upon the amount of the check. Merely requiring the bank to observe "reasonable" commercial standards begs the question of what should be considered reasonable. Because of such deficiencies in the revised Code, courts will continue to face questions involving the bank's ordinary care obligation if the revised Code is enacted in its present form.

The better course is to specify in the revised Code that the bank still has a duty to know its customer's signature.⁴⁵⁶ This is consistent with the contractual relationship between the parties that is created when the customer signs a signature card, and with the Code scheme that is premised upon the bank's duty to pay only checks with authorized signatures. The revised Code changes the balance between the customer and the bank by substantially protecting the bank from loss. In contrast, by proposing that the revised Code state that the bank still has an obligation to know the customer's signature, this article essentially recommends maintaining the balance contemplated by the present Code, under which both parties are given incentives to take precautions. This approach is justified by both parties' ability to take precautions; both sides should bear the responsibility for making the payment system work. An examination of economic principles, contract, and tort law, as well as UCC objectives, demonstrates that each party can make a strong case for foisting liability onto the other. Given that state of affairs, the proposed approach is essentially conservative. The present Code scheme has worked reasonably well; lacking clear evidence that it has not produced results outrageously favorable to customers and burdensome to banks, the present balance should be maintained with certain clarifying modifications.

One consequence of the decision to impose a duty on the bank to know its

453. Revision Draft — article 3, *supra* note 342, at § 3-103(7).

454. *Id.*

455. *Id.*

456. Because state legislatures' consideration of changes to the present Code will take place within the context of their deliberations over the revised Code, this article's proposals are presented as modifications to the proposed revisions.

customer's signature is the concomitant obligation on the bank to establish a procedure reasonably related to detecting forgeries.⁴⁵⁷ The Code should make clear that sending the customer a statement and cancelled checks does not constitute a reasonable procedure, because it amounts to no procedure at all.⁴⁵⁸

In determining whether a bank has established a reasonable procedure, courts should consider the role of technological innovations. For example, if low-cost, high-speed signature verification equipment⁴⁵⁹ becomes available, a court might decide that a bank that randomly examines one percent of all checks under \$5,000, rather than use such equipment, has failed to exercise ordinary care. It would be expensive to require banks to install state-of-the-art signature verification equipment every time such equipment becomes available. Instead, the revised Code should incorporate a "reasonably relates" requirement and add a comment stating that one factor courts should consider in assessing ordinary care is the availability of technological improvements.

Under the proposed modification, banks would not be required to conduct sight review of every check. Therefore, the revised Code should include the following provision: if the bank does not conduct sight review, it must notify the customer of that fact and inform the customer of the importance of examining each statement and promptly reporting forgeries for the customer to protect itself from loss.

The revised Code's requirement that the customer prove the bank's failure to exercise ordinary care "substantially contributed to loss" should be deleted. Even without that requirement most customers will refrain from suing under section 4-406 because of the substantial transaction costs of litigation and the uncertainty of success unless the bank has no procedure to detect forgeries. Further, including the substantial contribution requirement makes litigation even more impracticable, since it is unclear what the customer would have to show to satisfy the requirement.⁴⁶⁰

Finally, the revised Code could be improved appreciably by removing from it all comparative negligence concepts. The removal of such schemes would return the customer and the bank to about the same position they are in under the current Code. Removing comparative negligence principles from the Code arguably is objectionable since the entire loss may be imposed on a bank that lacked ordinary care even though the customer's conduct was negligent. Any potential gains in fairness achieved by comparative negligence, however, are out-

457. See *supra* notes 196-97, 239 and accompanying text for a discussion of the presumption that the bank knows its customer's signature and has a duty to verify its authenticity and that the bank is allowed to adopt any procedure, as long as it is reasonably related to discovering forged signatures.

458. See *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 134 552 N.E.2d 783, 789 (1990) (Calvo, J., dissenting) (merely sending cancelled checks not ordinary care).

459. See *supra* notes 131-33 and accompanying text for a discussion of innovative electronic equipment used to detect forgeries.

460. See *supra* note 372 and accompanying text for a discussion of difficulties interpreting and applying the substantial contribution requirement.

weighed by the uncertainty and increased litigation burden such a scheme imposes on both parties.

The impact of the proposed modifications to the revised Code would not be great. The new definition of ordinary care in the revised Code would be retained. The definition does not mandate radically new procedures; it is merely a less confusing statement of the standard of care requirement of the present Code. The allocation of loss under the proposed modifications remains the same as under the present Code. A major change under the proposed modifications, however, is the explicit requirement that the bank adopt a procedure reasonably related to detecting forgeries. In assessing the impact of this requirement, it is important to keep in mind that under both the present Code and the revised Code, the bank bears the loss on all checks it pays when the customer reports forgeries promptly, and on the first check in a series of checks when the customer does not report promptly.⁴⁶¹ In addition, when erroneous payments are made due to mistakes that are not within the scope of the customer's duty to report, the loss is on the bank.⁴⁶² Banks that want to protect themselves against these losses have already instituted procedures to detect unauthorized signatures or have purchased insurance. In some jurisdictions the proposed modifications would not increase the bank's liability, for some courts have already imposed the "reasonably relates" requirement upon banks.⁴⁶³

In those jurisdictions where courts have not held that banks must have a procedure that reasonably relates to forgery detection, banks with no procedure in place may incur the additional cost of establishing a procedure, absorbing the additional losses, or purchasing insurance to cover those potential losses. If the available evidence is accurate, the added cost should not be too great. Credit unions do not examine checks for forgeries because ordinarily the checks are held by a third party.⁴⁶⁴ Instead, credit unions purchase insurance to protect themselves from liability. The cost of the insurance "is minimal due to an extremely low loss ratio during the fourteen years" the credit unions have used this system.⁴⁶⁵ The paucity of reported cases indicates customers are filing very few lawsuits under section 4-406(3). In addition, it is reasonable to assume that the reported cases are the ones involving the most money. Yet almost all of the reported cases during the last decade involved amounts under \$100,000. The briefs filed by the banking associations provide no data indicating that forged signatures are a major problem for banks.⁴⁶⁶ Indeed, one bank concluded that

461. U.C.C. § 4-406(2)(b). See *supra* note 9 for the relevant text of the current section 4-406 and *supra* note 340 for the relevant text of the proposed revised section 4-406.

462. See, e.g., *Faber v. Edgewater Nat'l Bank*, 101 N.J. Super. 354, 244 A.2d 339 (1968) (checks charged against wrong account). See generally J. CLARKE, H. BAILEY, R. YOUNG, *BANK DEPOSITS AND COLLECTIONS* 119 n.51 (1972).

463. *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 186, 191 (Tex. Ct. App. 1989); *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 593, 676 P.2d 329, 332 (1984).

464. *Seibold & Kessler*, *supra* note 337, at 1097.

465. *Id.* at 1098.

466. Motion For Leave to File a Brief and Brief of the American Bankers Association as Amicus Curiae, *Wilder Binding Co. v. Oak Park Trust & Sav. Bank*, 135 Ill. 2d 121, 522 N.E.2d 783 (1990) (No. 67709); Brief of Amicus Curiae, The Illinois Bankers Association, on Behalf of Defend-

its data showed losses from forgeries are "infinitesimal."⁴⁶⁷ The modifications proposed in this article may result in higher costs to banks because they require courts to take into consideration technological innovations designed to identify forged signatures. Courts should require banks to adopt new technology to meet the ordinary care standard, however, only if it is available at a reasonable cost and will not unduly slow check processing.

CONCLUSION

Section 4-406 of the UCC fails to adequately deal with questions relating to the bank's duty of ordinary care when it engages in bulk filing. The case law addressing these issues is split between decisions that focus on the bank's relationship to its customer, and those that instead compare the bank's practices to those of other banks. The revised Code only partially remedies the defects of the present law by improving the definition of ordinary care. It leaves many issues unresolved and alters the balance of rights and obligations by constructing a loss allocation scheme that will preclude most customers from seeking to enforce their rights even when their banks engage in conduct that clearly violates their duty to exercise ordinary care.

This article proposes modifications to the revised Code that, unlike the revised Code, give substance to the contractual relationship between the bank and the customer, provide incentives for each party to take precautions, and encourage banks to take advantage of technological improvements. The proposal accomplishes these ends by establishing a two-fold test: (1) banks must exercise ordinary care by observing reasonable commercial standards; and (2) banks have a duty to know their customers' signatures even when the customer fails to report forgeries promptly. Because of this duty, banks are required to establish a procedure reasonably related to detecting forgeries of the customers' signatures. One factor in determining whether a bank's procedure meets the "reasonably related" standard is the availability of technological systems for detecting forgeries.

Banks would have the incentive to take precautions under the proposed system because the proposal would shift liability for all loss to the bank if the customer met its burden of proof. At the same time, customers would have to safeguard their checkbooks and report forgeries promptly because they would bear the loss unless they could show the bank's conduct did not meet the Code's standards.

While this proposal would result in more certainty than the present Code and the revised Code, a degree of uncertainty would remain, because the scheme fails to require that banks adopt any specific procedure. The advantage of this uncertainty is that it gives banks needed flexibility. The disadvantage of a flexible scheme is that prior to litigation neither the bank nor the customer can know

ant-Appellant, Oak Park Trust and Savings Bank, and Illinois Banking Corporation, *Wilder Binding Co.* (No. 67709).

467. Appellant's Brief and Abstract of Record at 25, *Medford Irrigation Dist. v. Western Bank*, 66 Or. App. 589, 676 P.2d 329 (1984) (No. 81-1914-J-1; A-26603).

definitely whether a bank's procedure will satisfy the standard, unless the bank has no procedure at all. Consequently, uncertainty will persist unless case law determines which procedures meet the standards. An element of vagueness is preferable to locking banks into rigid requirements, however. A reasonable amount of flexibility also is an improvement over the approach taken by the revised Code which, in effect, allows banks to adopt whatever forgery detection procedures they want because rarely is it rational for a customer to litigate under the revised Code.

