KRIEG DEVAULT

Insights

March/April Hoosier Banker: Compliance Connection with Brett Ashton

March/April 2017

By: Brett J. Ashton

Question: Our bank received a series of paper checks, drawn on a corporate account, that appeared to be made out to legitimate payees. In fact the checks were part of a scam, payable to bogus companies established by the employee who was depositing the instruments. We did not discover the fraud until several months later, when the drawer contacted us, demanding restitution. Who pays for loss in this situation, and does Indiana law provide special protections from this type of employee fraud?

Answer: The Indiana Uniform Commercial Code (IUCC) does provide guidance with respect to who is presumed responsible in this situation. Ind. Code § 26-1-3.1-405(b) provides: "For the purpose of determining the rights and liabilities of a person who in good faith pays an instrument or takes it for value for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent endorsement of the instrument, the endorsement is effective as the endorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the person bearing the loss proves that the failure to exercise ordinary care substantially contributed to the loss."

This begs the question: How does a bank prove that it exercised ordinary care under the IUCC? Both the Indiana code and the courts have provided some guidance here, as well. Ind. Code § 26-1-3.1-103(9) defines "ordinary care," in the case of a person engaged in business, to mean: "observance of reasonable commercial standards prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage."

Indiana courts faced with cases involving employee fraud leading to loss from an instrument payable in the name of the employer have held that, in determining whether a bank's conduct has substantially contributed to a loss under the statute requiring the exercise of ordinary care in paring or taking from an employee an instrument payable in the name of an employer, the court will view the conduct of the bank in its entirety. See Auto-Owners Ins. Co. v. Bank One, 879 N.E.2d 1086 (2008).

In finding that the bank was not responsible for the employee fraud in Auto-Owners, the Indiana Supreme Court noted the commentary to Ind. Code 26-1-3.1-405 that provides, in part: "Section 3-405 adopts the

principle that the risk of loss for fraudulent indorsements by employees who are entrusted with responsibility with respect to checks should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. Section 3-405 is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements on instruments payable to the employer or fraud in the issuance of instruments in the name of the employer. If the bank failed to exercise ordinary care, subsection (b) allows the employer to shift loss to the bank to the extent the bank's failure to exercise ordinary care contributed to the loss."

In short, banks that diligently follow their established procedures to identify fraudulent checks from among others will be able to assert that any loss is the responsibility of the employer involved, and not the bank. Note: As is true in any instance involving potential fraud, be certain to file a suspicious activity report where appropriate.

This information is provided for general education purposes and is not intended to be legal advice. Please consult legal counsel for specific guidance as to how this information applies to your institution's circumstances or situation.