Survey of Community Bank Practices with Respect to "Sight Examination" of Checks

Alvin C. Harrell
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By Alvin C. Harrell

1. Introduction

In October 2013 your author was retained by an Oklahoma City law firm to serve as an expert witness in a case1 involving the duty of a payor bank to exercise “ordinary care” in making “sight examination” of checks presented for payment.2 “Ordinary care” is defined in the Uniform Commercial Code (UCC) at section 3-103(a)(7), as the “observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged.”3

It should be noted that ordinary care, unlike the duty of good faith (which is sometimes confused),4 is not imposed on a broad basis in the UCC or its Articles 3 and 4.5 For example, UCC section 3-304 imposes an obligation of good faith in the performance and enforcement of every contract and duty within the UCC.6 In contrast, the duty to exercise ordinary care is imposed only in limited, specifically delineated circumstances (for example, in UCC Article 3 sections 3-404 through 3-406 and Article 4 sections 4-404, as relevant to the allocation of certain losses between innocent parties).7

 Whereas good faith requires honesty-in-fact and fair treatment of the other party to the transaction,8 ordinary care requires conformity to customary business practices for comparable transactions, to protect the party on whom the duty is imposed as a prerequisite to leaving or imposing the loss on another innocent person.9 In other words, before a party can impose the loss on another innocent person, the party must exercise ordinary care to protect himself or herself.

By its terms, the second sentence of the definition of ordinary care is limited to the issue of sight examination for purposes of the collection and payment of checks, and specifies a standard

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1. Raven Resources, LLC and David A. Sexton v. Legacy Bank, et al., Case No. CJ 2008-6242, Oklahoma County, OK (hereinafter the Case).
2. Ordinary care is a prerequisite to holding the bank liable for failure to perform obligations in good faith;
3. See generally, pages 9–11
4. See generally, pages 9–11
5. See generally, pages 9–11
Based largely on "general banking usage," Third, for example, a payor bank cannot impose a loss resulting from a forged drawer's signature on the account holder unless the account holder has been imprudent and the bank has exercised ordinary care in its "sight examination" of the items presented for payment.11

Your author was asked to conduct a survey of local banking institutions as to their practices with respect to these issues, in transactions comparable to those in the Case (the survey). While the Case was ultimately settled without the need for presentation of this evidence to the court, the results of the survey are noted here as a matter of potential interest to others involved in similar cases and transactions. While the sampling in the survey was necessarily small and limited to a local area (only six community banks in the Oklahoma City area fully responded and participated), the nature of the legal standard (being limited to "reasonable commercial standards, prevailing in the area")12) and the reduced number of community banks13 mean that this kind of survey may be the best evidence available in such cases. Thus, the survey described here may be of interest to others engaged in comparable transactions or litigation.

II. The Facts and Legal Issues in the Case

The facts of the Case were not unlike those of other check fraud cases that unfortunately continue to be relatively common today.14 The basic problem may arise when a corporate or other company insider draws unauthorized checks on the company's deposit account, e.g., payable to the insider or a bogus entity controlled by the insider or a confederate, or to pay debts of the insider.15 When the company discovers the fraud, sometimes after the dollar loss is considerable (perhaps even millions of dollars), the company may seek recovery from the payor bank16 on grounds that the fraudulent checks were not properly payable due to a forged or unauthorized drawer's signature.17 If the items paid were not properly payable, and no other defense applies, the bank must recredit the company's account for the improper payments.18

However, there are several possible defenses for the payor bank in this scenario, e.g., that the drawer's signatures were authorized under the law of agency (see UCC sections 3-401 and 3-402); the signatures were ratified by the company (see section 3-403); the company was negligent and this contributed to the fraud (see UCC section 3-406); or the company failed to examine its periodic account statements and give prompt notice to the bank of improper items (as required by UCC section 4-406). For payor banks, the latter two defenses are often the most important; however, both require (to some extent) that the bank exercised ordinary care in paying the checks.19

Thus, in a scenario like that in the Case, the company may allege that the payor bank failed to exercise ordinary care because it did not require the bank's staff to individually examine ("sign-examine") each of the fraudulent checks upon presentment, and compare the drawer's signature to the authorized signature on the deposit contract (commonly a "signature card"), so as to discover the forgeries.20 If the company can successfully assert that the bank failed to exercise ordinary care by conducting a proper sight examination, there is the likelihood of a significant liability for wrongful payment on the part of the bank, on the basis of comparative negligence.21 Thus, it is important that banks maintain procedures that constitute ordinary care in the routine payment of checks. A potential complication in this regard is that ordinary care requires the bank to comply with the reasonable commercial standards prevailing in that area,22 and this requires analysis of both reasonableness and the prevailing standards for comparable banks and transactions in that area. Both of these factors may require a fact-intensive analysis that involves consideration of banking standards and a comparison of the operating procedures of comparable institutions.23 Nonetheless, as illustrated by the survey conducted in this Case, some issues and practices are sufficiently clear that the resulting conclusion should be apparent despite the somewhat generalized legal standard.24

10. 66.

11. See supra notes 2, 7-10 and infra notes 17-19. UCC §§ 3-401, 3-405, 3-406 or 4-406 may preclude the customer from asserting the forgery against the bank. Otherwise, the items is not properly payable under UCC §§ 3-401 and cannot be charged to the customer's account; similarly, it cannot be dishonored after the midnight deadline (subject to some exceptions, see UCC §§ 4-215, 4-301 & 4-302); thus, absent ordinary care the bank will suffer the loss.

12. UCC § 3-103(a). See supra note 5.

13. The number of community banks has declined 8% since 1985 according to some sources. See, e.g., FDIC Access to Community Banks, Community Banks, 74 Directors & Trustees Digest No. 5, (October 2011). For obvious reasons, the trend has continued and even accelerated since enactment of the Dodd-Frank Act. See generally Jory R. O'Hara, Market Literature Processing - Dodd-Frank Act as a Death Knell for Community Banks, 67 Consumer Fin. L.Q. Rep. 326 (2013).


15. See supra note 14. See also, NAFCU UPDATE, 2013 WL 9750375 (supra note 18) (employee createdphony invoices billing the employer on behalf of a bogus entity). National Union Fire Ins. Co. v. Century Bank, 2013 WL 5308223 (D. Colo Sept. 26, 2013) (similar scenario). While this scenario also can be found in the context of consumer deposit accounts, most of the heavily litigated cases involve commercial entities, where the dollar amounts are likely to be larger.

16. The bank on which the checks are drawn. See definition at UCC § 3-103.

17. See UCC § 3-401. A payor bank cannot authorize a charge to the customer's account for items that are properly payable. See supra note 11.

18. See supra note 17. Note that normally in this scenario the payor bank cannot recover from the collecting bank that presented the item because no presentment warranty has been breached. See UCC § 4-206a. A check or other item deposited for presentment through the banking system is within the definition of "item" in Article 4.

19. See UCC §§ 3-406(a) & 4-406(b); if the bank failed to exercise ordinary care, and this failure substantially contributed to the loss, the loss will be allocated on the basis of comparative negligence.

20. Id.

21. See, e.g., UCC § 3-406(a) and UCC § 4-406(b); and infra notes 18 and supra note 19.

22. UCC § 3-103(a). See supra note 14.

23. See supra notes 19-22. Comparative institutions also make competitive comparisons, potentially complicating the survey process and adding to a material tendency to defer internal bank procedures and standards.

24. Id.
III. The First Issue: Sight Examination Practices

A. The Survey

The survey was conducted in two stages, as the legal arguments in the Case evolved. In the first stage the focus was the "trigger" amount (the dollar amount of a check) that would cause the payor bank to conduct an individual sight-examination of the check. Obviously, this trigger amount will vary according to a bank's transaction volume and tolerance for risk, and these factors may be related to a bank's size. One would expect a gradation of bank practices, with larger banks generally having a higher trigger amount as compared to smaller banks. The survey results confirm this expectation. Thus, in order to confirm whether a bank's trigger amount is consistent with the duty of ordinary care, it must be compared with other banks of roughly comparable size in the same general area.

The policy of the bank involved in the Case was to require that: (1) tellers individually verify (i.e., sight-examine) the drawer's signature on every check paid over the counter, regardless of the dollar amount; and (2) the staff of the bank's check processing center independently verify drawer signatures on all checks presented in the amount of $10,000 or more. The goal of the survey was to determine whether these practices conformed to reasonable commercial standards so as to constitute "ordinary care" pursuant to UCC section 3-103(a)(7).

As noted below, the results of the survey indicated that the above-described practices are commercially reasonable, and also indicated that the bank in question exercised ordinary care with regard to payment of the checks to the extent it followed these practices.

b. Operational Context and Survey Results

The number of checks processed through the banking system is truly enormous, even today with the increasing use of purely electronic payment systems.25 This volume means that it is a practical impossibility to individually confirm the drawer's signature on each item presented for payment through the bank collection system. Therefore, as a practical matter, each bank must establish a practice or policy that limits individual "sight-examination" verification efforts to checks above a specified dollar (or "trigger") amount. Some banks may be reluctant to reveal this dollar amount, perhaps due to concern that this would invite forgeries on items for lesser amounts; some banks may even claim to sight-examine all signatures, regardless of amount. In your author's experience, this is not possible in the context of the number of checks being processed and the resources available. Some such claims are likely to be public relations pronouncements designed to discourage forgery.

The results of the survey indicate that the dollar amount that triggers an individual "sight-examination" verification of the drawer's signature for most community banks in central Oklahoma is at or above $10,000.26 Therefore, as explained further below, the practice of a community bank in verifying the drawer's signature on checks at or even above that amount should be deemed commercially reasonable and meet the duty of ordinary care as defined in UCC section 3-103(a)(7).

In arriving at this conclusion, the survey investigated the check verification practices of community banks in central Oklahoma, with a focus on checks presented through the check collection system as well as presentments in person over-the-counter. Some banks were not willing to reveal their check verification practices, but, of those banks willing to respond, two at the larger end of the asset-size scale indicated a practice of sight-examination for checks above $20,000; this appears to be consistent with an appropriate standard of ordinary care for banks of their size. These banks also indicated that their practices have not changed over roughly the past ten years.

A third bank indicated that its trigger amount for sight-examination varies with the type of account and the volume of checks written on the account, among other factors. This bank also was at the large end of the asset-size scale and utilizes computerized fraud detection procedures not economically feasible for banks of smaller size. These procedures are not dependent on signature verifications. Because of these differences, this response was not appropriate for direct comparison in the context of the Case. Yet another bank, at the smaller end of the asset-size scale, indicated a trigger amount of $5,000; again, this was commensurate with that bank's small size, but also was consistent with a larger dollar "trigger amount" for a larger community bank.

Some of the other banks surveyed indicated that they do not rely on sight examination at all to a significant degree, recognizing that bank staff are not qualified signature examination experts and in any event cannot devote the time that would be needed to properly sight-examine the authenticity of all signatures on the large volumes of checks being presented and processed. Even an amateur forger who is familiar with the victim's signature can approximate that signature to an extent that the forgery likely will not be detected in the kind of cursory sight-examination that is inherent in the bank processing context. Moreover, the "truncation" of nearly all checks today (as a consequence of federal law) means that the ability to examine the original signature has been lost in most all cases, further reducing
the viability of sight examination as a tool to detect forgery in this context. As a result, some banks rely heavily on other safeguards built into the check collection system, including: (1) analyses designed to detect unusual or aberrational transaction features, e.g., unusual dollar amounts for that customer or type of customer; (2) customer supervision of the customer’s staff and others with access to the customer’s checks (consistent with the duties provided in UCC sections 3-401 through 3-407); and (3) the customer’s obligation to review the periodic statements and give notice to the bank of improper items pursuant to UCC section 4-406.

To a large degree, these safeguards are based on the fact that the customer is inherently more familiar with its own checking transactions and better able to monitor and supervise them than is the payor bank (which has, at best, only the fleeting glance at a signature as a basis for discovering unauthorized transactions, in contrast to the customer’s continuous supervisory authority, accounting controls and compliance procedures). This great diversity in the approaches utilized by banks to combat forgery and alteration creates challenges in terms of comparing bank performance as a standard of ordinary care.

Thus, it is important to recognize that the standard for ordinary care as defined at UCC section 3-103(a)(7) with regard to sight-examination of checks is liberal and very limited as to its requirements, and provides the flexibility needed to accommodate multiple risk tolerances and approaches to risk management. The practices of a bank should be measured accordingly; nonetheless, the practices illustrated in this Case (utilizing a $10,000 “trigger-amount”) clearly met the section 3-103(a)(7) standard of ordinary care.

IV. The Second Issue: Compliance Procedures

In the second phase of the study, comparable banks were asked to report on their compliance procedures. If any, for confirming and documenting that bank staff are properly following the bank’s procedures with regard to sight-examination of checks. Once again, multiple community banks of roughly comparable size in central Oklahoma were contacted. Again, six banks cooperated fully in this stage of the survey (the participating banks). The participating banks were asked essentially the following four questions:

- If a customer’s signature on a particular check is verified by sight-examination by a teller when the check is presented for payment over-the-counter, does the teller initial or otherwise make a mark on the original item indicating that he or she has sight-examined the item?

- Does the bank generate a written or electronic document each time a customer’s signature on a particular check is verified by sight-examination by a responsible employee, confirming the date, time and name of the employee who sight-examined the particular item?

- Does the bank utilize quality control inspections to confirm whether the employee responsible for sight-examining a customer’s signature on a particular check in fact performed his or her duty?

- Does the bank utilize oversight procedures to confirm whether a responsible employee’s decision, that a particular signature on a customer’s check which
One of the surveyed banks reported that it maintains a "log" to document the sight-examination of items above a certain "trigger" amount, and that this log is reviewed by a compliance officer. The bank did not reveal the dollar trigger for this function, but indicated that the amount was quite large. Obviously, the trigger would have to be very high, or this function would seriously interfere with the process of posting and paying checks, essentially negating the benefits of modern processing systems.

V. Summary and Conclusion

While the survey focused primarily on only six banks, the nature of the definition of ordinary care at UCC section 3-103(a)(7) and the limited number of comparable banks in a given area likely will mean that the practices at a relatively small number of local banks will be available and sufficient to identify the applicable industry standards "prevailing in the area." Moreover, some banks are understandably hesitant to reveal their internal procedures or fraud-prevention standards, or otherwise participate in such a survey, perhaps based on concerns about potential litigation and a desire to minimize fraud risks. This experience also suggests to your author that such surveys are likely to be very labor-intensive and may be made more difficult by the natural hesitancy of banks to respond to such inquiries, in the absence of a comfortable professional relationship between the bank and those conducting the survey.

That said, from your author's perspective the results of the survey in this case were instructive and helpful. Moreover, while it is difficult to know the precise relevance of any particular factor in this analysis, it can be noted that the Case in question was settled on terms favorable to the bank, with the bank paying roughly four cents on the dollar of the disputed checks. Given the apparent frequency of these types of cases, other banks may wish to periodically review their procedures in the context of the applicable industry standards, as illustrated in this article.

As noted, the banks in this survey ranged in size from roughly $125 million to roughly $1.6 billion. While as noted here their practices (and risk tolerances) varied somewhat (based largely on the bank's size), there was a clear convergence as regards the issues relevant in this Case. Illustrating this, a bank in the mid-range of asset-sizes responded to the first phase of the survey as follows:

The routine practice at [the bank] is to examine the drawer's signature on a check presented through an in-clearing cash letter at the amount of $10,000 or above due to the volume of items presented.

The routine practice at [the bank] is to examine the drawer's signature on a check presented at the teller line at the amount of $100 or above in order to keep lines moving quickly.

[The bank] also employs the use of software to filter-out checks presented daily which may be out of the current serial number range of a particular account, a serial number duplicated one or more times on items presented, or other suspicious criteria. If an item is identified by the software as suspicious, an image of the item is examined. If the signature appears to be irregular or unauthorized, the customer on whose account the item is drawn, is contacted to confirm whether the item is authorized or should be returned as unauthorized.

This response can be regarded as typical, and illustrative of ordinary care in this context.

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Summary of Final Rule Amending HMDA and What It Means for Covered Institutions

by Richard J. Andreano, William H. Finlay, Anne E. Sutherland and Wendy Tran

The Bureau of Consumer Financial Protection (CFPB) has released a final rule amending Regulation C, which implements the Home Mortgage Disclosure Act (HMDA), requiring mortgage lenders to report certain information about mortgage applications and loans in efforts to create transparency in the mortgage lending process.

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