# Corrigendum

Page ix of the thesis **replace the current abstract** with the following:

‘This thesis has three objectives: first, to examine the law relating to loss allocation resulting from fraud with consumer payment instruments and determine whether this allocation is efficient; second, to determine whether any right to stop or reverse payment associated with the payment instrument is efficient; and third, to suggest changes and reforms to achieve efficiency in these two areas.

The basic test to determine efficiency of allocation of fraud loss to be used in the thesis involves looking at the following questions: which party in the transaction or system can, because of size, wealth, insurance, or the ability to pass on costs, best bear the risk of non–payment? Which party can most easily avoid the loss? And which rule is the least costly rule to enforce?

In regard to electric funds transfer it was found that the test in the current Electronic Funds Transfer Code (EFT Code), although purporting to be worked out on efficiency principles is, in fact, unduly complicated and the thesis recommends the adoption of simple failure to report loss theft or fraud by the consumer as a test for allocation of fraud loss. Signature credit cards are currently not covered by the EFT Code and fraud loss allocation is determined by contract law but, nevertheless, a similar test is advocated in regard to them too.

In regard to cheques it was found the forgery rule as regards the drawer’s signature and the ancillary *Ligget* rule are basically efficient but the rule regarding indorser’s signature is inefficient - making cheques not transferable would help eliminate this inefficiency. As to fraudulent alterations, it was advocated that paying banks should bear total loss for fraudulent and material alterations with a right, of course, against the person who has made the alteration.

In regard to financial institution cheques, the thesis recommends that the definition of a financial institution cheque (which covers bank cheques) should be extended to cover cheques drawn by one financial institution on another one. It recommends that where consideration has been provided at any stage for a bank cheque then it should be able to be enforced. It was also advocated that the gist of the Australian Paper Clearing System assurances needs to be enshrined in legislation (an example of the sort of legislative change that would hopefully ensure certainty of payment has also been suggested). To ameliorate the position from an efficiency perspective, the following is also advocated: a duty of care in regard to the safekeeping of bank cheques should be introduced; responsibility for alterations should also be placed on the issuing banks as a spur to devise alteration proof bank cheques; and when consumers buy bank cheques they should be asked for what purpose it is being purchased and this should be written by the banks on the front of the bank cheque.

Whether a uniform rule for fraud loss allocation across different payment systems is a possibility is also explored. It was found that a uniform rule for fraud loss allocation would seem to be more efficient than making efficiency ameliorations to existing fraud allocation tests in the various payment systems.

Allied with the problem of fraud loss allocation is the issue of whether consumers should have a right of stopping or reversing payment if consumers perceive they are the potential victims of fraud or sharp dealing. Again the thesis examined whether this is efficient.

In regard to cheques it was found that the right to stop payment is efficient but that such a right could be ameliorated by allowing the drawer a right to set up any dispute against the vendor in the same action where the vendor/payee brings an action on the stopped cheque. Moreover, the right to stop cheques should be explicitly extended to stolen cheques. In addition banks should have to reaccredit the account in accordance with the stop payment order and banks should have the burden of proving that no loss stemmed from their error.

On the other hand, in regard to financial institution cheques (including bank cheques) if they are to be effective cash substitutes, efficiency demands that purchasers not be allowed to use their disputes with the vendor, even if they may seem to involve fraud, to stop the banks paying out on the bank cheques, unless there is a court order.

As to signature credit cards it is advocated the gist of American law on chargebacks absent any territorial restrictions should be put into Australian federal legislation. Allegations of contractual non compliance should require the buyer to send the goods back to the seller or, at least be able to show a bona fide attempt to do so, as a precondition to the exercise of chargeback rights and as part of a requirement that the buyer should make an attempt to first settle the matter with the seller.

Proposed federal legislation covering chargebacks should also extend to other forms of electronic payment like BPAY as well as PIN credit cards. Chargeback rights should also apply where debit systems mimic cash but with a $150 threshold before they apply and subject to the goods being returned to the seller.

Finally, the thesis explores whether a uniform right to stop payment would be more efficient than the inconsistency and inefficiency of current Australian stop payment rules and concludes that such right should be along the lines of the never enacted American *Uniform New Payments Code* since is clear, concise and efficient compared with other attempts to formulate uniform rules.’

Chapter 1, p 14, second last dot point on page **insert after the first sentence the following** : ‘Consumer is used in the sense of persons who are acquiring goods or services for their own use and not for re-supply or buying land for their own residential purposes.’

Chapter 1, p 11, after the sentence ‘The issuing bank of a letter of credit can refuse payment if the documents presented by the seller are non-conforming.’ **insert the following footnote**: *J H Rayner & Co Ltd v Hambro’s Bank Ltd* [1943] 1 KB 37.

Chapter 1, p12, top paragraph after the sentence ‘A corollary of this is that certain payment instruments used by business people like letters of credit are considered autonomous.’ **insert the following footnote**: *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 QB 127.

Chapter 2, p 22, after the sentence ‘Moreover these fees were not transparent.’ **insert the following footnote**: Ron Borzekowski, **E**lizabeth K. Kiser, Shaista Ahmed ‘ Consumers' Use of Debit Cards: Patterns, Preferences, and Price Response’ (2006) *FEDS Working Paper No.2006-16* ; Isujit Chakravort ‘Theory of Credit Card Networks: A Survey of the Literature’ *Review of Network Economics* Vol.2, Issue 2 – June 2003, 50; *Reserve Bank of Australia* George Gardner, Andrew Stone ‘Competition Between Payment Systems’ Competition Between Payment Systems Research Discussion Paper – April 2009

Chapter 2, p 23 top paragraph after the sentence ‘Following legal action by the Australian Competition and Consumer Commission (ACCC) against the banks and credit card companies and the failure of an appeal in the Federal Court by Visa, Mastercard and Bankcard, the Reserve Bank of Australia (RBA) intervened (there can be no appeal from its decision).’ **insert the following footnote**: The legal action was against one of the major banks for alleged price fixing contrary to s 45 A *Trade Practices Act* 1974 (Cth) - <http://www.rba.gov.au/payments-system/reforms/cc-schemes/final-reforms/attachment-2.pdf.> at 17 May 2010. The ACCC discontinued its action in the Federal Court against the National Australia Bank after the RBA intervened. An action by the credit card companies in the Federal Court challenging the RBA’s intervention failed: *Visa International Service Association v Reserve Bank of Australia* (2003) 131 FCR 300.

Chapter 2, p 40 after the sentence ‘In these sections it has been shown that efficiency, although a useful tool for assessing allocation of loss (indeed the main one to be used) has some limitations and should be tempered by some fairness considerations.**’ add the following sentence: ‘**If, for example, the principles of efficiency allocated loss to a person who was not at fault and not able to bear the loss, then fairness would suggest that such an allocation should not be made.’

Chapter 3, p62 starred footnote reads ‘[*] Pages 2-3, 5-7, 13-18, 21-25, 32-36 **change as follows**: ‘Pages 64-65, 70-74, 81- 83, 86-89, 90-94, 110-118.’ In place of the page numbers 23-31 appearing in the following ‘pp 27-31 have appeared as an article by R Edwards,’ **substitute** ‘104-110’.

Chapter 3, p64 after ‘Although there is constant talk of biometric recognition mechanisms,**’ insert the following footnote:** Anil Jain, Arun Ross and Salil Prabhakar ‘An Introduction to Biometric Recognition’(2004) Vol. 14, No. 1 *Transactions on Circuits and Systems for Video Technology, Special Issue on Image- and Video-Based Biometrics,* 1; Hackett, Richard P.; Stinneford, Ryan S.; Torian, Roberta Griffin Simon, L ‘Current Developments in Payment Systems, Deposit Accounts, and Electronic Delivery of Financial Services’(2006-2007) 62 *Business Law*. 675;. ‘*Give your grocery the finger*ASV (A Small Victory). Dec. 2002 < http://asmallvictory.net/archives/001839.html> at 18 May 2010.

Chapter 3, p 65 after the sentence ending with the words ‘accordingly the burden should be on the customer to bear the burden of proving it was an unauthorized use.’ **insert the following footnote:** Alan Tyree, *Digital Cash* (1997) 137.

Chapter 3, p65 first paragraph after the sentence ending with the words ‘for example, the number of times the ATM has been accessed with the same card, bank records and videos of the use of the machine.’ **insert the following footnote:** Discussion Paper on an Expanded EFT Code of Conduct, above n 3, 27.

Chapter 3, p77 after the sentence ‘There was also much talk of internet banking payment.’ **insert the following footnote:** Alan L Tyree ‘Virtual cash - payments on the internet’ (1996) 7 *Journal of Banking and Finance Law and Practice*, 35; Andrea Beatty ‘Internet banking, digital cash and stored value smart cards’ in Anne Fitzgerald, Brian Fitzgerald, Peter Cook, and Cristina Cifuentes (ed) *Going Digital* (1998), chapter 8, 90.

Chapter 3, p77 after the sentence ‘The First Branch of the Internet (FBOI) worked on this basis.’ **insert the following footnote:** Robin Edwards *Banking Transactions Law* (1999), 160.

Chapter 3, p 80, last paragraph, after the sentence ending ‘future developments in this area.’ **insert the following footnote:** Electronic Funds Transfer Code of Conduct, above n 7, cls 15, 16 and endnotes 38 -39.

Chapter 3, p 80, last paragraph, after the sentence ending ‘as well as small purchases’ **insert the following footnote:** In Hong Kong the travel smart card is called the Octopus card; for more details see < http://www.hong-kong-travel.org/Octopus.asp> at 25 May 2010.In Singapore the travel card is called SMRT card; for more details see <http://www.smrt.com.sg/trains/ticketing.asp.> at 25 May 2010.

Chapter 3, p 81, paragraph 2 , after the words ‘with some efficiency principles in mind.’ **insert the following footnote:** Discussion Paper on an Expanded EFT Code of Conduct ,above n 3, 3.

Chapter 3, p 81, paragraph 2, after the words 'The second EFT Code' **add the following:** '-Electronic Funds Transfer Code of Conduct as revised by the Australian Securities and Investments Commission's EFT Working Group (issued 1 April 2001 amended 18 March 2002)-'.

Chapter 3, p 86, last paragraph, after the words 'There is no legal compulsion to verify periodic statements in Australia' **insert the following footnote:** *Tai Hing Cotton Mills* v *Liu Chong Hing Bank* [1986] 1 AC 80; Alan Tyree, above n 1, 200.

Chapter 3, p93 after the sentence 'In one case the card was in a bedroom drawer and the undisguised PIN was in the user's backpack that she usually carried with her.' **insert the following footnote**: Australian Banking Industry Ombudsman's Annual Report 1995-96, 24.

Chapter 3, p95, first paragraph, sentence ending with the words 'how many cases were brought against individual banks.' **insert the following footnote**: Gregory Burton 'A Banking Ombudsman for Australia' (1990) 1 *Journal of Banking Finance Law and Practice* 29, 33.

Chapter 3, p110, paragraph 3, sentence ending with the words 'allocation rules from a number of sources' **insert the following footnote:** Discussion Paper on an Expanded EFT Code of Conduct ,above n 3, 31.

Chapter 4, p123, paragraph 1, sentence ending with the words 'possession to the *nemo dat* rule.' **insert the following footnote:** *Helby v Matthews* [1895] AC 471.

Chapter 4, p123, paragraph 1, sentence ending with the words 'without cash and access to credit at the same time.' **insert the following footnote:** W J Chappenden 'Bank Credit Cards' (1973) 5 *Commercial Law Association Bulletin* 19; see also Report on Fair Consumer Credit Laws (The Molomby Report) 41.

Chapter 4, p124, paragraph 1, sentence ending with the words 'receives the bill before it had to be paid.' **insert the following footnote:** Donald H Maffly, Alex C McDonald, 'Tripartite Credit Card Transaction: A Legal Infant,' (1960) *California Law Review* 459, 461.

Chapter 4, p124, paragraph 3, sentence ending with the words 'been the source of endless legal battles overseas and in Australia.' **insert the following footnote:** Edwards, above n 9.
Chapter 4, p124, paragraph 3, sentence ending with the words 'what can be regarded as a fetter upon competition itself is still a very blurred distinction.' **insert the following footnote:** Adam J Levitin, 'Priceless - The Economic Costs of Credit Card Merchant Restraints' (2007-2008) 55 *University of California Law Review* 1321.

Chapter 4, p125, paragraph 2, sentence ending with the words ‘were, and still are, only passive equity owners.’ **insert the following footnote:** Peter Z. Grossman ‘The Market for Shares of Companies with Unlimited Liability: The Case of American Express’ (1995) 24 (1)*The Journal of Legal Studies*, 63.

Chapter 4, p125, paragraph 2, sentence ending with the words ‘seeks to give good returns to its shareholders who typically do not have any business relationship with it.’ **insert the following footnote:** Gerald P. O'Driscoll, Jr. ‘The American Express Case: Public Good or Monopoly?’ (1976)19 (1) *Journal of Law and Economics* 163.

Chapter 4, p125, paragraph 2, sentence ending with the words ‘times the focus of anti-competitive legal actions.**’ insert the following footnote:** <http://www.rba.gov.au/payments-system/reforms/cc-schemes/final-reforms/attachment-2.pdf**.**> at 17 May 2010. An action by the credit card companies in the Federal Court challenging the RBA’s intervention failed: *Visa International Service Association v Reserve Bank of Australia* (2003) 131 FCR 300.

Chapter 4, p125, paragraph 2, sentence ending with the words ‘would restrict access to ATM and EFTPOS networks.**’ insert the following footnote**: Reserve Bank of Australia and Australian Competition and Consumer Commission *Debit and credit card Schemes in Australia A study of interchange fees & Access* October 2000 55.

Chapter 4, p125, paragraph 2, sentence ending with the words ‘failure of an appeal in the Federal Court by Visa, Mastercard and Bankcard,’ **insert the following footnote:** *Visa International Service Association v Reserve Bank of Australia* (2003) 131 FCR 300.

Chapter 4, p125, paragraph 2, sentence ending with the words ‘ (there can be no appeal from its decision).’ a**dd** after the word ‘decision’ the words ‘on the merits’.

Chapter 4, p142, paragraph 1, sentence ending with the words ‘the prime cardholder is ultimately dependent on the subsidiary card being returned’ **insert the following footnote:** The Code of Banking Practice, cls 27.2-3.

Chapter 5, p154, paragraph 1, sentence ending with the words ‘appeal by the Supreme Court of Canada.’ **insert the following footnote:** [1987] 1 SCR 711.

Chapter 5, p176, paragraph 1, sentence ending with the words ‘market rule that debts should be paid by the persons who owe them.’ **add the words** ‘of simplicity’ after the words ‘market rule’.

Chapter 5, p176, paragraph 1, sentence ending with the words ‘Cooter and Rubin’s rules, loss avoidance.’ **insert the following footnote:** As to the mix of Cooter and Rubin’s rules see Chapter 2, 31.

Chapter 7 p 222 **delete the following sentences** ‘Financial institution cheques including bank cheques are widely regarded as being tantamount to cash. This is demonstrated by acceptance of these instruments as payment at property settlements and for the purchase of motor vehicles.’

Chapter 10, p 299, paragraph 1, sentence ending with the words ‘reserve sufficient funds to meet the cheque when it is presented again.’ **insert the following footnote:** Dudley Richardson, *A Guide to Negotiable Instruments* (seventh ed) 112.

Chapter 12 p 334 paragraph 1, **delete the following sentence ‘**This thesis is about the efficiency of the allocation of loss resulting from fraud and the efficiency of any ancillary stop payment rights that the particular payment system may offer.’

Chapter 13 p 381 paragraph 3 beginning ‘Since merchants commonly’ **insert after the following words** ‘assuming that rights of chargeback are fairly well known by cardholders’ the following ‘(a somewhat dubious assumption)’.

Chapter 12 p 361, footnote 50 **delete** the words ‘an illegal’ and substitute the words ‘dubious as’ and then **add** at the end of footnote 50 : ‘The Trade Practices Commission, the predecessor of the ACCC, granted an authorization of the Bankcard Scheme on condition that merchants be allowed to charge differently to distinguish between cash buyers and credit card buyers- Bankcard Scheme: Interbank Agreement (1980) ATPR (Com) 169. Since the designation of the three major credit card schemes by the Reserve Bank under the *Payment Systems (Regulation) Act* 1998 (Cth) under Standard no 2 merchants can price differently.

Chapter 13 p365 starred footnote **delete** ‘pages numbers 21-24’ and substitute ‘pages numbers 396-4005’.

Chapter 13 p399 paragraph 3 sentence ending with the words ‘rights would effect rights under PayPal’s Buyer Complaint Policy.’ **insert the following footnote:** <http://www.lawrencechard.com/paypalfined.html> at 1 June 2010.

Chapter 13 p402 paragraph 3 sentence ending with the words ‘an annual fee to catch these ‘free loaders.’ **insert the following footnote**: Reserve Bank of Australia and Australian Competition and Consumer Commission *Debit and credit card Schemes in Australia A study of interchange fees & Access* October 2000, 52.

**Insert** page the following at p 440

## Bibliography

**<u>Statutes and Codes</u>**

**Australia**

*Bills of Exchange Act* 1909 (Cth).
*Cheques Act* 1986 (Cth).
*Goods Act* 1958 (Vic).
*Electronic Funds transfer Code* (1989) (revised 2001, amended 2002).
Australian Paper Clearing System Assurances.
Code of Banking Practice 2003 and amendments

**America**

*Electronic Funds Transfer Act*, also known as Regulation E, Codified *15 USC*§ 1693g.
*Truth- in- Lending Act* (TILA) §133(a)(1)(B).*codified* 15 USC § 1643.
*Uniform Commercial Code* (UCC) Section 3.
*New Uniform Payments Code* (Draft No 8).

**<u>Reviews and Discussion papers</u>**

Australian Banking Industry Ombudsman Review of the Code of Banking Practice, Issues Paper, February 2001.
Consumer and Business Affairs Victoria submission to the Viney *Review of the Code of Banking Conduct*, 2001,Electronic Funds Transfer Code of Conduct as revised by the Australian Securities and Investments Commission's EFT Working Group (issued 1 April 2001 amended 18 March 2002).
Discussion Paper on an Expanded EFT Code of Conduct Released by the Australian Securities & Investments Commission's EFT Working Group July 1999..
Explanatory Paper on proposed *Cheques* Bill prepared by the Attorney-General's Department, February 1984.
Jack (Chairman), Banking services law and Practice – Report by the Review Co*mmittee* (HMSO, 1989), 43.
The Molomby Report . Report on Fair Consumer Credit Laws  41.
Review of the Bills of Exchange Act 1909- 1958, 1964 (Manning Committee Report).
House of Representatives Standing Committee on Finance and Public Administration (Chairman Steven Martin) *A Pocket Full of Change: Banking and Deregulation* (1991
Reviewing the EFT Code ASIC consultation paper, January 2007.
Review of the Code of Banking Practice 2007-8.
Review of the Electronic Funds Transfer Code of Conduct 2007/08: ASIC proposals October 2008 (Consultation Paper 90).

**Typographical Errors**

P3, paragraph 3, line 3 ‘debit’ instead of ‘debt’.
P3, paragraph 3, line 7, insert after the word ‘payee’ the word ‘who’.
P 7, last paragraph, last line change ‘sale(EFTPOS)’ to sale (EFTPOS)’.
P 10, first paragraph, line 2, change ‘same thing}’ to ‘same thing)’.
P 10, fourth paragraph, after the words ‘be treated by the law’ insert question mark ’?’
P 13 heading ‘Proposed chapter outlines’ change to “Chapter outlines’**.**
P13, second paragraph, change the word ‘efficiency’ wherever it appears to ‘Efficiency’.
P 17, first paragraph, line 5 ‘*Sn*eddon’ instead of *Sn*eddon.
P 22, paragraph 1, line 1, ‘1998 (Cth) and’ instead of ‘1998 (Cth)and’.
P 23, second paragraph, line 2, after the word ‘to’ insert ‘be’.
P 25, second paragraph, line 4,‘at an’ instead of ‘at a’.
P26, second paragraph, line 2,‘non payment’ instead of ‘non- payment’.
P 27, second paragraph, line 3 after the words ‘seem to’ insert ‘be’.
P 27, second paragraph, line 4, after the words ‘In addition’ insert a comma.
P 35, second paragraph, line 2, eliminate the word ‘winds’.
P 39, first paragraph, line 4. eliminate space occurring after the words ‘abates the’.
P 87, second paragraph, line 1, eliminate the word ‘apply’ before the word ‘presumably’.
P 87, second paragraph, line 2, ‘so it may be that’ instead of ‘so it may be that it may be’.
P 92, first indented paragraph,, line 2, eliminate the space after the words ‘of a ‘and replace the word ‘Cord’ with the word ‘Code’.
P 98, last paragraph, line 2, after the word ‘where’ insert ‘a’.
P 101, first paragraph, line 5 insert the word ‘the after the word ‘took’.
P 102, second paragraph, line 4 ‘expanded’ instead of ‘expended’.
P 103, first paragraph, line 1 ‘Questions’ instead of ‘Question’.
P 103, last paragraph, line 3 replace ‘It serves no deterrent fault’ with ‘It serves as no deterrent to fault’.
P 104, first line, replace ‘consumer’s sense’ with ‘consumers’ sense’.
P 107, paragraph 1, line 3, replace ‘on’ with ‘about’.
P 123, paragraph 1, line 1, replace the word ‘bankcard’ with the word ‘Bankcard’.
P 140, paragraph 1, line 1, replace ‘cash’ with ‘cash’.
P 141, paragraph 3, line 6, eliminate the word ‘and’.
P 143, paragraph 1, line 6, replace the word ‘give’ with ‘gives’.
P 143, paragraph 3, line 4, replace the words ‘Small Business’ with ‘small business’.
P149, paragraph 2, line 4, replace the word ‘Director’ with ‘director’.
P 153, paragraph 3, line 4, eliminate space after the words *Tai Hing*.
P 155, paragraph 2, line 3, replace the word ‘though’ with the word ‘thought’.
P 158, paragraph 2, line 1, after the word ‘something’ insert the word ‘of’.
P 164, indented quote, line 7, replace ‘shown’ with ‘show’.
P 169, paragraph 1, line 2, eliminate the word ‘the’ before the word ‘*Barclays*‘.
P 169, paragraph 3, line 1, eliminate the word ‘the’ before the word ‘*Simms’.*
P 172, paragraph 2, line 3, eliminate the word ‘debts’.
P 175 paragraph 1, line 13, replace the word ‘invokes’ with the ‘invoke’.
P 177, paragraph 3, line 6, insert ‘a’ before the words ‘small amount’.
P 184, paragraph 2, line 4, replace the word ‘on’ with the word ‘of’.

P 188, last paragraph, line 2, replace the word ‘concessions’ with word ‘concession’.
P 199, paragraph 2, line 1, replace the words ‘The Act’ with ‘The *Cheques* Act’.
P 206, paragraph 2, line 3, replace the words ‘liquidators a company in creditors’ voluntary winding up’ with ‘liquidators of a company in a creditors’ voluntary winding up’.
P 206, paragraph 2, line 6, replace the words ‘(“The Account”)’ with (“the Account”).
P 206, paragraph 2, line 9, replace the word ‘Liquidator’ with ‘liquidator’.
P 206, paragraph 2, line 19, insert the word ‘be’ between ‘ to’and ‘the’.
P 208, paragraph 4, line 1, replace the words ‘liable for on’ with ‘liable on’.
P 212, paragraph 3, line 4, remove the word ‘somewhat’.
P 213, paragraph 4, line 7, eliminate the last two words in ‘not possible to conclude to conclude’.
P 214, paragraph 1,line 19, insert ‘it’ after ‘alterations’.
P 215, paragraph 3, line 2, insert the word ‘rogue’ after the words ‘by the’.
P 216, paragraph 2, line 2, replace the word ‘says’ with the word ‘holds’.
P 216, paragraph 4, line 4, eliminate the word ‘somewhat’.
P 220, paragraph 3, line 1, insert comma after the word ‘common’.
P 220, paragraph 3, line 2, replace word ‘talk’ with the word ‘discuss’.
P 228, paragraph 2, line 1, insert the word ‘Australia’ after the word ‘In’.
P 235, paragraph 2 line 2, insert a space after ‘$50,000’.
P 241, paragraph 2, line 9, remove the word ‘whether’.
P 243, paragraph 3, line 2, remove first reference to the word ‘explain’
P 248, paragraph 1, line 4, remove the word ‘somewhat ’.
P 248, second dot point, line 1, remove the word ‘somewhat ’.
P 268, paragraph 3, line 3, replace the word ‘use’ with the word ‘used’.
P 275, paragraph 1, line 3, replace the word ‘laible’ with ‘liable’.
P 282, paragraph 2, line 4, remove the word ‘somewhat ’.
P 283, paragraph 2, line 8, remove the word ‘somewhat ’.
P 287, paragraph 1, line 5, replace the word ‘a’ with the word ‘be’.
P 290, paragraph 2, line 3, remove space after the word ‘card’.
P 290, paragraph 3 indented, line 3 replace ‘stripped-out’ with ‘stripped out’.
P 303, paragraph 2, line 1, remove the word ‘somewhat ’.
P 309, paragraph 4, line 2, ‘cheques’ instead of ‘cheque’.
P 315, paragraph, line 2, insert ‘the’ after the word ‘to’.
P 324, footnote 22, eliminate, ‘: see Ch X, 12.’ and add full stop.
P 325, paragraph 5, line 3, eliminate the word ‘view’.
P 328, paragraph 1, line 6, replace the word ‘plead’ with ‘pay’.
P 330, paragraph 1, line 6, remove the word ‘somewhat ’.
P 331, paragraph 2, line 6, insert comma after the word ‘credit’.
P 332, paragraph 3, line 1,  after the word ‘letters’ add ‘of credit’.
P333, paragraph 2, line 4, add full stop after the word ‘simplicity’.
P 359, paragraph 3, line 6, ‘choose’ instead of ‘chose’.
P 361, paragraph 2, line 2, ‘charge backs’ instead of ‘charge –backs’.
P 362m paragraph 1, line 3, ‘it suggests’ instead of ‘it supports it suggest’.
P 375, paragraph 4, line 2, ‘*Westpac Bank*’ instead of ‘*Westpac banking’.*
P 379, para 3, line 14, ‘Code’ instead of ‘code’.

P 385, para 1,  line 2, ‘Code of Banking Practice’ instead of ‘Banker’s Code’.
P 393, heading, ‘*ANZ’s* ‘ instead of ‘*Bank X's’.*
P 393, para 3, line 2, ‘ANZ’s ‘ instead of ‘Bank X's’.
P 394, para 1, line 3, ‘internet instead of ‘net’.
P 396, para 3, line 8, insert cfull stop after ‘rights’.
P 397, para 3, line 1, ‘Whether a payer may’ instead of ‘Whether payer may’.
P 400. para 1, line 5, delete ‘by it’.
P 400. para  3, line 4, ‘give tips’ instead of ‘give the tips’.
P 429, para 1, line 1, ‘an old friend’ instead of ‘and old friend ’.

# THE EFFICIENCY OF ALLOCATION OF FRAUD LOSS WITH CONSUMER PAYMENT INSTRUMENTS AND OF THE RIGHT TO STOP PAYMENT

**Robin Russell Edwards LL.M. (Monash)**

**A thesis submitted in fulfilment of the requirements of the degree of Doctor of Philosophy**

**Department of Business Law and Taxation**
**Faculty of Business and Economics**
**Monash University**

**Submitted:** /9 / 1 / **2010**

# TABLE OF CONTENTS

**Chapter 1: Introduction to thesis**

1. Introduction 1.
2. Overview 1.
3. Three basic methods of payment 3.
4. Two problems with consumer payment systems 4.
5. When can fraud occur with cheques and to whom the loss can be allocated 4.
6. Bank cheques and fraud 6.
   - When fraud can occur with bank cheques 6.
   - Parties to whom bank cheque fraud loss can be allocated 6.
7. Manual use of credit cards 7.
   - When fraud can occur 7.
   - Parties to whom manual credit card fraud loss can be allocated 7.
8. Electronic funds transfer 7.
   - When fraud can with EFT 8.
   - Parties to whom EFT fraud loss can be allowed 8.
9. How allocation of fraud loss is to be evaluated 8.
10. The right to stop payment 9.
    - Inconsistency 10.
11. How the right to stop payment is to be assessed 11.
12. Method 13.
13. Proposed chapter outlines 13.
14. Limitations 13.

**Chapter 2: Theory**

1. Overview 15.
2. Outline 16.
3. Efficiency as a test 17.
   - Economic analysis of the law 18.
   - Meaning of efficiency 19.
   - Impediments to efficiency with the payment system 21.

- Tests for economic efficiency 25.
- Cooter and Rubin's rules for efficient allocation of loss 26.

4. Rules versus standards and efficiency 32.
5. Efficiency and fairness 34.
6. Legal concepts having heuristic value in terms of efficiency and fairness 41.
   - Negotiability 42.
   - Autonomy doctrine 48.
   - Assignment of a debt theory 52.
   - Unilateral contract theory 54.
7. Methodology 55.
8. Conclusions 61.


**Chapter 3: Electronic Funds Transfer and Fraud Loss Allocation**


1. Overview 62.
2. Outline 63.
3. Fraud facilitation 63.
   - Nature of the Personal Identification Number (PIN) 63.
   - Delivery of Pins and cards 66.
   - Physical configuration of ATMs 68.
   - Internet fraud 69.
4. The first version of EFT Code 70.
   - Restricted Application 70.
   - Loss allocation in the first EFT Code 71.
   - Efficiency and Loss Allocation in the First Code 74.
5. The second EFT Code 2001, operational 2002 76.
   - Rapid changes on the ground 76.
   - Application of the second EFT Code 78.
   - Loss allocation in the second EFT Code 81.
   - Criticism of the second EFT Code's allocation of loss 84.

6. The second EFT Code allocation in the light of the Cooter & Rubin 94.
7. The third Code proposals 96.
   - Perceived problems relating to fraud 97.

- Retention of the Loss Allocation Test of the Second EFT Code 101.
- Plain English Allocation Rules 104.

8. Foreign models 110.
   - The Electronic Funds Transfer Act (EFTA) 110.
   - Comparison of US EFT allocation rules second EFT allocation 115.
9. Conclusions 118.

**Chapter 4: Fraud Loss Allocation and Signature Credit Cards**

1. Overview 120.
2. Outline 121.
3. Co-operative endeavours, collusion and efficiency 122.
   - Network development 122.
   - Multi-outlet and international networks 123.
   - Co-operative versus competition 124.
   - Collusion 125.
4. Allocation of liability for loss in regard to signature and credit cards 127.
   - EFT Code does not cover credit cards used with signature 127.
   - Contract and Code of Banking Practice 128.
5. American Law and fraud allocation 132.
6. Forgery of signature by itself is not the major cause of fraud 134.
7. Cost of efficiency of the rule for manual use of signature credit cards 136.
8. Summary 145.

**Chapter 5: Allocation of Liability for Fraud with Cheques**

1. Overview 146.
2. Outline 146.
3. Legislative background 147.
4. The forgery rule 147.
   - The drawer's signature 148.
   - Bank argue for a more extensive duty of the customer 154.

- Ratification 159.

5. Cost of efficiency of the forgery rule as regards the drawer's signature 159.
   - Loss spreading 160.
   - Loss avoidance 161.
   - Rule simplicity 163.
6. Failure of bank to obey mandate – the Ligget defence 167.
7. On the issue of cost efficiency of the Ligget defence 174.
8. Liability of persons subsequent of forgery of drawer's signature 178.
9. Efficiency of subsequent parties' liability for forgery of the drawer's signature 180.
10. Forgery of indorsement on an order cheque and the positions of the banks 183.
11. Efficiency of allocation of liability for forgery of an essential indorsement 187.
12. Summary of conclusions and recommendations 197.


**Chapter 6: Allocation of Fraud Liability Resulting from Alteration of Cheques**


1. Overview 198.
2. Outline 198.
3. Material alterations must also be fraudulent 199.
4. Liability of the drawer versus liability of the drawee bank 200.
5. Employer carelessness and alterations 202.
6. Liability of parties subsequent to the alteration 205.
7. Liability of collecting bank and altered cheques 206.
8. American law in regard to alterations 209.
9. On the efficiency of allocation of liability for alterations 211.
10. Conclusion and reforms 216.


**Chapter 7: Fraud involved in the Issue of Bank Cheques and Allocation of Liability**


1. Overview 218.
2. Outline 218.
3. Definition of a bank cheque 219.

| | | |
|---|---|---|
| 4. | Why bank cheques are used and how they impact the bargaining process | 221. |
| 5. | Parties likely to impugn validity of autonomous payment instruments | 227. |
| 6. | Failure of consideration for the issue of bank cheques | 227. |
| 7. | The American position | 244. |
| 8. | The Australian Paper Clearing System assurances | 245. |
| 9. | Cost efficiency of allocation of liability | 249. |
| 10. | Summary and recommended changes | 253. |

**Chapter 8: Other Instances of Fraud in regard to Cheques**

| | | |
|---|---|---|
| 1. | Overview | 255. |
| 2. | Outline | 255. |
| 3. | Duty of care to safeguard bank cheque forms | 256. |
| 4. | Cost efficiency of allocation of liability for loss of bank cheque forms | 258. |
| 5. | Alterations to bank cheques | 261. |
| 6. | Cost efficiency of allocation of liability for alterations to bank cheques | 265. |
| 7. | The NAB warning – a hypothetical | 268. |
| 8. | The cost efficiency of allocation of loss in the two NAB examples | 275. |
| 9. | Conclusions | 279. |

**Chapter 9: A Uniform Rule for Fraud Loss Allocation**

| | | |
|---|---|---|
| 1. | Overview | 281. |
| 2. | Outline | 281. |
| 3. | Arguments in favour of uniform rules for fraud loss allocation | 282. |
| 4. | Arguments against uniform rules for fraud loss allocation | 286. |
| 5. | The US attempt at a uniform rule for allocation of fraud loss | 287. |
| 6. | Efficiency of the failed UNPC rules | 291. |
| 7. | Conclusions | 293. |

**Chapter 10: The Right to Stop Payment with Cheques & Efficiency**


1. Overview 294.
2. Outline 295.
3. Payment by cash compared with cheques 296.
4. Theoretical legal basis of the right to stop payment of cheques 298.
5. Reasons for stop payment 299.
6. Nature of payment by cheque and right to stop payment for disputes 300.
7. Efficiency of stopping payment in regard to disputes 304.
8. Stop payments in regard to lost or stolen cheques 308.
9. Efficiency of stop payment in regard to lost or stolen cheques 309.
10. Conclusions and recommendations 310.


**Chapter 11: Stopping Payment on Bank Cheques**


1. Overview 313.
2. Outline 314.
3. Jus Tertii 314.
4. Rights of the purchaser of the bank cheque giving rise to a right to compel the issuing bank not to pay 317.
5. Arguments in favor of the purchaser being able to stop payment 318.
6. The bank as drawer 319.
7. Are personal defences or equities different 321.
8. Uncertainty engendered by the right to stop payment 323.
9. Position if the bank cheque made out to the payees' name or order 323.
10. The American position 326.
11. The cost efficiency of allowing complaints of the bank cheque buyer/remitter vis-à-vis the payee being used to stop the drawer bank from paying 328.
12. Summary 333.


**Chapter 12: Chargebacks and Signature Credit Cards**


1. Overview 334.
2. Outline 334.

| | | |
|---|---|---|
| 3. | Meaning of chargeback | 335. |
| 4. | Why chargebacks are preferable to litigation | 337. |
| 5. | Charge back rights more extensive than right to stop payment on a cheque | 338. |
| 6. | How chargeback developed in America | 339. |
| 7. | Arguments in favour of chargeback | 341. |
| 8. | Arguments against chargebacks | 343. |
| 9. | The American legislation | 344. |
| 10. | The transplant of the chargeback concept to Australia and how it applies | 349. |
| 11. | Cost efficiency of chargeback rule | 357. |
| 12. | Summary of recommended change | 363. |


**Chapter 13: Electronic Funds Transfer and Chargebacks**


| | | |
|---|---|---|
| 1. | Overview | 365. |
| 2. | Outline | 366. |
| 3. | EFT Chargebacks | 366. |
| 4. | Cases on EFT chargebacks | 368. |
| 5. | Exclusion of chargeback rights | 379. |
| 6. | Credit card chargebacks, giros and other systesm | 385. |
| | • BPay | 385. |
| | • PayPal | 397. |
| 7. | The credit/debit card stop payment anomaly | 401. |
| 8. | The efficiency of chargebackrights in an electronic context | 406. |
| 9. | Summary of recommended change | 409. |


**Chapter 14: A Uniform Stop Payment Rule**


| | | |
|---|---|---|
| 1. | Overview | 410. |
| 2. | Outline | 412. |
| 3. | Uniform stop payment right | 412. |
| 4. | Arguments for and against a uniform stop payment right | 413. |
| 5. | Distinction between a stop payment for lost or stolen instruments and a uniform right where there are disputes | 421. |

6. Stop payment rights in regard to disputes 422.
7. Efficiency considerations 423.
8. Conclusions 426.

**Chapter 15: Seeking Solutions – Uniform Laws or Ameliorations to Diversity**
1. Overview 427.
2. Outline 427.
3. The application of Cooter and Rubin's rules to fraud allocation 427.
4. Fraud loss allocation: ameliorations to diversity or uniform rules 432.
5. Stopping or reversing payment: ameliorations to diversity or uniform rules 432.
6. Efficiency in perspective 435.

## ABSTRACT

This thesis has three objectives: first, to examine the law relating to loss allocation resulting from fraud with consumer payment instruments and determine whether this allocation is efficient; second, to determine whether any right to stop or reverse payment associated with the payment instrument is efficient; and third, to suggest changes and reforms to achieve efficiency in these two areas.

Consumer payment instruments such as cheques have ancient roots in commercial bills of exchange and negotiable instruments. Many of the characteristics of these reflect the law merchant and the need for negotiability of payment instruments. It is debatable, for instance, whether most modern consumers want their cheques to be fully transferable. The law relating to negotiable instruments had, of course, a system for allocation of loss resulting from fraud that sheeted home responsibility for the loss to the person that was at fault; or, if this was not possible, to the person that was closest to the fraud and could have avoided it. This undoubtedly reflected the implicit view that negotiable instruments were, all other things being equal, used by knowledgeable business parties. The rise of banks and the use of cheques, however, brought different pressures and perspectives. Banks were able, for example, to lobby governments to secure protection for themselves from fraud. Consumers, on the other hand, were relatively ineffective in changing this imbalance; so it is therefore not surprising that fraud loss allocation gave scant attention to 'loss spreading', the idea that the system should bear fraud losses and spread them over all the users of the system.

The other recent sea change in the payment system area has been the switch from paper to electronics. Here, recent initiatives such as the Electronic Funds Transfer Code have sought to make allocation of fraud loss better reflect the

position of consumers vis-a-vis financial institutions but can still be improved as far as efficiency is concerned.

Allied with the problem of fraud loss allocation is the issue of whether the consumer should have a right of stopping or reversing payment if he or she perceives they are the potential victims of fraud or sharp dealing. Again it should be determined whether this is efficient. Does such a right, for example, correct the imbalance of bargaining power between consumers and vendors or will it be abused by consumers?

Such problems call for efficient solutions either by way of ameliorations to current law or by the introduction of uniform laws.

**DECLARATION**

In accordance with Monash University Regulations for Doctor of Philosophy the following declarations are made:

I declare that this thesis contains no material which has been accepted for the award of any other degree or diploma in any university or other institution, and to the best of my knowledge this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

The thesis contains no work prepared by or in conjunction with a person with whom I am or have been a supervisor, or which I or any student supervised by me has presented or which the student intends to present for an award of the university or any other tertiary institution.

I published the following work, which forms part of the thesis, during my candidature:

Robin Edwards, 'Fraud Loss under the Australian Electronic Funds Transfer Code' (2009) *Journal of International Banking Law and Regulation* 24, (7) 361-8, pp 27-31

Robin Edwards, 'The EFT Code Review: The Rules Versus Standards (principles) Debate' *Australian Banking and Finance Law Bulletin* (2009 )24 ( 8), 125-128.

Robin Edwards, 'Does Law Follow Money?' (2009) 21 *Bond Law Review* 41-64.

Robin Edwards 'PayPal and Chargeback' accepted for March edition of *Journal of Banking Finance Law and Practice* 2010.

Dated: ……June 2010…………………………………………………………………

Signed: …Robin Russell Edwards
………………………………………………………………………

**Notice 1**



**Notice 2**

# ACKNOWLEDGMENTS

I would like to thank my supervisors Janine Pascoe, Helen Anderson and Alan Tyree.

I would also like to thank Brendan Sweeney for his technical and other help.

All errors and omissions are mine alone.

# Chapter 1

# INTRODUCTION

**My central thesis is that the allocation of the risk of non-payment from fraud with consumer payment instruments both paper and electronic may not be efficient. This will be done by adopting as a model, the three part test of Cooter and Rubin.[1] A corollary of this is whether consumers have or should have a right to stop or reverse payment and whether this is efficient. Finally, the issue of whether reforms should be made to the current allocation of fraud risk and rights to stop payment and how this could be achieved will be looked at.**

## 1.1 Overview

The great change that is still taking place in consumer payment systems throughout the world is the switch from paper to electronic payment systems. This will not mean the complete demise of paper forms of payment, just as the development from token money to paper money did not bring in its wake the disappearance of coins. Consumer paper money as exemplified by cheques will still continue to occupy an important place for those irregular payments where electronic payment is not feasible. But more and more electronic money is being used by consumers for payments. This presents something of a problem for legal systems since, at least in English speaking countries, the law is more familiar with paper systems and has developed sophisticated rules for loss allocation when there is fraud and also contemplates rights of stopping payment. This is not to say that they are necessarily efficient but if nothing else these paper system laws provide some background to efficiency considerations.

---

[1] Robert Cooter and Edward Rubin, 'A Theory of Loss Allocation for Consumer Payments' (1987) 66 *Texas Law Review* 63-130.

An inkling of the problem can be seen in a recent example of internet fraud. Prior to the Olympic Games of 2008 many consumers bought tickets over the internet using their credit card numbers from ‘beijingticketing.com’ and from chinaolympic2008tickets.com’ only to discover that they were victims of a scam, the tickets never came.[2] Now, if their credit card schemes allow a ‘stop’ payment in the form of a reversal of payment, who should bear this? Obviously, the fraudsters are not to be found – they already have the benefit of the payment and undoubtedly withdrawn the money from their banks; so should the loss be borne by the consumer, the issuer of the card (the buyer’s bank), the merchant, or the fraudulent merchant’s bank?

This thesis will maintain that in regard to both paper and electronic consumer payment instruments and methods the current rules relating to fraud allocation and stopping payment need to be revised in the light of efficiency considerations.

**1.2 Outline of this chapter**

This chapter will address the following issues:

- What are the basic methods of consumer payment?
- What are the issues that this thesis will examine?
- When can fraud occur with cheques and to whom can the loss be allocated?
- When can fraud occur with bank cheques and to whom can the loss be allocated?
- When can fraud occur with credit cards and to whom can the loss be allocated?

[2] Daniella Miletic, ‘Scammers Run Olympic Rings Round Beijing Fans’, *The Age* (Melbourne), 5 August 2008, 5.

- When can fraud occur with EFT and to whom can the loss be allocated?
- How can allocation of fraud loss be evaluated?
- What are consumers' rights to stop or reverse payment?
- How can the efficiency of stop payment rights be evaluated?

In addition an outline of chapters will be given as well as limitations of the thesis.

### 1.3 Three basic methods of payment: similarity of systems?

There are basically three methods of payment that also can be utilized in an electronic system: first, crediting or debiting one's own account -ATMs provide a familiar example of this; second, giving credit instructions to one's own bank - giro systems like BPay provide a good example of this; third, giving a debit authorization to another person - a familiar example of this is an EFTPOS transaction: the consumer gives the merchant authority to 'pull' the money out of his account.

Now, it should not be thought that there is anything new in these basic methods of payment. A cheque, for example, is an example of the third category, debt authorisation – the drawer gives the payee who deposits the cheque into his or her bank the ability to 'pull' the money out of his account. Somewhat confusingly a cheque is described as being 'pulled' since the cheque is typically put into the payment system by the payee, although it is written by the payer, that is, it is the payee is the person that first accesses the payment system and therefore 'pulls' the money to her or his account. The terms 'push' and 'pull' are frequently used to describe payment systems. Where the payer begins the payment process it is described as being 'pushed' and where the payee initiates the process it is described as being 'pulled. Also giro systems have been around for centuries and are essentially an example of the second method, the payer giving credit instructions to the bank – the consumer via his bank 'pushes' the money to the payee's account.

So although electronic payment is relatively new its basic forms echo pre-existing forms of payments.

### 1.4 Two problems with consumer payment systems to be looked at

There are four main problems that must be tackled by any payment system. First, when is payment made, that is, when is it final; second, what happens if there is an error in payment; third, how is loss allocated when there is fraud; and fourth, should the system allow the payer to stop payment or "pull back" a payment.[3]

This thesis will concentrate on problems three and four, namely allocation of loss when there is fraud and the allied right, if any, for the payer to stop payment. It will illustrate that the present rules in regard to these two problem areas are inefficient and lead to costly outcomes.

### 1.5 When can fraud occur with cheques and to whom can the loss be allocated?

Fraud is a major reason for non payment and is a contentious area since it usually involves two innocent parties and the law has to decide which party should wear the loss.

[3] Ronald Mann 'Making Sense of Payments Policy in the Information Age' (2005) 93 *The Georgetown Law Journal* 633, 638.

Cheques are not as frequently used as they were in the past by consumers.[4] Nevertheless, they are still an important payment instrument since they can be used to make payments when other forms of payment like credit card may not be able to be used. They are particularly useful for 'once off' payments where typically the vendor cannot offer electronic payment facilities. Moreover, they can be used where the parties are not face to face.

*When*

Fraud may occur at a number of points in time during the life of a cheque. At the inception, for example, when the drawer's signature has been forged.

It may occur after the cheque has been issued; for example, a fraudulent or material alteration or the forgery of an essential endorsement.

It may occur at the point of collection; for example, when there is a conversion of the cheque by a rogue and the rogue tries to have his bank, the collecting bank, obtain the money from the drawer's bank, the paying or drawee bank.

*Parties to whom cheque fraud loss can be allocated*

The parties to whom the loss could be allocated will therefore vary according to when the fraud occurs but are generally as follows: the forger (usually not able to be located or a person of straw); the paying or drawee bank, that is, the bank upon which the cheque is drawn; the drawer of the cheque, that is, the customer of the paying or drawee bank; the payee or subsequent holder of the cheque if it has been transferred; the collecting bank, that is, the bank where the cheque is deposited and which obtains the money from the paying bank; or a combination of the foregoing.

[4] Alan Tyree, *Weerasooria's Banking Law* (2006) 119.

### 1.6 Bank cheques and fraud

Bank cheques are cheques drawn by the bank upon itself .Bank cheques, or more accurately financial institution cheques, are regarded rightly or wrongly, as safe alternatives to cash. They are therefore treated somewhat differently by the law compared to ordinary cheques. Accordingly, fraud problems with them warrant separate treatment because of their special nature. Frequently vendors will stipulate payment by this means, for example, in real estate transactions or for the sale of cars. They are regarded as being less likely to be countermanded and less likely to be subject to fraud. They are widely regarded as a safe cash substitute.

*When fraud can occur with bank cheques*

Fraud may occur at a number of points in time mainly due to the circumstances where bank cheques are used. It may occur due to the loss by the bank itself of the bank cheque forms and fraudulent use thereafter; or it may happen due to fraud by the purchaser of the bank cheque, for example, a purchase with counterfeit notes; or it may occur because of fraud by employees of the purchaser of the bank cheque, for example, an employee stealing a bank cheque made out to a specific bank, for instance, Country Bank and then using this to pay a debt owed by the fraudulent employee to Country Bank; or it may occur due to fraud by employees of the payee, for example, an employee altering the name on the bank cheque and paying it into a personal account.

*Parties to whom bank cheque fraud loss can be allocated*

Again the parties to whom the loss could be allocated will therefore vary according to when the fraud occurs but are generally as follows: the wrongdoer; the bank drawer of the cheque; the payee or subsequent holder of the cheque; the collecting bank; or a combination of the above.

**1.7 Manual use of credit cards**

Credit cards with signatures are used in face to face transactions. They are not suitable for distance shopping or use over the internet. Consumers may avail themselves of the revolving credit function of the card. Or they may simply use them as a substitute for carrying cash. (Quaere whether this difference in use should have any bearing on the allocation of loss.)

*When fraud can occur manual use of credit cards*

Again fraud may occur at different points in time during the life of a credit card transaction: at the inception, for example, fraudulent issue of a credit card or after the credit card has been issued by way of forging the cardholder’s signature

*Parties to whom manual credit card fraud loss can be allocated*

The parties to whom the loss could be allocated will therefore vary according to when the fraud occurs but are generally as follows: the wrongdoer; the cardholder; the issuing bank (the cardholder’s bank); the merchant; the merchant’s bank.

**1.8 Electronic funds transfer**

These may be effected in various ways: use of credit card number over the phone or over the internet, use of electronic funds transfer at the point of sale(EFTPOS), use of stored value card (smart cards), internet banking, electronic bill payment systems such as BPAY, and digital cash to name but a few.

*When fraud can occur with EFT*

Again fraud may occur at different points in time: at the inception, for example, by fraudulent use of the personal identification number (PIN) by employees of the card issuer. Once a card has been received by the consumer there might be fraudulent use of the PIN by family members. After theEFT process has begun there may; for example, fraud by hackers.

*Parties to whom EFT fraud loss can be allocated*

The parties to whom the loss could be allocated will therefore vary according to when the fraud occurs but are generally as follows: the payer; the payer's bank or institution; banks or institutions involved in the transfer; the payee; and the payee's bank or institution.

**1.9 How allocation of fraud loss is to be evaluated**

The foregoing demonstrates that fraud can occur in many different ways with both paper instruments and electronic forms of payment, whether used face to face or via electronic media. It also showed that the loss can be allocated to a range of parties according to the exact circumstances of the particular fraud. [5] This thesis proposes to assess the various legal rules for allocating loss according to principles derived from economic literature, namely, Cooter and Rubin's 'rules'[6] whereby the following questions are asked to assess the efficiency:

[5] The reasons for particular loss allocations by existing laws are the subject of the chapters which follow.

[6] Cooter and Rubin, above n 1.

- Which party in the transaction or system can because of size, wealth, insurance, or the ability to pass on costs, best bear the risk of non – payment?
- Which party can most easily avoid the loss?
- Are the allocation rules the least costly rule to enforce?

Needless to say, considerations of fairness also emerge here. Suffice it to say at this stage that the Cooter and Rubin rules have some inherent fairness concepts.

### 1.10 The right to stop payment

Some methods of payment allow the payer to stop or reverse payment. In the case of a stop payment 'right' the law appears to offer disparate rights and duties depending on the type of payment instrument method used. Even if there is no fraud involved there can still be disputes about late delivery or non-delivery or that there has not been compliance with the underlying contract, for example, in terms of quality. Often this too will be viewed by the consumer, rightly or wrongly, as amounting to fraud. Alternatively, the stop payment reason may be because of loss, theft or destruction of the payment device. The issue of whether there is a right to stop payment is particularly important when the parties are at a distance and can be of vital importance when buying goods from overseas via the internet. The cost of the goods and the fact that there are different jurisdictions makes litigation an unattractive possibility.

With fraud the cause of the problem of allocation is typically a third party, a rogue who exits the scenario, leaving the law to sort out which of two innocent parties should bear the loss. On the other hand, with a right to stop payment the cause of the non payment is an action by the payer; prompted perhaps by an apprehension of fraud or that there has not been compliance with the underlying contract. There can be other reasons for stop payment apart from fraud and disputes about goods and services (often seen by consumers as the same thing}, for example, when an instrument is lost or destroyed

Different payment instruments will be looked at in this context, namely, cheques, bank cheques, credit cards used manually and EFT in general including electronic use of credit cards.

*Inconsistency*

The following are apparent inconsistencies in regard to the right to stop payment:

- with cash there is no right to stop payment.
- with cheques the drawer has a right of stop payment.
- with bank cheques there would appear to be no right of stop payment.
- with EFTPOS (electronic payment at point of sale) there would appear to be no right to stop payment.
- with payment with credit card there is, in effect, a right to stop payment because of the right of chargeback.

The obvious question here is why is there such differing treatment and how should the risk and loss be treated by the law.

If the system allows a stop payment it must be determined who should bear this burden, at the very least in the case of a dispute until it is resolved. The parties to whom the burden can be allocated are basically: the payer; the payee; the payer's bank; or the payee's bank.

### 1.11 How is the right to stop payment to be assessed?

How, then, is the right to stop payment to be assessed? Obviously in some cases the cause of the fraud may be the reason why there has been a stop placed on payment. The right can therefore be seen as a type of self help remedy. But is it to be judged in the same light as rules for allocation of loss when there has been fraud caused by a third party rogue? It is suggested that although efficiency is an admirable way of assessing this right, the focus of efficiency should be somewhat different. Such a right should be viewed from the economic perspective of the consumer versus the retailer and the nature of the underlying transaction.

There are two striking aspects in retailing to consumers nowadays. The first is the size of retailers, take supermarkets, for example: a consumer vis-à-vis a supermarket is a dwarf. The disparity in bargaining power is obvious. The second is the rise of sales over the internet. It is often easier to buy a book or a CD over the internet than it is to buy it locally at a shop. However, since the nature of the transaction – a sale where the buyer and seller may even be in different country- it may call for a different rule about reversibility of payment since the buyer is faced with the possibility of fraud or non compliance with the underlying contract. Distance facilitates both these possibilities.
It is submitted that the nature of the underlying transaction should play an important role in determining the appropriate rule in terms of stopping payment.

Some insights about the role of the underlying transaction and the appropriate 'stop' payment rule or absence thereof, may be gained from looking at an example from a business context. The issuing bank of a letter of credit can refuse payment if the documents presented by the seller are non-conforming. This represents the bargain by two parties: the law assumes that the importer and exporter, business people, know what they are doing. In essence the buyer says to the vendor 'I'll pay you before I receive the goods but this is on condition that the documents that represent the goods are precisely what I stipulated in the letter of credit'- (the buyer, of course, stipulating in the letter of credit those documents that are most probably going to result in the receipt of what was bargained for). The law therefore upholds this bargain since it has been arrived at freely and by knowledgeable parties. A corollary of this is that certain payment instruments used by business people like letters of credit are considered autonomous.

This is not to say that Cooter and Rubin's rules are totally irrelevant here: assessing which party should bear the loss until the matter is resolved legally is merely a slight adaptation of their first rule about which party can best bear the loss. In deciding whether a right to stop or reverse payment is efficient, Cooter and Rubin's rule about which party can most easily avoid the loss becomes - which party is responsible for the fraud or non compliance with the underlying contract?

Of course, not even law makers have hearts of stone, so efficiency must also be tempered by what is fair or equitable. Taking a florid example from a different context, the health system, it may be efficient to eliminate all people over 50 in terms of lower costs but, of course, most people would find this morally repugnant. But how does one determine, what is fair or equitable? Phenomenologically there is no objective position and deliberate human communication and understanding must be called into play.

Fairness, if commented upon, will therefore be assessed in terms of "How would you like this to happen to you?" Fairness as an issue will, however, only be touched upon in passing as the main emphasis will be on efficiency.

### 1.12 Method

This thesis will examine each of the various methods of payment and the current rules in the light of Cooter and Rubin's 'rules' for efficient allocation of loss.

### 1.13 Proposed chapter outlines

Chapter 1 Introduction.
Chapter 2 Theory.
Chapter 3 efficiency of allocation of loss with EFT fraud.
Chapter 4 efficiency of allocation of loss with fraud with credit cards used.
Chapter 5 efficiency of allocation of loss with forgery on cheques.
Chapter 6 efficiency of allocation of loss with alterations on cheques.
Chapter 7 efficiency of allocation of loss with fraud with the issue of bank cheques.
Chapter 8 efficiency of allocation of loss with fraud with other sorts of bank cheque fraud.
Chapter 9 efficiency of stop payment with cheques.
Chapter 10 efficiency of stopping payment with bank cheques.
Chapter 11 efficiency of Code of Banking Conduct chargebacks.
Chapter 12 efficiency of EFT chargebacks.
Chapter 13 Conclusions and reforms.

### 1.14 Limitations

- The law examined will be mainly Australian law with some overseas comparisons.
- The Australian law examined will be the law in force up until the end of the calendar year 2009.
- Comparisons will be largely limited to American law.

- As fairness is difficult to assess it will only be commented on in an ancillary manner.
- Criticism of economic theories of efficiency will not be undertaken.

### 1.15 Meanings

- Whenever the word 'bank' this should be read as also covering financial institution and vice versa. (The old distinctions between banks and other forms of financial institutions such as building societies and credit unions have been largely eliminated. A cheque, for instance, is defined in s 10 of the *Cheques Act* 1986 (Cth) as order in writing 'addressed by a person to another person, being a financial institution.' Moreover, prudential regulation is now across all financial institutions.}However, ease of reading and familiarity makes the use of the word 'bank' apposite in many instances.
- The word 'consumer' is used in a broad sense without any particular legal meaning ascribed to it by legislation. Consumer payment instruments in particular do not include things like letters of credit and performance bonds that are used in a business to business setting.
- The expression 'bank cheque' is used rather than 'financial institution cheque'.

# Chapter 2

# THEORY

## 2.1 Overview

In the previous chapter the types of risks of non payment and the players involved were outlined and it was shown that fraud and disputes about non compliance with the underlying contract could occur with all kinds of payment instruments and at different points in time. There are, of course, in all the situations a number of people and institutions to whom the loss can be allocated. This could be resolved in a number of different ways:

1. letting the loss lay where it falls. This would, generally speaking, represent a complete abdication by the law as well as involving a great deal of unfairness; so this will not be considered any further.
2. allocating the loss according to fault, which is the traditional legal method.
3. allocating the loss in the light of efficiency principles.
4. allocating loss by considering ‘fairness’.
5. allocating loss by way of a combination of the above.

This chapter will look at theories of efficiency (3) and its relation to allocation of loss by way of fault (2). Fairness and how it relates to efficiency (4) will also be discussed.

Although this thesis is basically concerned with the allocation of fraud loss which, naturally, involves looking at the loss after the fraud has occurred, a consumer in practice who perceives, rightly or wrongly, that he or she is about to become the victim of fraud wants to know whether they can nip the matter in the bud by stopping payment.

Thus although the central thesis is that the allocation of fraud loss with consumer payment instruments may not be efficient, a necessary corollary of this is whether the right to stop or reverse payment to prevent or combat fraud is also efficient or not. Consistency and fairness are also closely linked to efficiency and these will be dealt en passant.

Since the allocation of fraud loss and the right to stop or reverse payment involve slightly different considerations – indeed, enough to justify their being dealt with in separate chapters in the body of the thesis - the theories that may be relevant to any discussion of efficiency and how it relates to the issues of fraud loss and stopping payment are broad enough to be discussed here as a whole.

## 2.2 Chapter Plan

In this theory chapter the following questions will be addressed:

- Why use economic concepts of efficiency to look at loss allocation and the right to stop payment?
- Do the rules versus standards debate have any relevancy to efficiency in this context?
- What is the relationship between fairness and efficiency and should it inform the examination of fraud loss allocation and the right to stop payment?
- What legal concepts may have heuristic value in terms of efficiency and fairness of allocation of loss?
- What methodology will be used to employ the above?

**2.3 Why efficiency?**

In 1999 the Australian Securities and Investment Commission engaged Professor Mark Sneddon, Special Counsel in Electronic Commerce with Clayton Utz, a major Australian law firm, to prepare a first draft of a revised Electronic Funds Transfer (EFT) Code of Conduct and accompanying commentary.[1] *Sn*eddon suggested that allocation of unauthorized transaction losses be viewed from an economic efficiency perspective based on Cooter and Rubin's seminal article.[2] This article and its efficiency concepts will be discussed in more detail subsequently. There are two noteworthy aspects to this: this was the first time in Australia that allocation of loss was looked at expressly from this perspective; second, the resulting EFT code purports to be efficiency based in terms of loss allocation. Whether this is so will be looked at in more detail in Chapter 3.

This also prompts the question of whether allocation of loss for fraud is efficient in regard to other forms of consumer payment such as cheques, bank cheques, and credit cards used with a signature, the latter not being covered by the EFT code. It also prompts the question whether consumer rights to stop or reverse payment are efficient.

It is not asserted that efficiency is an absolute truth. This thesis merely argues that in the main, efficient allocation is usually fair – but not always. At times fairness must be pressed into action too. Yet efficiency provides an insightful analytic framework for the allocation of risk and loss and consumer rights to stop or reverse payment.

---

[1] Alan Tyree, *Weerasooria's Banking Law* (2006) 119.

[2] Robert Cooter and Edward Rubin, 'A Theory of Loss Allocation for Consumer Payments' (1987) 66 *Texas Law Review* 63-130.

### 2.3.1 Economic analysis of the law

The genesis of this interest in efficiency and allocation of loss is the economic analysis of law. This is a relatively modern approach, with strong roots at the University of Chicago in the 1960's.[3] The approach has a growing number of followers,[4] but is certainly not without critics.[5] Economic analysis allows us to look at the law from another perspective. In the words of an American judge and academic:

> Economics is the study of rational behavior in the face of scarcity.... The legal system, too is about coping with scarcity. If there were an abundance of every good thing, there would be no need for law... If there is scarcity, law cannot be understood apart from economic thought. [6]

Economic analysis can be used in a positive way - to explain the current law along economic lines, or in a normative sense - to prescribe the law as it should be, again in economic terms. In trying to apply economic analysis to determine which party should bear the risk of non payment, both a positive and a normative or prescriptive approach is required.

---

[3] Richard Epstein, 'Law and Economics: Its Glorious Past and Cloudy Future' (1997) 64 *University of Chicago Law Review* 1167.

[4] Richard A Posner, 'Some Uses and Abuses of Economics in Law' (1979) *University of Chicago Law Review* 281; Douglas G Baird, 'The Future of Law and Economics: Looking Forward' (1997) 64 *University of Chicago Law Review* 129.

[5] See, eg, Martha Nussbaum, 'Flawed Foundations: The Philosophical Critique of (a Particular Type of) Economics' (1997) 64 *University of Chicago Law Review* 1197.

[6] Frank H Easterbrook, 'The Inevitability of Law and Economics' (1989) 1 *Legal Education Review* 1.

Economists variously examine concepts such as value, utility, and efficiency.[7] It is the concept of efficiency that is most widely used in economic analysis of law and that will be used here. [8] To quote Jules Coleman, an American academic: 'Whether the new law and economics is restricted to model theoretical applications or whether instead it is advanced as an explanatory or normative discipline, its central organizing idea is that of economic efficiency.' [9]

### 2.3.2 Meaning of efficiency

In broad terms efficiency means that a system operates with the minimum amount of waste. Efficiency is improved if the amount of 'drag' or "waste" is cut down. One could say that a system is operating efficiently if the ultimate result is achieved using the least resources available. And losses to uncompensated third parties are minimized – called negative externalities.

It should be borne in mind that payment instruments or methods are but a means to an end, usually in a consumer context the acquisition of goods, services and real estate. The cheaper the payment instrument mechanism, that is, the fewer external expenses it puts on the underlying transaction, the more efficient it is. As Professor Rubin puts it:

> The more inexpensive this mechanism [payment mechanism] is to use, the more efficient it is, that is, the fewer extraneous expenses it imposes on the underlying transaction. Economists describe such

---

[7] See, eg, Richard A Posner, *Economic Analysis of Law* (1992).

[8] For a broad discussion on the merits of efficiency as a fundamental criterion in economic analysis of law, see generally 'Symposium on Efficiency as a Legal Concern' (1980) 8 *Hoffstra Law Review* 485-770.

[9] Jules L Coleman, 'Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law' (1980) 68 *California Law Review* 221.

> extraneous expenses as transaction costs. In the payment context, this means minimizing the cost of the payment mechanism as a whole.[10]

Every payment system has costs; for example, with the cheque system there is the cost of the cheque, the cost of collection and payment and the cost of the clearing system to name a few. Most of these are paid for by the customer. These extraneous expenses are called by economists 'transaction costs'.[11] A rough definition of efficiency is therefore the minimization of these transaction costs. For instance, if A pays B with a cheque it costs about 30 cents but if A pays B with a bank cheque it will cost A $10 or more. Prima facie, the ordinary cheque is therefore more cost efficient. In theory it leaves more of the money from the underlying transaction to be divided between A and B. But if B were not confident that A's cheque would be paid B might insist upon a bank cheque. Who, in effect, pays the cost of this will be determined by the contractual terms.

It is here that the Coase theorem, an important concept in efficiency, needs to be mentioned.[12] Coase argued that putting aside the costs of bargaining (zero transaction costs), the parties will arrive at the most efficient solution, regardless of where the law places liability. This somewhat surprising idea can be explained in terms of regarding rights as forms of property. However, if there are significant transaction costs, the efficient outcome may not occur under every legal rule. The preferred legal rule is therefore the one that minimizes transaction costs. The legal rule that minimizes prevention and avoidance costs, damage costs and transaction costs will therefore be the most efficient.

---

[10] Edward Rubin, 'Efficiency, Equity and the Proposed Revision of Articles 3 and 4' (1991) 42, *Alabama Law Review* 551, 561.

[11] Ronald H Coase, 'The Problem of Social Costs', (1960) 3 *Journal of Law and Economics* 1.

[12] Ibid.

### 2.3.3 Impediments to efficiency with the payment system

In theory, at least, the market will produce efficiency: competition will mean that the parties involved will arrive at an efficient payment contract. But Professor Rubin points out that efficiency will not occur if there is a market failure.[13] In essence, he suggests that there are three main sources of market failure: monopoly or limits on the number of competitors- this can also cover monopoly or undue market power obtained through collusion ; externalities – costs imposed on those not a party to the transaction; and, finally, information asymmetry. These need to be examined from the point of view of the Australian payments system.

*Monopoly*

Taking the monopoly point first, this could not be really said about the Australian payment system today. Indeed every reasonable effort has been made to make the system more competitive. The *Cheques and Payment Orders Act 1986* (Cth) allowed non bank financial institutions into the 'cheque' system by allowing them to use agency cheques and payment orders. Subsequent changes to the act in 1992, the name being changed to the *Cheques Act* 1986 (Cth), allowed non bank financial institutions to have cheques drawn on them, the first common law country to allow this. This meant that payment orders were no longer required.

Access to the clearance system has also been facilitated. The role of the central bank, the Reserve Bank of Australia, is crucial here. It operates under the *Reserve Bank Act* 1959 (Cth). Most of its powers and functions in the payments system derive from the Act and the *Payments Systems (Regulation) Act* 1998 (Cth).The power to determine the payments system policy of the Reserve Bank resides with its Payments System Board (PSB). This includes the exercise of responsibilities under the *Payment Systems (Regulation) Act*

[13] Coleman, above n 9, 551, 563.

1998 (Cth)and the *Payment Systems and Netting Act* 1998(Cth). Under the *Reserve Bank Act*, the PSB has responsibility for regulating the payments system it may: designate a particular payment system as being subject to Reserve Bank direction; determine rules for participation in the system, including access to new participants; set standards for the system on matters relating to safety and efficiency; and arbitrate on disputed concerning the system over matters relating to access, financial safety, competitiveness and systemic risk. Thus, it can be seen that the payments system in Australia is quite open and competitive within the bounds of prudential regulation.

*Collusion*

Collusion will also prevent the market from operating properly. There has been quite a deal of evidence of this. The Australian Competition and Consumer Commission (ACCC) is responsible for ensuring that payments system arrangements comply with the competition and access provisions of the *Trade Practices Act* 1974(Cth). The bankcard system introduced in Australia in 1974 had many anti competitive features that were eventually cleared by the then Trade Practices Commission subject to anticompetitive features being dropped.[14]

Interchange fees have also been in recent times the focus of anti-competitive legal actions. An interchange fee is the fee charged by one bank to process credit and debit transactions made on cards from another bank; for instance, a consumer use his or her CBA credit card in a shop that has a NAB credit card terminal. The collective setting of such fees posed a problem under the price fixing prohibition under s 45A of the *Trade Practices Act*. Moreover these fees were not transparent. Most cardholders had no idea that these fees were being

[14] Robin R Edwards, 'The Australian Payment System and Competition' Law and Economics Association Conference, Melbourne University, July 1997.

passed onto them. Following legal action by the Australian Competition and Consumer Commission (ACCC) against the banks and credit card companies and the failure of an appeal in the Federal Court by Visa, Mastercard and Bankcard, the Reserve Bank of Australia (RBA) intervened (there can be no appeal from its decision). The upshot was that banks from November 2003 could only charge interchange fees that reflected true costs. This has almost halved the amount charged. The RBA and the ACCC have also sought to make the market more competitive by allowing in more participants.

*Externalities*

Externalities to the payment system as a whole, that is, negative effects on others in the payment system would not seem to a problem. The payment system is monitored to prevent crashes and contagion via capital adequacy and liquidity rules.

*Information asymmetry*

Information asymmetry may also prevent the market from functioning properly.

Information asymmetry occurs when one party has superior information to the other and can therefore obtain benefits or allocate costs, thus distorting the 'efficient' contractual process. Arguably where consumers are involved the possibility of information asymmetry is high since they do not have the benefit of 'repeat' experiences or the financial resources to obtain the necessary information. A consumer, for example, might use one EFT system whereas a bank has the experience of dealing with thousands of applications and also has the benefit of legal advice and other expertise. The bank has intimate knowledge of the system and more power compared to the consumer and therefore the contract usually reflects this.

In a consumer context, the law cannot assume that there is equality of bargaining power. Indeed, there can be something of a presumption the other way. In theory a free market will allow the parties to arrive at an efficient payment contract. But this may not happen if there is information asymmetry. The problem has been described in the following way:

> …Information asymmetry occurs when one party to the transaction has better information than another and thus is able to obtain benefits or allocate costs to an extent that decreases the overall efficiency of the contract.
>
> Where market failure occurs, private contract will not effectuate the social goal of economic efficiency and there is an economic justification for imposing substantive legal rules. If efficiency is the goal, these legal rules should be designed to reallocate costs in a manner that approximates the contract that the parties would have reached had they possessed the necessary information.[15]

This suggests that the right to stop or reverse payment should be viewed as a way to correct the imbalance between buyer and seller to promote efficiency. Hence it is proposed to look at the right to stop payment from both the transactional point of view as well as an efficiency point of view. Given this imbalance between consumer and seller, it can perhaps be suggested that:

> legal rules [relating to rights of stopping payment] should be designed to reallocate costs in a manner that approximates the contract that the parties would have reached had they possessed the necessary information.[16]

[15] Rubin, above n 10, 561-2.

[16] Ibid 561-2.

The market therefore will not produce an efficient contract if there is market failure. Rules about allocation of liability should bring about the distribution of costs so that it is close to what the parties would have arrived at had they had the requisite information. This would therefore decrease the total cost.

*Conclusions*

The above outline shows why efficiency is important to the allocation of loss. It also provides a sketch of some of the general theories on efficiency and shows how the Australian payment system is generally competitive but that parties may not arrive at a efficient payment contract due to information asymmetry and collusive conduct. The allocation of loss rules and rights to stop payment should reproduce the agreement that the parties would have arrived at were it not for market failure due to information asymmetry and collusion.

### 2.3.4 Tests for economic efficiency

There are a number of economic tests for efficiency, two key ones being 'Pareto superiority' and 'Kaldor-Hicks efficiency'.[17]

Pareto superiority requires that both parties are made at least as well off, in the sense that a Pareto-superior transaction is one that renders at least one person better off and no person(s) worse off.[18] Very few rules or doctrines create a Pareto superior effect, as most have some detrimental effect on at least one person, even if it is merely a rise in prices or added costs of insurance.

---

[17] Above n 9, 222.

[18] Other key tests are 'Pareto optimisation' and 'wealth maximisation'. For detailed explanation of the different notions of efficiency, see Coleman, above n 8.

As an alternative model, the Kaldor-Hicks model of efficiency examines whether the transaction results in a net overall benefit, so that the combined benefits to the parties involved do not exceed the resulting (net) detriment to any third parties adversely affected by the transaction. A legal rule is Kaldor-Hicks efficient if it could be made Pareto efficient by some parties compensating others so as to offset their loss.

#### 2.3.5 Cooter and Rubin's rules for efficient allocation of loss

However, some more specific tailored principles are more appropriate when considering how to determine allocation of risk for non- payment. As mentioned the current EFT allocation of losses purport to be worked out on the basis of a three fold test designed specifically to test the efficiency of allocation of loss in regard to payment instruments. Cooter and Rubin have identified three general principles derived from efficiency literature.[19]

- The loss spreading principle – which party in the transaction or system can, because of size, wealth, insurance, or the ability to pass on costs, best bear the risk of non–payment?
- The loss bearing principle – which party can most easily avoid the loss?
- The loss imposition principle – the best rule is the least costly rule to enforce.

These principles will now be looked at in more detail.

*The loss spreading principle*

[19] Cooter and Rubin, above n 1, 63-130.

**U**nder this principle, one asks: which party can most easily bear the cost at the lowest price?

This factor in determining risk allocation is relatively straightforward. The size of the parties concerned and their ability to spread the risk are major factors. Financial institutions and merchants would therefore seem to better candidates. In addition the size of losses also has to be taken into consideration. If a loss were massive it might play havoc with the financial system if the risk were put upon the financial institutions. But losses in the consumer context are usually small and predictable; so they can be easily passed on. Moreover, financial institutions because they deal with millions of transactions are in a unique position to know the size and frequency of losses. To a lesser extent this could be said of merchants – they too can pass losses onto the public or they may be able to take out insurance to cover the loss of non payment or, at the very least, they may be able to claim losses as a tax deduction. However, generally speaking merchants are not as wealthy as financial institutions nor are they exposed as frequently to as many losses as financial institutions, an important factor in a financial institution's ability to calculate the cost of passing the loss onto its customers.

Consumers are generally not in a position to pass the loss on and, moreover, if it were a heavy loss it could be devastating to an individual. Could not insurance cover this risk? Since the risk is remote that the loss would fall on any individual it would not be worthwhile for a consumer to insure against this risk, even if an insurance product were available.

*The loss bearing principle*

The imposition of liability often teaches the person a lesson so as they will not repeat the same behavior. Allocation of liability also acts as a warning. From an efficiency perspective allocation of liability should target the person who can avoid loss at the lowest cost. In any payment system there will inevitably be more than one person who can reduce risks; for instance, a customer of a bank might be expected to take care of his or her cheque book. On the other hand, it might be expected that the bank that should be careful how it makes the cheque book available to customers. Perhaps, for example, it should not send cheque books through the ordinary mail.

This also brings into play complex and even unsolvable problems of how people react to the assigning of loss. There may be differences between how a sophisticated banker might react and how an ordinary consumer might react. Here knowledge and responsiveness are important. Behavioral economics suggest that an individual is likely to underestimate a negative future event unless someone in his or her immediate ken has recently experienced this.[20] Moreover, with individuals optimism prevails the further the event seems in the future [21] On the other hand, financial institutions face problems with payment instruments and systems everyday. One could therefore, generally speaking, expect them to be more responsive than consumers who only on odd occasions might face problems. If, for argument's sake, it could be shown that consumers in general are ignorant of rules for assigning liability for loss, then it would seem to be pointless assigning liability to them since one could not expect any rational response from them. Complex rules might also be more difficult to learn. Happily there seems to be some evidence that consumers learn over the long term, at least, but the matter is not free from doubt. [22] On the other hand, if it could be shown that financial institutions are not responsive to allocation of liability to them, then some other way of eliciting the correct response might be desirable.

---

[20] Amos Tversky and Daniel Kahneman, 'Judgment Under Uncertainty: Heuristics and Biases' (1974) 185 *Science* 1124, 1127-28.

[21] Stefano Dellavigna and Ulrike Malmendier, 'Contract Design and Self Control: Theory and Evidence' (2004) 119 *Quarterly Journal of Economics* 353; G Lowenstein and RH Thaler, 'Anomalies: Intertemporal Choice' (1989) 3 *Journal of Economic Perspectives* 181.

[22] Mita Sujan, 'Consumer Knowledge: Effects on Evaluation Studies Mediating Consumer Judgements' (1985) 12 *Journal of Consumer Response* 31.

One of the major issues that arises here is the issue of care but, as noted, there is usually more that one person who can act prudently. A rule that might be easy to devise and apply, for example, strict liability, might send the wrong message to other parties who may be able exercise care to avoid the loss. Hence rules often split the assignment of liability in an effort to make more than one party take precautions; for example, in regard to fraudulent alterations of cheques, banks should not pay out on them but the drawer owes a duty not to draw them in such a way so as to facilitate alterations.[23] This, however, makes the formulation of the rule complicated and might also make the enforcement of it more difficult.

An important point in assessing financial institutions' responsiveness is the effect in might have on technological innovation. Payment system innovation has been very rapid in the past twenty years, largely due to computer developments. If, for example, liability for fraud was assigned to financial institutions it might act as a spur to find technological innovations to reduce fraud.

*The loss imposition principle*

Efficiency requires that enforcement of liability be as cheap as possible. Obviously letting the loss lay where it falls would be cheap but might be highly dubious in the light of the other efficiency rules mentioned above. Accordingly simple and clear rules seem to be required here.[24] Fault based rules, especially split liability rules, invite complicated legal complications but may be defensible on other efficiency principles. Strict liability is simple but again it might not be appropriate in the light of loss spreading and loss

[23] *Cheques Act 1986* (Cth), s 78(2).
[24] Elizabeth Hoffman and Matthew Spitzer, 'The Coase Theorem: Some Experimental Tests' (1982) 25 *Journal of Law and Economics* 73.

reduction. Rules that cut down on the need for evidence would also seem to promote efficiency. For example, to determine whether a bank customer has left sufficient space to facilitate fraudulent alterations requires time and expert evidence to establish.[25] Hence it is costly.

How rights are to be enforced is also important: civil litigation, criminal enforcement, administrative enforcement, and alternate dispute resolution are all possibilities. The cheapest enforcement process would be the most efficient. One important factor to be borne in mind here is under-enforcement. If legal costs are too high or the process is too difficult then consumers in particular may shy clear of enforcing their legal rights especially if the loss involved is small. From the perspective of financial institutions and merchants the effect of adverse publicity might also be a factor in determining the possibility of civil litigation. On the other hand, since financial institutions must live daily with payment rules they also have an incentive to litigate if the rule is unclear or if they consider it is unfair because it allocates liability unfairly.[26] Fixed damages might also make enforcement simpler and less costly than working out damages in civil enforcement.

Administrative enforcement is by its nature not particularly helpful to individual consumers who sustain losses, although it might be helpful in enforcing general rules. [27] Under-funding by government and bureaucratic lethargy are also factors that undermine the efficiency of administrative enforcement.

Criminal enforcement is a possibility when fraud is involved. The usual difficulties arise here. Proving a breach of the law beyond a reasonable doubt means that enforcement is difficult. Criminal statutes usually are precise and

[25] *Commonwealth Trading Bank of Australia v Sydney Wide Stores Pty Ltd* (1981) CLR 304; 35 ALR 513.
[26] In *National Australia Bank Ltd v Hokit Pty Ltd* (1996) 38 NSWLR 377 the bank sought to widen the duties a customer owes to the paying bank.
[27] Laura Nader, 'Disputing without the Force of Law' (1979) 88 *Yale Law Journal* 998, 1006.

often complicated. Any doubts will be resolved in favor of the accused. Moreover, criminal enforcement will not usually assist consumers who have sustained loss as a result of fraud.

*The mix of Cooter and Rubin principles*

Even though the three principles above help inform us about the efficiency of allocation of risk of non payment, it does not mean that they should necessarily be given equal weight. The first principle, the loss spreading one, is about whom can best absorb or pass on the loss; the second, the loss bearing principle, is about preventing the loss; and the third, the enforcement principle, is about the cost of enforcement. But to determine the efficiency of allocation of risk of non payment, one must consider the total cost. Hence one principle might carry more weight than the other. Indeed, the principles may contradict one another: for example, the loss spreading principle (who can bear the loss) might clash with the loss bearing principle (who can avoid the loss). Thus the cost of one must be balanced against the cost of the other. It may even be that the overall cost means one of the principles can be completely discounted in the calculation; for example, it may be that the allocation of loss should simply be assigned to the party best able to spread the loss.

Remembering that ideally allocation of risk rules should a produce a result that mimics what knowledgeable parties would have arrived at on a contractual basis, the choice is fundamentally between loss bearing and loss avoidance or a mixture of the two. Clearly the loss spreading principle suggests that most of the loss should be borne by banks because they can easily loss spread. Rubin maintains that in an efficient allocation of loss:

> The bulk of the loss would generally be allocated to the financial institution, because the financial institution can spread it through the prices it charges to all users of the system, and because the institution is

> in the best position to decide how much money to spend on avoiding the loss.[28]

On the other hand, loss could be assigned to consumers to induce them to take precautions if they would lessen the risk; but care must be taken that they are commensurate: too much caution should be avoided as well as too little. Ideally litigation and adjudication should also be minimized.[29]

*Conclusions*

The above sections have described some of the general tests for efficiency and the more tailored Rubin and Cooter tests for judging the efficiency of allocation of loss with payment instruments. It has also shown what this three fold test involves and its utility in weighing up the efficiency of loss allocation. In addition rights to stop payment should be viewed as correcting the imbalance in consumer contracts resulting from information asymmetry.

### 2.4. Rules versus standards and efficiency

The literature on rules and standards may also be helpful in determining the efficiency of loss allocation. Cooter and Rubin's rules for efficiency, for instance, argue that in terms of loss imposition, the law is more efficient if it allows for cheaper adjudication. Putting it somewhat simply, the best law from an efficiency point of view is the simple one. There is a considerable literature on the issue of rules versus standards which may be relevant here.

A rule has been defined as 'a statement of the prescription of the law on some matter, usually applied to one more specific and detailed than a doctrine or principle' whereas a standard usually is 'indefinite, fixed by a formula which

[28] Above n 10, 564.
[29] Ibid.

permits individual judgment in the circumstances of the particular case e.g. reasonable care, due diligence, the care of the reasonable man, the prudent trustee, and so on.' [30]

Broadly speaking, it is argued that rules are better for technical repeat transactions whereas standards are better for opaque events. A good example of the latter might be s 52 of the *Trade Practices Act* 1974 (Cth) whereas the *Bills of Exchange Act* 1909 (Cth) might be a good example of the former. Since most payment systems involve repeat transactions this suggests that rules might be better. However, rules are usually more complicated which might make adjudication more difficult. Standards though since they are couched in terms of generalities usually require precedents to make sense of them and are arguably not conducive to settlement of disputes. This tendency has been described as follows:

> A standards-based approach reduces the predictability of case outcomes, and is therefore likely to cause a decrease in the settlement rate. Since the costs of litigating are generally higher that the costs of settlement out of court, the consequence is to raise the total costs of legal dispute resolution.[31]

One also has to take into consideration how likely people are to inform themselves of the law in regard to payment instruments or methods. If they are unlikely to concern themselves then this might have relevance in terms of Cooter and Rubin's second rule about which party can most easily and cheaply avoid the loss. If, for example, they are unlikely to inform themselves of the law, it may not matter whether it is a standard or a rule.

[30] *The Oxford Companion to Law* (1980), 1093.
[31] Isaac Erhlich and Richard A Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *Journal of Legal Studies* 257, 265.

Such considerations thus may be important in terms of efficiency of allocation of loss and relevant to the issue of consumer rights to stop payment.

### 2.5 Efficiency and Fairness

*Does efficiency lead to a fair result?*

There is much that is written about the law and efficiency that many find morally offensive; for example, Posner's analysis[32] of rape in terms of consensual sex being relatively expensive for men and therefore rape being less expensive, brought howls of protest.[33] The same can be said of his analysis of adoption law in terms of supply and demand.[34] Even Pareto efficiency seems to some to be morally dubious; for example, if 90 per cent of the population is starving and 10 per cent are extremely wealthy, if the law takes anything from the 10 per cent, then this is not Pareto optimal.[35] To say that a state of affairs is Pareto optimal is, according to these critics, praising with faint praise indeed.

To take another example, assume that a provision in an 'equal' partnership agreement leaves a deceased partner's share of $100,000 to be divided between the two surviving partners but does not stipulate how this is to be done. To most people it would seem fair, all things being equal, that each gets $50,000. But if $999,999 was give to just one partner and $1 to the other, this would be Pareto optimal because neither of them is left worse off than before, despite the fact that to most people it would seem unfair.

---

32 Richard A Posner, *Sex and Reason* (1992).
33 Martha Fineman, 'The Hermeneutics of Reason: a Commentary on Sex and Reason' (1993) 25 *Connecticut Law Review* 503.
34 Elizabeth Landes and Richard Posner, 'The Economics of the Baby Shortage' (1978) 7 *Journal of Legal Studies* 323.
35 Amartya Sen, quoted in George R Feiwel (ed) *Issues in Contemporary Microeconomics and Welfare* (1985) 3.

Kaldor Hicks analysis also presents us with problems in terms of being able to identify quantifiable and predictable benefits and detriments stemming from decisions.

Suppose there are two individuals, A has $1000 and B has $10,000. Assume some government decision means that A finishes winds up with $2,000 and B with $9,900. There is no Pareto improvement since B is now worse off. But it may be valid under the Kaldor-Hicks test since A could compensate B anywhere between 1 and 1000 dollars to accept this alternative situation. But here it is the mere possibility for compensation that counts. Kaldor-Hicks merely requires that the possibility for compensation exists, and thus does not necessarily make each party better off (or neutral). Kaldor-Hicks test ask what would happen if the winners were to compensate the losers. The typical cost-benefit analysis suffers from some of the criticisms to which the utilitarian test of the 'greatest happiness' is subject.

But some of these criticisms maybe somewhat misplaced: looking at the law from the angle of efficiency is merely one approach. Efficiency is these days usually not the sole criterion to evaluate law and advocate reform.[36] However, looking at the law through the lens of efficiency has its merits. As it was conceded by one critic of the law and economics:

> While one may find the underlying values of law and economics distasteful, disagree with its underlying assumptions or empirical assertions, retain skepticism as to the use of efficiency as a judicial decisional rule, and reject its political orientation, it is difficult to ignore the realism of an approach which reminds us that in a world of scarcity, tradeoffs are inevitable and that 'given scarcity, judicial

[36] Gary Minda, *Postmodern Legal Movements* (1995).

> decisions …create, transfer, or destroy valuable things and effect people's decisions.[37]

*What do we mean by fairness?*

Quite often it is advocated that either fairness concerns or economic considerations, but not both, should be the basis for loss allocation. But what do we mean by fairness? There is a common thread that runs through the monotheistic religions in terms of not harming others: 'Do unto others as you would have them do unto you' (Christianity); 'Love thy neighbour as thyself'[38] (Judaism); 'None of you truly believes until he loves for his brother what he loves for himself.' (Muslim).[39] The moral imperative from some religions therefore is self restraint and not harming others, reciprocal regard for others. Once when asked by a cynic to recite the whole of the Torah while standing on one foot, Hillel, the Jewish sage, said 'What is hateful to you do not to your neighbor; that is the whole of the Torah, while the rest is the commentary thereof.' [40] The idea of the 'Golden Rule' is not, of course, confined to monotheistic religions; for example, Buddhism provides 'Hurt not others in ways that you yourself would find hurtful.'[41] Hinduism provides 'One should not behave towards others in a way which is disagreeable to oneself. This is the essence of morality. All other activities are due to selfish desire.'[42]The idea of social equity or fairness is thus fairly wide spread throughout different cultures.

---

[37] Gary Minda 'The Law and Economics and Critical Legal Studies Movement in American Law' in
N Mercuro (ed) *Law and Economics* (1980) 104.
[38] *Leviticus* 19:18.
[39] Muhammad (c CE 571-632), Hadith 13 of *An-Nawawi's Forty Hadiths*.
[40] The Torah is the first five books of what Christians call the Old Testament; here though, in this context, it is probably referring to whole of Jewish law.
[41] Udana-Varga 5:18.
[42] Mahabharata, *Anusasana Parva* 18:113:8.

But what if the person is, say, a masochist? He or she would then want others to be subjected to pain. However, it is obvious that the rule is intended not to cater to abnormal or eccentric persons but to apply to a reasonable person or average person.

*Is there a test for fairness?*

It is unclear what methodology one uses to determine whether a law is fair or equitable. The difficulty has been summarized as follows:

> Unlike economic efficiency, there are no systematic rules, no generalized methodology for social equity. It is a question of balance or judgment that rests upon our sense of what is fair in a given situation. One approach is to place oneself in the position of a particular person, and ask whether one would reasonably experience a sense of unfairness or resentment. A second is to imagine addressing a person who felt disadvantaged, and see if one can formulate a satisfactory way of explaining to the person why the situation must continue. These two approaches rest upon a conceptual framework of empathy and rationality and rationality (or dialogue) as a means of dealing with other people. [43]

Empathy as a way of understanding plays a key role in hermeneutic theory.[44] The gist of the so called Golden Rule is to determine how you would wish to be treated if you were in the situation of the person affected.

*Can efficiency be also fair?*

Some maintain that efficiency and fairness do not merely coincide but are principles that are inextricably wedded, one inevitably leading to the other.

---

[43] Coleman, above n 9, 570.
[44] See, eg, Hans-Georg Gadamer, *Truth and Method* (1975) 118.

Professor Phillips argues, for example, that there is a commercial culpability scale that underlies the American Commercial Code, descending at the top from the 'intention principle' (those that willfully cause the event or situation that causes the loss first bear the loss) , then to the 'knowledge principle' (those that knew of the relevant circumstances are next allocated the loss), then next to the 'negligence principle' (those who reasonably could have discovered the loss causing the event or situation before acting) and, finally, to the 'strict liability principle'( loss is allocated here to the party who could have avoided the loss at the least cost). Thus Phillips argues that being careful in business is a moral issue and that morality will produce efficiency. Cooter and Rubin do not find this convincing, pointing out that precaution is but one element in efficiency. Loss spreading, one of their principles for loss allocation, largely depends on the size and ability of the firm to pass on costs; yet, it could not be argued, so Cooter and Rubin maintain, that allocating loss on this basis alone would be fair, even though it might be efficient.[45] Many people would disagree with this, especially if the loss can be passed onto others or via the tax system as a tax deduction.

One of the problems with looking at allocation of loss is the constant intrusion of the idea of fault which, of course, relates to fairness. Indeed, Professor Rubin concedes that:

> The concept of fault is deeply embedded in our collective sensibility… In fact it is the instictiveness of these feelings and the persuasiveness of this explanation that makes an economically efficient loss allocation scheme difficult for may people to accept.[46]

[45] Tyree, above n 1, 92.
[46] Above n 10, 576.

*Are Cooter and Rubin's three principles inherently fair?*

Interestingly, Cooter and Rubin argue that by applying their three fold test for allocation of loss they come up with recommendations that are not all that different to legislative proposals advocated by consumer advocates. They suggest that this abates the common criticism that the economic perspective ignores social equity.[47]

Looking at Cooter and Rubin's three principles of efficiency it can be seen that to a certain extent there is an inherent morality in the sense of social equity or fairness in each of them. The loss spreading principle, for instance, is nothing other than the idea that it is wrong to let the loss totally fall on an individual when it can be easily shouldered by all of us. If one were to say, for example, that the loss resulting from a fraudulent alteration should be borne solely by banks this does not on the face of it seem very fair. But the point is that the bank passes this cost onto all the users of the system. The moral principle of spreading the risk underlies insurance law including health care schemes – we all pay a little so that the cost does not all fall on the individual.

The second principle, loss avoidance, is clearly an explicit moral one. Intent and fault permeate most laws, indeed this is what usually renders an issue justiciable. In the absence of these there is usually an approximation to it: which person could have prevented the harm? Who was closest to fault? We often see this idea at work when the law has to choose between two innocent victims of fraud. If, for example, a seller is tricked into parting with goods by a fraudster in exchange for a worthless cheque and the rogue then sells them to an innocent third party, the law favors the latter on the basis that the vendor took the risk by exchanging the goods for a 'rubber' cheque.[48] In a similar way, if a buyer has possession of goods although not the legal title to them, for

[47] Above n 2, 63, 66.
[48] *Goods Act 1958* (Vic) s 29.

example, he has paid a deposit on them and been given possession by the vendor and then dishonestly sells them to an innocent third party, the law favours the latter.[49] The vendor took the risk, so he bears the loss. Of course, the person who can most easily avoid the loss is the rogue who merely has to change his behavior. In theory, the loss falls on the rogue but he or she is rarely found and is usually insolvent.

Even where efficiency is the ultimate goal of the legislation it is not always awarded primacy by the law. A statute like the *Trade Practices Act* 1974 (Cth) with provisions aimed at maintaining and preserving competition to ultimately promote efficiency has an authorization procedure whereby the detriment of an anticompetitive practice can be outweighed by public benefits and therefore be permitted.

In short even anticompetitive behavior (therefore inefficient) can sometimes be beneficial. Efficiency should not be the only test. In one authorization application, for example, an inherently anticompetitive agreement between competing refrigerant coolant producers to impose a levy to discourage the use of ozone depleting gas was granted on the basis that removing the harm to the environment was such a benefit to the public that it outweighed the anticompetitive detriment of the price fixing nature of the agreement.[50]

*Conclusions*

In these sections it has been shown that efficiency, although a useful tool for assessing allocation of loss (indeed the main one to be used) has some limitations and should be tempered by some fairness considerations. Nevertheless, it is submitted that broadly speaking the Cooter and Rubin rules are not devoid of moral content. As a general proposition most people, all other things being equal, would agree that a person who is at fault should bear

[49] *Goods Act 1958* (Vic) s 31.
[50] Refrigerant Reclaim Australia Ltd, A90854, Final Determination, 7th May 2003.

the loss. If fault is not easy to discover or prove or too costly then most people would not find it morally repugnant that the person who can pass on the cost of the fault should bear it.

### 2.6 Legal concepts that may have heuristic value in terms of efficiency and fairness in allocating loss.

Are there any legal concepts or theories in regard to payment instruments that may have heuristic or normative value in terms of efficiency and fairness?

It is fashionable to think that law developed without any explicit regard to efficiency. Parisi commented on the significance of the law and economics movement thus:

> One effect of the incorporation of economics into the study of law was to irreversibly transform traditional legal methodology. … Economics provided the analytical rigor necessary for the study of the vast body of legal rules present in a modern legal system. The intellectual revolution came at an appropriate time, when legal academia was actively searching for a tool that permitted critical appraisal of the law, rather than merely strengthening the dogmatic consistencies of the system.[51]

Undoubtedly economics has provided a useful prism for academics to examine legal rules over the last 50 or so years. However, it may be tentatively suggested that a number of concepts, namely, negotiability and autonomy in regard to payment instruments perhaps have efficiency aspects that are not

---

[51] Francesco Parisi, 'Positive, Normative and Functional Schools in Law and Economics' (Law and Economics Working Paper Series, George Mason University School of Law, 2004) 4.

explicitly articulated in case and statute law[52] in regard to allocation of loss. The theory of an assignment may also be relevant to third party payment systems and may inform the debate on efficiency. Likewise the concept of the one party contract may also explain the allocation of loss in regard to certain payment instruments like the credit card.

### 2.6.1 Negotiability

*Transferability*

Transferability is to be distinguished from negotiability. Transferability means the physical handing over of the instrument, for example, A gives B a bill of exchange made out to 'B's name or bearer'. As it is a bearer instrument it can be transferred to C by delivery.[53] If it was made out to the name of the 'payee or order', for example, 'Pay B or order', B could hand it over to C and endorse on the back of it, for example, Pay C, B.[54] This is transferability.[55] It is possible to have transferability without negotiability but not the other way around.

*Negotiability*

But what is meant by negotiability? To answer this one needs to turn to basic property principles.

---

[52] It should be recalled that statute law in regard to negotiable instruments is in the main a codification of case law.
[53] *Bills of Exchange Act 1909* (Cth) s 36(2).
[54] *Bills of Exchange Act 1909* (Cth) s 36(3).
[55] Historically this happened very early. The following in 1479 is similar to a modern promissory note.
Jorge Cely, Je vous promets payer a votre vouloir, ou au porteur de cests, six livres etc gros money de Flandres en moi rend cest sign de mon saign manuel ... Signature (see Michael Postan *Private Financial Instruments in Medieval England* (1930) 37.)
The fact that this promissory note refers to 'or bearer' (au porteur) underscores the point that the law merchant as administered by the merchants' courts gave recognition to negotiability at least two hundred years before the common law courts.

If a piano is stolen from A and the thief sells it to an innocent third party, then as between A and the innocent third party, A would prevail. The legal reasoning is that the thief had no ownership of the piano and therefore cannot pass a good title to the third party, even though the third party may be innocent. This is referred to as *nemo dat quod non habet* rule (no one can give a better title than he has).

The law therefore favors the owner at the expense of the innocent third party. This has lead to a number of exceptions being created in favor of the innocent third party.[56] This tension prompted Lord Denning in *Bishopgate v Motor Finance Corporation Ltd v Transport Brames Ltd* to comment:

> In the development of our law, two principles have striven for mastery. The first is for the protection of property: no one can give a better title than he himself possesses. The second is for the protection of commercial transactions: the person who takes in good faith and for value without notice should get a good title.[57]

Nevertheless, it is clear that the fundamental rule is that one cannot give a better title than he himself possesses. However, it is clear that some exceptions in favor of the third party are necessary to protect the market place.

*Why negotiable instruments are an exception to the nemo dat rule*

Negotiable instruments are an exception to this basic rule. The primary concern of the common law was to ensure certainty of payment If an instrument qualifies as a negotiable instrument the bona fide taker for

---

[56] For example, the seller in possession and the buyer in possession exceptions: *Goods Act 1958* (Vic) ss 31, 32.
[57] [1949] KB 332, 336-337.

value takes free from defects in title (such a person is called a holder in due course). On the other hand, if the instrument is not truly a negotiable instrument then the transferee, although innocent and giving value, takes subject to defects in title and equities since he or she is the mere transferee of contractual rights and is subject, as noted above, to all counter claims and equities arising from the underling transaction.

As Lord Mansfield said in *Peacock v Rhodes*

> The holder of a bill of exchange, or promissory note, is not to be considered in the light of an assignee of the payee. An assignee must take the thing assigned, subject to all the equity to which the original party was subject. If this rule applied to bills and promissory notes, it would stop their currency. The law is settled, that a holder, coming fairly by a bill or not, has nothing to do with the transaction between the original parties; unless, perhaps, in the single case, (which is a hard one, but has been determined,) of a note for money won at play.[58]

The importance of negotiable instruments as being an exception to the *nemo dat* rule is easy to understand if currency notes are considered for a moment. If the *nemo dat* rule applied here it would mean that every time a person accepted a currency note in payment there would be a risk that a previous holder might have stolen it.

Lord Mansfield[59] has put it like this in *Miller v Race*:

---

[58] 1781. 2 Doug. 633.

[59] The role of Lord Mansfield in successfully grafting the law merchant onto the common law cannot be underestimated. Yet it should be recognized that the common law did not easily accommodate the law merchant and there was a deal of hostility to this essentially 'foreign' law; for instance. Buller J in *Smart v Wolff* observed that Sir Edward Coke 'seems to have entertained not only jealousy of, but an enmity' against the Court of Admiralty's jurisdiction in commercial matters: (1789) 3 TR 323,348. When the merchants' courts, the Fair Courts, the

> It has been quaintly said, “that the reason why money cannot be followed is because it has no ear mark:” but this is not true. The true reason is upon account of the currency of it: it can not be recovered after it has passed in currency. So, in case of money stolen, the true owner cannot recover it, after it has been paid away fairly and honestly upon a valuable and bona fide consideration: but before money has passed in currency, an action may be brought for the money itself.....A bank-note is constantly and universally, both at home and abroad, treated as money, as cash; and paid and received, as cash; and it is necessary, for the purposes of commerce, that their currency should be established and secured. .... No dispute ought to be made with the bearer of a cash-note; in regard to commerce, and for the sake of the credit of these notes; though it may be both reasonable and customary, to stay the payment, till inquiry can be made, whether the bearer of the note came by it fairly or not.[60]

Certainty of payment is paramount to the proper functioning of any stable economic system. (It should not be overlooked that English currency notes were and still are promissory notes.)[61] Thus the holder in due course – the innocent third party who took the instrument for value and without notice of

---

Staple Courts and later on, the Admiralty, applied the law merchant to negotiable instruments, it provided a theory upon which liability was based, even if the theory was based on custom. This explains the quite extraordinarily advanced decisions relating to negotiable instruments. As early as 1437 a court exercising staple jurisdiction in *Burton v Davey* recognized a bill payable to a specified payee or bearer: it thus recognized that the instrument was transferable and that whoever had possession of it could bring an action on it: 3 *Select Cases on the Law Merchant*, 23 Seldon Society (Hall ed, 1932) 117. By implication, the case also suggests that the bearer may obtain a better title than the person who transferred it had.

[60] (1785) 1 Burr 452, 457-460.

[61] Statute also began to play an important role in the development of negotiable instruments. The act of 1694 that set up the Bank of England provided that notes issued by it were to have all the classic characteristics of negotiable instruments: they were to be transferable by endorsement; the bona fide transferee was to take free from defects in title and disputes between prior parties; and the possessor had a right to bring an action in his own name. In fact the Bank of England issued the notes payable to bearer, as was customary, and merchants treated them as negotiable by delivery.

any defects in title – was accorded supremacy. Commerce could not have been sustained without a reliable form of currency.

The age old concepts of negotiation and holder in due course were developed over centuries. The idea of transferability developed first but the idea of the cutting off of defences of prior parties and the ability to obtain a better title than the person who transferred the instrument – the most important aspect of negotiability - developed much later.[62] It took a decision by Lord Mansfield in 1758, *Miller v Race*, [63] for the common law to definitively recognize that a bona fide transferee from a rogue could obtain a good title to such an instrument, although there were earlier cases that held that a bona fide transferee could acquire a good title from a mere finder.[64] It has been said with little fear of contradiction that 'When Lord Mansfield resigned from the Office of Chief Justice in 1788, the fundamental principles of the law relating to negotiable instruments were firmly established'.[65] Subsequent decisions until the passing of the great codification act, the *Bills of Exchange Act* 1882 were, in the main, clarifications and illustrations of the principles already established.

*Codification of the negotiability concept*

The Australian *Bills of Exchange Act* 1909 (Cth) is based on the English *Bills of Exchange Act* of 1882. The English *Bills of Exchange Act* 1882 is a codification of the two and half thousand English common law cases. The Australian *Cheques Act* 1986 (Cth) is in turn derived from the Australian *Bills of Exchange Act* 1909 (Cth) since there was some confusion as to whether

[62] See text around n 53.
[63] 1 Burr 452, 2 Keny 189 (KB 1758).
[64] *Anon* (1699) 1 Salk 126; 3 Salk 71; 1 Ld Raym 738.
[65] James Holden, *History of Negotiable Instruments in English Law* (1955) 145.

some of the provisions applied to cheques.[66] Thus the concept of negotiability so essential to the viability of an effective currency entered the backdoor and became central to the law on cheques.

The concept of negotiability is both a keystone to the Australian *Bills of Exchange Act* 1909 (Cth) and the *Cheques Act* 1986 (Cth). Indeed, under the *Cheques Act* it is not even possible to restrict the transferability of a cheque, an essential requirement of negotiability.[67] But is this concept that plays such a significant role in the allocation of liability for loss appropriate for a 'modern' payment instrument like the cheque? This will be explored in subsequent chapters.

*Conclusion*

The primary concern of negotiability was to assure the remote party who took a negotiable instrument would obtain a good title – it was designed to promote confidence in money and thus facilitate commerce at a time when the state did not issue currency notes and promissory notes and bills of exchange performed this task. However, the concept was retained and still plays an important role in regard to allocation of risk and loss. There is therefore something of a tension between the two which will also be explored in later chapters. Negotiability also relates to rights to stop payment; for example, it is not possible to maintain a stop payment on a cheque which is in the hands of a distant party who qualifies as a holder in due course.[68] Again this aspect will be explored in subsequent chapters.

[66] For example, did the provisions about giving a notice to parties before bringing a legal action on a bill apply also to cheques?
[67] *Cheques Act 1986* (Cth) s 39(2).
[68] *Cheques Act 1986* (Cth) s 49(2).

The above legal concepts or theories in regard to payment instruments have heuristic or normative value in terms of efficiency and fairness. They explain why the law took a particular choice and favored one party over another.

### 2.6.2 The Autonomy doctrine.

Again this may shed some light on the efficiency of allocation of loss rules. Autonomy of letters of credit posits that disputes about the underlying contract should be set aside and that enforcement of payment be the primary concern, leaving the parties to fight it out on the contract in another legal action

Although letters of credit are outside the terms of the current hypothesis since they cannot be regarded as consumer payment instruments, it is a template that prompts pertinent considerations in terms of allocation of fraud loss and especially consumer rights to stop or reverse payment.

The letter of credit has been described in by Denning L J in *Pavia & Co SPA v Thurmann – Nielsen* in the following terms:

> The buyer requests his banker to open a credit in favour of the seller and in pursuance of that request the banker or his foreign agent issues a confirmed credit in favour of the seller. This credit is a promise by the banker to pay money to the seller in return for the shipping documents. Then the seller, when he presents the documents, gets paid the contract price.[69]

Typical of the court's attitude on the autonomous nature of the letter of credit are the words of Jenkins LJ in *Hamzeh Malas & Sons v British Imex Industries Ltd*:

[69] [1952] 2 QB 84, 88.

> ..... it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the good are up to contract or not.[70]

*Letters of credit not to be used to enforce sales contract*

In cases where there is a dispute about the underlying contract the parties must depend upon their rights under the contract. Attempts to freeze or stop payment under the letter of credit cannot be used as a surrogate way of enforcing the sales contract. The Uniform Customs and Practices for Documentary Credits (UCP 600) echoes the court's insistence on the independent nature of letters of credit where it provides in Article 4.

> a) A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honor, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defences by the applicant resulting from his relationships with the issuing bank or the beneficiary.
>
> A beneficiary can in no case avail himself of the contractual relationships existing between the bank or between the applicant and the issuing bank.

Similarly, Megarry J refusing an injunction to stop banks paying pursuant to an irrevocable letter of credit in *Discount Records Ltd v Barclay's Bank Ltd*, made the following comment at:

[70] [1957] 2 Lloyd's Rep 549, 550.

> I would be slow to interfere with banker's irrevocable credits, and not lest in the sphere of international banking, unless a sufficiently grave cause is shown; for interventions by the court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits.[71]

*Bills of exchange derived from the letter of credit generate separate contracts*

It should also be appreciated that bills of exchange drawn by the seller under the letter of credit against the bank and accepted have also a separate existence from both the underlying sales contract and the letter of credit. Typically letters of credit in the Anglo Australian tradition call for the beneficiary to draw bills of exchange upon the bank in his favor for payment, usually the bills will be for 30, 60 or 90 days. These bills once accepted by the bank are independent of the letter of credit. If, for example, the buyer was successful in restraining the operation of the letter of credit because of fraud - one of the rare instances where the court will interfere with a letter of credit - then if the seller had negotiated accepted bills of exchange to innocent holders in due course they would still be able to enforce them against the bank.[72] The bills of

[71] [1975] 1 WLR 315, 448.

[72] The banker under the letter of credit by accepting, that is, writing his signature at the top has primary liability on the bill pursuant to s 59 of the *Bills of Exchange Act 1909* (Cth). This would mean the payee – the exporter – or any person to whom the bill may be transferred will firstly sue the acceptor if it is not paid. The exporter has signed the bill as drawer and pursuant to s 60 of the *Bills of Exchange Act 1909* (Cth) engages that it will be paid. This liability will arise after that of the acceptor. Hence it is said that the drawer has secondary liability. Here, of course, the payee is the exporter too; so there would be no point in the payee suing the drawer in any litigation. But the payee could indorse the bill to someone else in exchange for goods or money. The bill may not be due for payment until the expiration of a certain period of time from the date of acceptance. The exporter may well decide to discount the bill, that is, to sell it for less than the face value and obtain money now rather than wait for the time period to expire. The investor will obtain the full face value assuming the acceptor pays. If the acceptor does not pay then the investor may look to the drawer for payment since he has secondary liability. If the exporter discounts the bill to someone else he will have to sign the bill on the back as indorser and transfer it to the buyer. The indorser has tertiary liability and undertakes all the obligations set out in s 60(2) of the *Bills of Exchange Act 1909* (Cth). Thus the exporter would have tertiary as well as secondary liability. All these liabilities stem from the bill of exchange rather than from the letter of credit.

exchange are thus independent of the sales contract and even the letter of credit. In this context they are considered autonomous.

Generally speaking, once the letter of credit has been opened, then the buyer has no standing as regards the direct relationship generated by the letter of credit.

Rugg C J in *Moss v Old Colony Trust Co* expressed the idea thus:

> The letter of credit, when so accepted and acted upon by the person in whose favour it is issued, becomes a contract between them wholly independent of the relations between the writer of the letter of credit and its customer.[73]

It should not be thought that because an instrument or manner of payment is viewed as autonomous, that is therefore always going to be paid. Even payment with cash will be ineffective if the notes are counterfeit. Payment, for example, may not be made because of fraud or forgery.

But bearing in mind this caveat, the autonomy concept is primarily concerned with certainty of payment. If the overseas seller was not certain of payment he would not make up the order and commit himself or herself to production. It facilitates commerce. It is
therefore highly relevant to the issue of the efficient allocation of loss and rights to stop payment.

*Conclusion*

The autonomy concept epitomized by the letter of credit is meant to cut off arguments about the underlying contract in regard to the payment instrument

[73] (1923) 140 N E 803.

and relegate parties to their rights and obligations under the contract. Pay first then fight. Again the raison d'etre is certainty of payment, a crucial matter in international trade where parties cannot communicate so easily. The concept of autonomy may thus have relevance in regard to consumer payment instruments if certainty of payment is crucial and this may also relate to the issue of efficiency of loss allocation and the allied issue of the right to stop payment. In regard to the latter, should the consumer, for example, be able to stop or reverse payment if she or he perceives fraud? This leaves the money with the would be buyer while the dispute is legally settled – the opposite to what happens with a letter of credit. These matters will be covered in later chapters.

### 2.6.3 The assignment of a debt theory

Another theory that may inform the issue of allocation of loss and rights to stop payment in the light of efficiency principles is the principle of an assignment of a debt.

Where there is a three party payment mechanism such as a credit card, leaving aside negotiable instruments, there seem to be two theories that provide the payee with a right to the payment.[74] There may be a legally enforceable undertaking by the payer vis-à-vis the payee: a good example of this is a letter of credit. (Letters of credit have long been regarded as exceptions for the need for consideration to move from the promise to the promisor.) A legally enforceable undertaking should be distinguished from a mere mandate given by the buyer to the payer to pay the seller. A mere mandate in itself will be enforceable between the buyer and the payer but not by the seller, the prospective payee, against the payer since the seller is not a party to the contract and Anglo- Australian law does not have any third party beneficiary

[74] Benjamin Geva, 'The Concept of Payment Mechanism' (1986) 24 *Osgoode Hall Law Journal* 1, 15-19.

concept.[75] The other theory that gives the payee a legal basis for enforcement of payment from the payer is the assignment of a debt theory. Under this theory a debt between X (the debtor) and Y (the assignor) is assigned to Z (the assignee). Putting it in terms of a credit card transaction (without saying that this is necessarily a correct analysis), Y, the seller, assigns the debt owed to him by X the buyer to Z, the credit card issuer which then pays Y 97% of its value. Z then collects from X in due course a 100% of the debt plus interest if credit has been extended to X.

*Assignee takes subject to equities and defences*

According to assignment theory the assignee takes subject to equities and defences between the buyer and the seller. Obviously this theory favors the buyer as he can effectively stop the payment on the basis, for example, that the buyer has a counterclaim against the seller or that the goods are defective. On the other hand, the seller is interested in certainty of payment. The seller, the prospective, payee, does not want to be affected by such disputes since this would mean that the payment mechanism is not truly independent.

Obviously certainty of payment is highly relevant to the allocation of loss with payment instruments and the concept therefore has considerable heuristic value.

*Conclusion*

---

[75] England has enacted third party beneficiary legislation. The United Kingdom introduced the *Contracts Rights of Third Parties* which came into force on the 11th November 1999 and applies to contracts made after 11th May 2000. Some jurisdictions have legislation that repeals the third party common rule which stops a person from accessing a contract to which the person is not a party. Several states in Australia, namely, Queensland and Western Australia have seen fit to abrogate the third party rule: see D Khoury 'Third Party Protection' (2004) 78 *Law Institute Journal*, 50. These statutes differ broadly in their terms. New Zealand and Singapore have also abrogated the third party rule by legislation: *Contracts (Privity) Act 1982* (New Zealand) and *Contracts (Rights of Third Parties) Act* (Cap 53B Statutes of the Republic of Singapore).

The assignment of debt theory facilitates underlying defences being set up against remote parties and therefore may play a role in regard to allocating loss and, especially, in regard to rights to stop payment.

### 2.6.4 The unilateral contract theory

Again this theory may be instructive in terms of understanding allocation rules in regard to modern payment instruments in the light of efficiency and fairness. Every legal student is familiar with *Carlill v Carbolic Smoke Ball* case[76] and the gist of the notion in regard to payment instruments has been summarized thus:

> In a unilateral contract, only one party undertakes a legal obligation, which becomes binding and enforceable in accordance with its terms when some person to whom it is addressed performs the conditions of the promise.[77]

The idea of a unilateral contract has a long history in regard to payment instruments. At first the unilateral promise in a promissory note was not recognized by the common law.[78] But the law merchant had no problems with lack of privity and the law merchant was eventually adopted by the common law. Thus the promise in a promissory note is enforceable by a remote party who brings himself or herself within the terms. This is, of course, nowadays in a statutory form[79] but cases going back several centuries recognized this concept.[80] Again this concept may inform the debate on allocation of loss and rights to stop or reverse payment.

---

[76] [1893] 1 QB 256.
[77] Crawford and Falconbridge, *Banking and Bills of Exchange : a Treatise on the Law of Banks, Banking, Bills of Exchange and the Payment System in Canada* (8th ed, 1986) ¶ 11:01.2
[78] *Buller v Cripps* (1703) 6 Mod 29, 87 ER 793 (QB).
[79] *Bills of Exchange Act 1909* (Cth) s 94.
[80] *Philpot v Briant* (1828) 4 Bing 717,720.

*Conclusion*

Overall in section 2.6 as a whole it has been shown that a number of legal concepts, particularly those associated with payment instruments - negotiability, autonomy, and assignment- may play a key role and even be determinative in allocating liability for loss as well as being relevant to the issue of stopping payment. To what extent these concepts are relevant to the efficient and fair allocation of loss thesis will be explored in more detail in subsequent chapters.

## 2.7 Methodology

This section will consider the different methods or approaches that will be used to test the hypothesis that the allocation of fraud loss and the right to stop payment with consumer payment instruments may not be efficient.

In testing the main thesis, namely, whether the allocation of fraud loss is efficient and whether any accompanying rights to stop payment are also efficient, the following approaches will be used.

1. The application of the Cooter and Rubin test to the rules of allocation of loss or non payment once these have been determined. The following will also be used.
2. The historical method.
3. The analytical-systematic method or approach.
4. The functional method or approach.
5. The comparative method approach.

Subsequent chapters will use a combination of these approaches. However, sometimes one approach may be favored over others. Below will be sketched what each method entails and its positive and negative aspects.

*The historical approach*

Perhaps no other area of law is more amenable to an historical approach than the area of payment instruments and systems since these have often been the result of commercial growth and adoption over time rather than resulting from legislation or planning. Moreover, negotiable instruments often represent exceptions to general legal rules that can be understood in a historical context. German legal historians, in particular, have been pioneers in this approach. Holdsworth in *A History of English Law* acknowledges, for example, Brunner's massive contribution in this domain.[81] The 19th century German scholarship is also admirably summarized by Dabin.[82]

The historical approach may throw light on why in certain countries cheques play an important role, for example, Britain, Australia, and the United States, whilst in other countries like Germany, they have a limited role. In turn this might throw light on the allocation of liability rules and why, for example, they might differ from, say, the liability allocation rules for credit cards.

However, the historical approach in itself will not suffice to examine the problem at hand and needs to be part of a wider approach.

*The analytical-systematic method or approach*

This approach is perhaps the most used to explain and examine payment instruments. Typically, in common law countries payment instruments are

---

[81] William Searle Holdsworth, *A History of English Law*, vol 8, (2nd ed, 1937) 132,136.
[82] Leon Dabin, *Fondements du Droit Cambiaire Allemand* (1959).

examined in the light of contract law and property law; for instance, negotiable instruments have some of the same characteristics of chattels- they can be owned, physically held and transferred to others. Yet, nevertheless, they still have unique characteristics that make them different to other chattels (a stolen negotiable instrument, for example, can still confer a good legal title on an innocent remote third party giving value)[83]; so property concepts might on occasions be of limited help in the quest for a better understanding. Contractual considerations might also assist to a certain extent; for example, the person wishing to enforce the 'promise' contained in a negotiable instrument must show consideration. However, the rules in regard to consideration have peculiarities that are exceptions to general contractual rules.[84] Again contractual concepts may be deceptive or limited in terms of clarification of rules relating to payment instruments.

The analytical-systematic method or approach therefore is extremely important but inadequate by itself to explore the problem of allocation of loss.

*The functional method or approach*

---

[83] The holder in due course is recognized, for example, by the *Cheques Act 1986* (Cth) as being at the pinnacle of the ascending order of holders, namely, holder, holder for value and holder in due course: s 50(1). As such the holder in due course is accorded the extraordinary privilege of being able to receive a better title to a cheque than the person who gave it to him, and to take free from disputes between the immediate parties to the cheque: s 49(3). The holder in due course also holds the cheque free from defects in title as well from mere personal defences available to the drawer and prior indorsers against one another: s 49 (2)(a).

[84] In addition, the *Cheques Act 1986* (Cth) presumes certain holders to be holders for value. Section 37 provides:

> Where value has at any time been given for a cheque, the holder shall, as regards the drawer and indorsers who became indorsers before that time, be conclusively presumed to have taken the cheque for value.

This section can be best explained by an example. A gives B, his hairdresser, a cheque for $80; B then gives it to his gardener for some work to be done; after he has finished the work the gardener gives it to his brother C, as a gift. The cheque is an order cheque duly indorsed by the parties except of course, A, the drawer, and C, the brother, the final indorsee. What is C's position if the cheque is dishonoured? C cannot sue the gardener because he gave no value for the cheque. He can, however, sue A, the drawer or B, the indorser, since both received value for it and became such before the time when value was given for the cheque by the gardener.

As the name implies the emphasis here is not on form but function. In regard to payment instruments it can be argued that the peculiarities of these may be explained by the fact that they are meant to take the place of money and that therefore the characteristics of transferability, negotiability and the rules for working out priorities between ownership must also reflect this. The advantage of this approach is that it may allow the scholar to pierce the veil of form to discover the true essence of the payment instrument. It also facilitates study of apparently different concepts from different legal systems since the focus is on the purpose or function. This approach is therefore often combined with the next approach.

*The comparative approach*

Initially it is useful perhaps to delineate what is commonly agreed by the traditional school not to be comparative law. First, it is not just the mere study of foreign law or a branch of it. Secondly, it is more than just making comparisons. Thirdly, it is not merely the classification of different systems of law. According to the traditional school comparative law involves further steps.

Alan Watson, an important figure in the traditional school, suggests it ‘is the study of the relationship of one legal system and it its rules with another.’[85] Comparison plays a key role but the comparative lawyer goes beyond comparison to explain and evaluate solutions offered by different legal systems. It is the appraisal of influences that occur between one system of law and another and, because this usually takes place over a period of time, it necessarily involves some legal history.

[85] Alan Watson, *Legal Transplants : an Approach to Comparative Law* (revised ed, 1993) 6.

*What can be achieved through comparison?*

First, comparison may provide insights into the reasons for similarities and differences; for instance, the common law favours the Roman law rule of *nemo dat quod non habet* principle[86] ( you cannot give a better title than you have), subject to certain exceptions, one of the most important exceptions being negotiable instruments.[87] On the other hand, in Europe the opposite principle is usually favored, summed up in the maxim *en fait de meubles possession vaut titre* (in the case of movables possession equates with title).[88] In short under most civil law in a choice between the original owner and a person who acquired goods in good faith and for value, the latter prevails. Hence to a civil lawyer the fact that under the common law a remote party who takes a negotiable instrument in good faith and for value prevails over the original owner does not seem surprising since it accords with the civil law general principle whereas to a common lawyer it is an astonishing exception to the common law rule.

Secondly, comparative law may offer problem-solving qualities. Different systems of law may have different underlying theories in regard to payment instruments. Thus to solve a problem that presents itself in one system of law it may be instructive to examine the theory underlying that rule and then compare it with the theory underlying the operative rule in another system.

---

[86] A more accurate Latin maxim is *nemo plus iuris ad alium transferre potest quam ipse haberet*.

[87] The *nemo dat* principle is the same under Roman law as noted by William Buckland and Arnold McNair in *Roman Law and Common Law* (2nd ed, 1965) where the authors say at 77 'In a very important respect Roman and English law unite in differing from most modern civil law systems. Both adhere to the maxim *nemo dat quod non habet*'.

[88] Article 2279 of the French Civil Code provides that possession á titre de propriétaire must be uninterrupted, peaceful and obvious (nec vi, nec clam, nec precario). It is therefore clear that not all possession will give rise to a good title. Moreover, since a certain amount of time must pass before ownership can arise it is obvious that the article cannot give rise to ownership if the possession is transient. Moreover, the exceptions under article 2280 are numerous: if, for example, the owner loses the moveable, or it is stolen from him, he has a period of three years during which he could recover it from anyone he finds in possession unless the possessor acquired the property 'at a fair or market or at a public sale, or from a merchant selling similar articles'. In such a scenario the original owner could not demand possession except on condition of paying the person in possession the price he had paid for it.

Thirdly, comparative law may be of some assistance in understanding current law or formulating new laws or ameliorations by way of comparing different ways of thinking that prevail in different systems of law. It is said, for example, that the common law is characterized by an empirical and pragmatic way of thinking to find solutions to an immediate problem rather than working from a general theory.[89] Civil law lawyers, on the other hand, are more likely, it is said, to formulate a theory or concept by a priori speculation and then to deduce consequences.[90]

Fourthly, comparative law may shed light on the nature of payment instruments and payment systems.

Fifthly, although comparative law may show differences, functional equivalence may nevertheless be discernable; indeed, comparison may suggest this functional equivalence. Are, for example, the payment instruments under consideration meant to mimic cash? If the answer to this is positive, the maybe the difference between legal systems can be explained away; or, if there are similarities, maybe the functional equivalence explains this.

Sixthly, comparative law may assist in understanding the transplants and grafts of laws from other legal systems onto our system.

In section 7 the various approaches that can be used to test the main task of determining whether the allocation of fraud loss and the right to stop or reverse payment with consumer payment instruments is efficient have been outlined.

---

[89] Lord MacMillan *Law and Other Things* (1937) 76.

[90] Roger Voegeli, *La Provision de la Lettre de Change and son Attribution au Porteur* (1947) 261. The German legal scientist (quoted by John Henry Merryman in *The Civil Law Tradition* (1969) 71) Rudolph Sohm wrote that:

> A rule of law may be worked out either by developing the consequences that it involves or by developing the wider principles that it presupposes… the more important of these two methods is the second ie the method by which, from given rules of law, we ascertain the major premises they presuppose. The law is thus enriched, and enriched by a purely scientific method.

A mixture of methods will be thus used to test the main thesis and solutions if it transpires that some or all of the rules are not efficient and fair. Some methods will be used more often than others; for example, the analytical-systematic method will undoubtedly be pressed into service in determining what the current rules are; other methods like the comparative one may be useful in suggesting solutions.

Each chapter will examine the current law: its defects, inconsistencies and difficulties; and then the Cooter and Rubin principles will be applied to determine whether the current rules are efficient. Ameliorations will then be suggested.

**Conclusions**

This thesis is concerned with the efficiency allocation of fraud loss and any allied rights to stop payment. The primary basis for determining this will:

- Be economic concepts of efficiency, in particular, Cooter and Rubin's tests for efficient allocation of liability outlined in the section 3. Here rules versus standards in section 4 may also assist.
- Whether or not the rules are fair will not be a major preoccupation given that Cooter and Rubin's have their own inherent fairness but will be touched upon.
- Various legal concepts such as negotiability and autonomy explored in section 6 will also be utilized to further this task.
- Throughout, the methods set out in section 7 will be employed.

## Chapter 3

## ELECTRONIC FUNDS TRANSFERS AND FRAUD LOSS ALLOCATION[*]

### 3.1 Overview

In 1983 the Martin Review group on the Australian Financial System recommended the establishment of an Australian Payments System Council (APSC). A part of its brief was to consider standards for Electronic funds transfers (EFT). The responsibility was subsequently given to ASIC. Around the same time Treasury also headed up an interdepartmental group to look at the matter from a legal point of view. Basically, there were three options: legislation, a code or letting the market decide. Since 'free markets' were the order of the day and supposed to produce the best results, this was the chosen option. As Professor Tyree points out this option was rather ironical since 'free markets' had themselves engendered the EFT concerns.[1] Having been deliberately excluded from the federal process, the states' Standing Committee of Consumer Affairs Ministers (SCOCAM) recommended government intervention and a produced a draft code. This resulted in their inclusion in the process at a federal level and ultimately resulted in a code - the same as the states' one - that was ultimately approved by the Federal Government of the day.

This thesis asks whether the allocation of loss from fraud is efficient in regard to consumer payment instruments and methods. As Cooter and Rubin point out ' because loss allocation in the payment system is a technical and largely

---

[*] Pages 2-3, 5-7, 13-18, 21-25, 32-36 have appeared as an article by R Edwards, 'Fraud Loss Under the Australian Electronic Funds Transfer Code' (2009) *Journal of International Banking Law and Regulation* 24, (7) 361-8; pp 27-31 have appeared as an article by R Edwards, 'The EFT Code Review: The Rules Versus Standards (principles) Debate' *Australian Banking and Finance Law Bulletin* (2009 )24 ( 8), 125-128.

[1] Alan Tyree, *Banking Law in Australia* (2005), 343.

monetary subject, economic analysis seems to be an appropriate and promising place to start.'[2] An analytic framework allows one to more objectively assess loss allocation rules which are usually the result of political compromises. To make a proper assessment one has to be aware of the problems and how the law has dealt with these issues in the past.

### 3.2 Outline of this chapter

This chapter will examine the efficiency of EFT allocation of fraud loss and will address the following questions.

- What are the main causes and problems with EFT fraud?
- How have the various versions of the EFT Code handled fraud loss?
- Have the tests for allocation of fraud loss been efficient?
- Are any foreign models for loss allocation more efficient?
- What conclusions can be drawn?

### 3.3 Fraud facilitation

#### 3.3.1 The Nature of the Personal Identification Number (PIN)

The fundamental problems when the customer's mandate was changed from a written signature to a PIN have been described as follows:

> 1. It effectively displaced years of case law on the liability of financial institutions for acting on unauthorised instructions. It permitted institutions to create new rules for allocating liability by contract.

[2] Robert Cooter and Edward Rubin, 'A Theory of Loss Allocation for Consumer Payments' (1987) 66 *Texas Law Review* 63, 66.

2. The choice of technology used often made it difficult, if not impossible, for parties, by ex post facto examination of the transaction, to gather evidence to evaluate whether an instruction was unauthorised or had been altered. There are two aspects to this point:

• It was often impossible to distinguish an unauthorized instruction from an authorised instruction (eg if a 4 digit PIN is the authentication mechanism, the PIN is identical whether keyed by an authorised or unauthorised user whereas a forged signature may be examined at the time of the transaction and afterwards to differentiate it from a genuine signature); and

• The transaction audit trail did not necessarily collect data that was helpful in distinguishing authorised from unauthorised use (eg a camera at an ATM).[3]

Although there is constant talk of biometric recognition mechanisms, such as finger print recognition and iris recognition, none of these have been adopted in Australia, it would seem, because of the costs involved. It therefore is highly likely that number recognition is going to be the access mode for many years to come.

The obvious problem or question  with fraudulent use of the PIN is: who should bear the burden of proving unauthorized use? With cheques it has always been incumbent on the paying bank to show that it has the authority to pay the cheque, even though usually it is the customer who alleges there has been a forgery.[4] The paying bank has a copy of the customer's signature, so in

[3] Discussion Paper on an Expanded EFT Code of Conduct Released by the Australian Securities & Investments Commission's EFT Working Group July 1999, 27.

[4] *Joachimson v Swiss Bank Corp* [1921] 3 KB 110, 127.

theory it can match the signature on the cheque with the specimen of the customer's signature. In short the unique biometric nature of the customer's signature facilitates authorisation.

On the other hand, a PIN carries no inherent biological identification feature. Banks, in the past at least, have argued that the customer is in the best position to know whether the PIN has been misused and that accordingly the burden should be on the customer to bear the burden of proving it was an unauthorized use. Consumers have argued that in fact banks have more relevant information, for example, the number of times the ATM has been accessed with the same card, bank records and videos of the use of the machine.

The determination of who should bear the burden has been a key issue in the different versions of the EFT Code. Any Code in terms of efficiency would at least make this clear. Previous Codes were deficient in this respect.

Needless to say, the consumer must initially show that there is something wrong. Usually, a consumer will notice that there is something wrong when the consumer receives the periodic statement. If fraud is to be discovered or, better still, nipped in the bud, such statements should be received frequently. This is something that lies in the province of the banks. An efficient EFT Code should also address this issue.

Receipts are also important. Retention of these is something that lies with consumers. ASIC recently pointed out that:

> Receipts are also important for electronic banking because they help consumers to reconcile their statements and identify unauthorized transactions.[5]

The content and format of receipts is something that lies with merchants and banks and an efficient EFT Code would provide rules for these.

### 8.3.2 Delivery of PINS and cards

A fraudster looks at a payment system like a mediaeval knight contemplating a siege of a fortress: where are the entry points and weaknesses? The fraudster does not have to look very far. Clearly the card and the PIN are the keys to the castle. A fraudster therefore frequently looks to these first.

Astonishingly enough, neither the original nor the second version of the EFT Code actually require financial institutions to obtain a written receipt by the potential user of the card or the PIN: astonishing since the original draft of the first code did provide for this. It is not uncommon to send them out under separate cover by post. In the case of a replacement card, all a fraudster has to do is to find out the expiry date of a card and the address of the cardholder from, say, a friendly check-out assistant at a supermarket and wait for the postman at the cardholder's address (not too difficult to obtain if the cardholder has groceries sent home). This gives him the card. And any check-out assistant could see the PIN without much difficulty.

Sometimes, it is only the card that is sent by mail, the PIN being obtained at a bank branch. Such a practice is evidenced by a case that came before the Banking and Financial Services Ombudsman (now called the Financial

---

[5] Review of the Electronic Funds Transfer Code of Conduct 2007/08: ASIC proposals October 2008 (Consultation Paper 90), para 13.

Ombudsman Service).[6] Here the potential card user was sent a card by mail, she being already in receipt of the PIN which she had received at a branch. Monies were taken on several occasions from ATMs. The customer claimed she never received the card. The bank could not produce any receipt of the card, so it argued that use of it proved receipt. This argument was rejected by the Ombudsman. She maintained that she kept no record of the PIN, had committed it to memory and had not divulged it to any one. The Ombudsman found in favor of the consumer since the bank could not produce evidence of receipt.

Such a scenario is not uncommon. The writer, who worked for a large organization, received some years ago through its internal mail system an envelope made out to R .Edwards. It contained a PIN. The Edwards for whom it was intended had recently arrived in Australia from America and not yet having a fixed abode, had apparently given his work address. The aforesaid PIN was, of course, passed onto the intended recipient by the writer. But the system is thus potentially prone to error and fraud.

Although the current EFT Code does not require proof of receipt it is obviously in the best interests of financial institutions to do so since the account holder has no liability for losses that arise from transactions which required the use of any device or code  forming part of the user's access method and that occurred before the user has received any such device or code (including a reissued device or code).[7]

There is also a presumption in the current EFT Code that the account holder did not receive the device or code (eg PIN) and the burden is then on the bank to prove otherwise and one of the ways it can do this by way of a receipt. [8]

[6] The Australian Banking Industry Annual Report 1992-1993, 60-1

[7] Electronic Funds Transfer Code of Conduct  (1989) (revised 2001, amended 2002), 5.2 [c].

[8] Ibid.

Proof of delivery to the correct address will not suffice; nor can the Terms and Conditions of use set up an estoppel on this.[9]

It is difficult to understand why the current EFT Code does not explicitly require banks and other financial institutions to obtain written proof of delivery; admittedly, banks with extensive branch networks might have something of a competitive advantage over others but such a receipt is only a 'one off' event so even this is not much of an argument against a receipt requirement.

Banks, of course, have set up their own identification procedures, for example, passwords and the like known only to the customer. This undoubtedly reduced the risk of fraud but it is not mandated by law.

### 3.3.3 Physical configuration of ATMs

A not uncommon way of illegally obtaining the PIN is for the rogue to watch the user insert it into an ATM, sometimes referred to as "shouldering."[10] Here the physical configuration of ATMs is important, especially how the screen and entry pad are set up. If the screen is vertical and entry pad are vertical it makes it easier for people to see the entry of the PIN whereas a horizontal pad makes observation by others much more difficult. The Australian Securities and Investment Commission in its Report of Compliance with the Payment System Codes of Practice and the EFT Code of Conduct recommended compliance with Australian Standard AS 3769 that advocates shielding to protect the entry of the PIN into ATMs. Obviously, cost is a factor here but more recent ATMs have horizontal entry pads.

---

[9] Ibid.

[10] Text around footnote 17.

In terms of 'skimming' ATMs also offer great possibilities for rogues. There have been bank warnings and newspaper reports on how fraudsters attach a skimming device to make it appear as part of the machine – a hidden camera records the entry of the PIN and the card passes through a device that takes the information of the MAGNETIC (MAG) strip before the card goes into the genuine ATM reader, thus facilitating the perfect reproduction of a card together with knowledge of the PIN.[11] Of course, the card holder is oblivious of this and usually only realizes that something is amiss when contacted by the bank or when he or she receives a statement.

An EFT Code based on efficiency concepts would encourage the use of systems that are less prone to fraudulent misuse.

### 3.3.4 Internet fraud

The use of credit card numbers over the internet is so obviously open to abuse that it scarcely credible that this is still the major way to pay for goods and services over the internet. This major loophole encouraged, amongst other things, the adoption of chargeback rights in the Code of Banking Practice and warrants a separate chapter even though it comes within the terms of the current EFT Code.

Although internet fraud is not as extensive as credit card and cheque fraud, it nevertheless saps confidence in internet payment use.[12] Obviously banks are responsible for devising EFT payment systems and should therefore bear responsibility for any hardware and associated software but should they bear responsibility for 'phishing' and attacks from malicious software, or should consumers bear some responsibility?

[11] <http://www.police.qld.gov.au/News+and+Alerts/Media+Releases/2007/03/ATM+card+skimming+device+located.htm> at 17/6/08.

[12] Reviewing the EFT Code ASIC consultation paper, January 2007, 3.11-3.12.

Of the above concerns and problems that engender fraud the nature of the PIN is by far and away the major problem, although illegal access to internet banking passwords by way of wireless internet access without encryption, reported on the ABC Four Corners program (17/8/09), is becoming a major fraud problem. Once the rogue has access to the account, he or she sends the money to an overseas account, often via a 'donkey' – an unsuspecting Australian bank account holder who is paid a small commission. Enforcement procedures in the foreign country against the rogue, in the unlikely event of any conviction, are virtually impossible.

### 3.4 The first version of EFT Code (1989)

No law can be appreciated without looking at its history and the development of the EFT Code shows how the law has struggled with how to efficiently deal with the allocation of loss resulting from fraud. The first Code was drawn up without any theory of loss allocation like that of Cooter and Rubin's from which efficient rules can be generated. As Cooter and Rubin point out, an analytic framework greatly assists in the formulation of law.[13]

#### 3.4.1 Restricted Application

The first version of the EFT Code had a very restricted application.

The first Code only applied to " the combined use of an EFT card and a personal identification number (PIN)" (first EFT Code clause 1.1). It therefore did not cover remote electronic access to accounts.

[13] Cooter and Rubin, above n 2, 66.

The first  EFT Code did not cover credit cards used manually i.e. with a signature or the use of credit cards over the phone or Internet since no PIN was used and the use of the PIN was essential for the application of the first EFT Code.

### 3.4.2 Loss allocation in the first EFTCode.

Broadly speaking the first EFT Code endeavoured to share losses between the users and card issuers for unauthorised use of the card, that is, one carried out without the cardholder's knowledge or consent.  The user was to bear liability if he or she had been at fault in regard to the PIN security or if he or she had unreasonably delayed notification.  If the cardholder had not been careless or at fault then, part from the first $50, any other loss was born by the card issuer. This was far from an ideal situation – in particular it did not specify who had the burden of proof. The matter was often reduced to an undignified slanging match, the card issuer chanting that the system was infallible and that therefore the card holder must have been at fault; and the cardholder, meanwhile, swearing that he or she had not been at fault. Obviously, as discussed already, the problem lay with the nature of the PIN: it is a relatively crude and anonymous form of access. It is the exact opposite of a signature on a cheque which is easy to access but difficult to replicate whereas a PIN is difficult to access (perhaps not so difficult to access when one frequently witnesses mothers holding up young children to punch in the numbers and saying out aloud the PIN) but easy to replicate. The evidentiary problems with this have been described as follows:

> The difficulty with a fault-based loss allocation model, at least concerning fault in regard to PIN security, is the lack of direct evidence that either side can bring as to who performed the transaction and how they came to know the access method. This often leads to an evidential impasse, a temptation for account institutions to make judgments in their

> own interests when faced with an absence of direct evidence and resulting cynicism on both sides.[14]

The first EFT Code provided that the cardholder would bear liability:

> 5.6 Where the cardholder has contributed to losses resulting from unauthorised transactions by voluntarily disclosing the PIN, indicating the PIN on the card or keeping a record of the PIN (without making any reasonable attempt to disguise the PIN) with the card or liable to loss or theft simultaneously with the card; ..”.

But the first EFT Code did not elaborate on what was a reasonable attempt to disguise the PIN. Quite a few bank brochures of conditions of use did, however, give examples. The Commonwealth Bank conditions of use Electronic Banking[15] which the bank warranted had complied with the EFT Code, provided as follows on this point.

> "…we will **not** consider that you made a reasonable attempt to disguise your PIN if you only:
>
> -recorded the PIN number in reverse order; or
> -recorded the PIN as a ‘phone’ number where no other ‘phone’ numbers are recorded; or
> -recorded the PIN as a four digit number, prefixed by a telephone or area Code; or
> -recorded the PIN as a series of numbers with any of them marked, circled or in some way highlighted to indicate the PIN; or

[14] Discussion Paper EFT 1999, above n 3.

[15] In use late 2000.

> -recorded the PIN disguised as a date 9/6/63 where no other dates are recorded; or
> -recorded the PIN in an easily understood Code, eg. A=1, B=2, etc."

One of the contentious areas, given the lack of clarity as to burden of proof, was what happens when access was gained at a first attempt? Needless to say the banks argued that this was proof positive that there had been disclosure. Not every one agreed with this interpretation. The following are comments from the 93-94 Australian Banking Industry Ombudsman Report on the issue of unauthorised access at first attempt:

> ... for sometime, the Electronic Funds Transfer (EFT) Code has been shown to be inadequate in assisting Case Managers to resolve cases involving unauthorised ATM access gained at first attempt using the correct PIN while the consumer denies keeping a record of it.
>
> Give the inadequacies of the EFT Code provisions, entering the correct PIN at first attempt is not given an insignificant weight when assessing the merits of the case.
>
> A policy has been adopted to enhance the consistency of decision making in such cases. The Scheme regards unauthorised access achieved at first attempt using the correct PIN as a substantial, although not a conclusive indicator that the cardholder has contributed to the financial loss. This fact is considered along with other relevant information to assess the extent to which the consumer's actions have contributed to that loss. [16]

The practice of "shouldering" was also described in the 95-96 Australian Banking Industry Ombudsman Report, as follows

[16] Australian Banking Industry Ombudsman Report 1993-94, 6.

> 'Shouldering' is the term used to describe a cardholder being watched, usually over the shoulder, when they enter their PIN either at an ATM or EFTPOS terminal. A thief may well identify a cardholder's PIN by shouldering the cardholder at an ATM. The thief may then steal the bag, wallet or purse from the cardholder sometime later and use the card and the PIN obtained by 'shouldering' to obtain access to the cardholder's account using the card and correct PIN.
>
> When a cardholder says they did not reveal their PIN, and yet the account has been accessed using the card and correct PIN, one possible explanation may be that the cardholder was shouldered. This can be checked by looking at computer logs to see if they show that the card was used at an ATM or EFTPOS terminal just before the theft disputed transactions. :[17]

The views of the Banking Industry Ombudsman were a significant factor in the second revision of the EFT Code which will be discussed further on in this chapter.

### 3.4.3 Efficiency and Loss Allocation in the First Code

It will be recalled that the Cooter and Rubin 'tests' to assess efficiency of allocation of liability for loss are as follows:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?

[17] Australian Banking Industry Ombudsman Report 1995-96, 24.

- Which rule is the cheapest to apply?

First, in terms of loss spreading – perhaps the most important of the Cooter and Rubin tests - the merchants and banks were in the best position to do this but the banks constantly reiterated the litany that the system was virtually infallible as proof that there must have been a disclosure by the cardholder.

Second, overall it could be said that the rules for allocation of loss from fraud in the first version of the EFT Code were defective from an efficiency point of view since in terms of reducing loss behavior, the loss allocation rules gave a somewhat confusing message: if the card holder had unreasonably delayed or been at fault then the cardholder bore the loss (this at least is coherent) but even if the cardholder had not been at fault he or she still bore $50. It was not clear what purpose this $50 'fine' served.

Third, the rules were not clear in terms of who had the burden of proof – this offends the Cooter and Rubin 'rule' that simplicity is desirable since it reduces litigation costs.

Moreover, the first version of the allocation of liability made no reference to chargeback rules, although undoubtedly they existed as part of the credit card network system in the event of an unauthorized payment. Therefore, in the event that the cardholder was not held liable for the loss – something that the rules militated against finding- then, as between the bank and the merchant, it was often the merchant that inevitably bore the loss. But this was not at all evident from the loss allocation rules. There was thus a lack of transparency. It is clear that the first version of the EFT allocation rules for loss were not worked out explicitly in the light of any efficiency concepts and even the Banking Industry Ombudsman found them inadequate.

### 3.5 The Second EFT Code 2001, operational 2002

#### 3.5.1 Rapid changes on the ground

Within a relatively short space of time, five years or so, the impact of the widespread use of computers and the internet in the late 1990s led to more and more electronic payments. In the 1980s , for example, it was possible to book theatre tickets over the phone using one's credit card number but one had to sign a credit voucher to obtain the tickets. But soon the requirement of a signature was bypassed and the mere quoting of the credit card number sufficed. Consumers also began to use credit card numbers over the phone and internet to buy goods and services. The potential for fraud therefore expanded exponentially.

EFTPOS (Electronic Funds Transfer at the Point of Sale) was also one of the fastest developing forms of payment to retailers. The consumer's account at the issuing institution was accessed on line and debited. Consumers could also withdraw cash at the point of sale.

There was also much excitement about the development of the smart card. This card had embedded in it a micro-processor chip which was capable of storing a great deal of information. (Even most current cards like the ones used at EFTPOS and at ATMs still have a magnetic stripe on them and communication with a host computer is necessary to obtain authorisation.) Smart cards, on the other hand, could work at terminals without a link up and the account records and other information could be kept in the card. It was graphically described as an electronic purse. Sophisticated smart cards like Mondex could also be recharged with value at an ATM or even over a special phone. The benefits to the consumer were that the consumer did not have to carry around cash and this also reduced the cash requirements of the merchant.[18]

There was also much talk of internet banking payment. The gist of this usually was that a creditor accepted substitution of a third party's payment obligation for that of the debtor. A trusted financial institution was connected with the payment system so that users would be assured that payment messages would be honored. The First Branch of the Internet (FBOI) worked on this basis. Customers of FBOI (potential buyers over the Internet) purchased a pre-paid Visa ATM card and FBOI was allowed by the customer to have a duplicate and PIN and with this FBOI could debit the card in favor of itself. Sellers contracted with FBOI on the basis that `all transactions will result in collection from the customer and payment to the vendor'. The customer of FBOI confirmed payment to the seller by way of an e-mail and the seller's account balance at FBOI was increased. Payment could be sent to FBOI by the either the buyer or by the seller. All e-mail messages were encrypted. The 'money' could be collected in $US cheques or provided by way of pre-paid Visa ATM cards.

All of these developments on the ground meant that the first EFT Code was hopelessly out of date in terms of application and also, arguably, in terms of allocation of losses given that the possibilities of fraud had increased.

In retrospect, it is sobering to contemplate that many of these mooted possibilities like smart cards have not really had much market success in Australia so far. It is presumed that the cost involved is not matched by the returns.

[18] Alan Tyree, *Banking Law in Australia* (1998) para 8.91.

### 3.5.2 Application of the second EFT Code

If an EFT Code does not cover all, or most, consumer electronic applications it is hardly going to be efficient. The second EFT Code made some positive changes in terms of application. The first Code referred to only card issuers but the second EFT Code referred to account institutions. This new term undoubtedly included card issuers but also institutions that had accounts that customers could electronically transfer funds to or from. Thus, it could apply to large retailers and organizations like Telstra. Even so, providers of new forms of electronic payment like electronic gift cards and travel cards and PayPal are not covered by the second EFT Code. This makes for an uneven playing field for providers and one of the ways suggested to combat this problem is to make membership of the EFT Code compulsory.[19]

The second code expanded coverage to remote funds transfers intended to be initiated by an individual using electronic equipment and an access method. The first Code only applied to "the combined use of an EFT card and a personal identification number (PIN)" (first EFT Code clause 1.1). It therefore did not cover remote electronic access to accounts. The second EFT Code in clause 1.1 provided that:

> " EFT transactions are funds transfers initiated by giving an instruction, through electronic equipment and using an access method, to an account institution (directly or indirectly) to debit or credit an EFT account maintained by the account institution."

This had to be read in the light of the second EFT Code 1.2 which provided that a funds transfer was the transfer of value to or from an EFT account and that this could be done electronically.

[19]:ASIC proposals October 2008, above n 5, proposal B5.

> "A funds transfer is the transfer of value to or from an EFT account (regardless of whether the EFT account has a debit or credit balance before or after the transfer) including between two EFT accounts or between an EFT account and another type of account. Without limitation, the transfer of value may be effected by one or more of the following:
> * Adjusting one or more account balances;
> * Transferring currency or a physical payment instrument;
> *Transferring electronic representations of value (e.g. digital coins or payment instruments); or
> *Adjusting amounts of stored value whether recorded on a card or other media (e.g. loading and unloading stored value)."

Thus, the second EFT Code covered remote access to accounts, for example, telephone transfers, e-mail and internet transfers, transfers using TV etc. The second EFT Code therefore had been adapted to take into account new ways of transferring money. But it did not cover things like electronic bills of exchange, electronic letters of credit and electronic applications for loans and it did not cover transfers to and from accounts primarily used for business purposes (see clause 1.3). It also may not have covered funds transfers that involve "biller accounts".[20]

---

[20] These were accounts designed to provide credit and to facilitate payment to retailers. They did not allow payment to third parties. They were defined in clause 1.5 of the second Code as follows:

> "biller account" is an EFT account maintained by an account institution solely to record amounts owed or paid by its customer in respect of the provision of goods or services to its customer by the account institution.

A retailer, for example, might allow its customers credit. If there was a transfer of value eg BPay from a bank account to the biller account to pay the retailer, then Part A did not apply to the retailer's receipt from the bank (but the debit from the bank account may have been covered by Part A). The customer of the retailer may also have caused a debit of the biller account to the retailer's account to pay for goods. Such a transfer of funds was arguably not covered by Part A.

The second EFT Code went beyond the plastic card. There was an addition of a definition of “access method”. The first EFT Code only covered plastic cards used with a PIN. But the second EFT Code defined "access method" in a very broad way so that it covered, for example, magnetic strip cards, biometric identifiers (e.g. iris readers), cards with chips, digital signatures, passwords and the like. But it did not cover manual signature where this was the principal intended means of authenticating a user's authority to give the instructions, for example, a person signing a credit account voucher when using a credit card.

The second EFT Code had also something to say about chargebacks with credit cards. It is to be noted at this stage that it had no application to debit cards. It is quite common for banks to have a ‘charge-back’ clause in the agreement with the merchant. If the card user disputes liability or claims an action against the merchant the transaction may be 'charged back’ or reversed. This is also of crucial importance when there is an unauthorized use of a credit card. Given the wide use of credit card numbers over the phone and internet this was of prime importance when drafting the second EFT Code. But it only applies to unauthorized use not to ‘quality’ disputes- the law governing the latter is found in the Code of Banking Practice. The whole issue of chargebacks will be dealt with in subsequent chapters since it relates to consumer rights to stop payment.

The first EFT Code made no references to smart cards. Envisaging their future adoption Part B of the second EFT Code made minimalist rules regarding loss and unspent value on the basis that to go beyond this might hamper future developments in this area. As it now transpires developments in Australia in regard to smart cards have not been great. Both Hong Kong and Singapore have smart cards that can be used for transport as well as small purchases.

Overall, the second EFT Code improved the application of it but one can query the efficiency of a Code that does not cover all players and electronic means for consumers to make payments.

### 3.5.3 Loss allocation in the second EFT Code.

The second EFT Code was worked out with some efficiency principles in mind. Three options were put forward to the EFT Working Group for allocating liability for unauthorised transactions:

Option A - substantially retaining the approach of the first Code

Option B - apportioning liability between the user and account institution on a no fault basis unless the institution can affirmatively prove that the user was fraudulent, disclosed the PIN, or was negligent in a certain specific ways. If this was not the case the cardholder would be strictly liable for $150 and the financial institution the balance.

Option C - the U.S. approach, where the user is only liable for delays in reporting lost or stolen devices or failing to report unauthorised transactions shown on a periodic statement.

The EFT Working Group effectively choose Option B: see Clause 5 of the second EFT Code.

*Burden of proof to be on the banks*

Broadly speaking, the second EFT Code thus provided consumer would only be liable in three situations:

1. Where the bank could affirmatively prove the user's fraud or breach of the security requirements in regard to the user's secret Code and that this contributed to the loss.

   The reference to security requirements above meant that the user could not:[21]

   * voluntarily disclose one or more of the Codes to anyone

   *indicate one or more of the Codes on the outside of the access device, or keep a record of one or more of the Codes (without making any reasonable attempt to protect the security of the Code records) so that they were liable to loss or theft simultaneously. Ditto where there was no access device

   * after the adoption of the second EFT Code select a Code that represented the user's birth date or part of the user's name having been warned by the bank not to select such a Code

   * act with extreme carelessness in failing to protect the Codes.

2. Where the bank could affirmatively prove the user delayed notifying loss or theft or breach of security requirements
3. Where a secret Code (typically the PIN) was required and neither 1 nor 2 apply, the user was then liable for no more than $150.

Thus, it was only when the cardholder had been extremely careless in failing to protect the security of the Codes or negligent in specific ways or fraudulent that the cardholder was to bear the loss; and, even then, only when the financial institution could affirmatively prove this. This seemed to mean the burden of unauthorised use was effectively borne by financial institutions which in turn could pass the costs of loss onto users of the system.

[21] Electronic Funds Transfer Code of Conduct as revised by the Australian Securities and Investments Commission's EFT Working Group (issued 1 April 2001 amended 18 March 2002) Clause 5.6.

The strict liability meant, at least in theory, that most cases would be able to be decided quickly and efficiently by the Banking Ombudsman. Any financial institutions would have some difficulty in affirmatively proving fraud or carelessness. It would therefore only be in special cases that the banks would seek to shoulder this burden. The EFT Working Group for the second EFT Code made this point about the loss allocation rules.

> This option takes account of principle 3 (that liability allocation rules should be simple, clear and decisive so as to minimise the costs of administering them) [this is a reference to Cooter and Rubin's third principle]. It effectively apportions liability between the user and account institution on a no fault basis (thus eliminating time consuming and contentious fault assessment). Liability is apportioned unless the institution can affirmatively prove that the user was fraudulent or grossly negligent in specific respects. The intention behind this model is that the vast majority of cases will be dealt with at the no fault apportionment level. In only a small minority of cases will an institution be able to affirmatively prove gross negligence or fraud to the higher standard specified. This option therefore reduces the time and resources and contentiousness in many EFT unauthorised transaction disputes. [22]

It was contended that such a model was efficient to administer since the user's obligation was clearly delineated, thus making adjudication easy and therefore less costly. It was contrasted with loose standards like "the user take all reasonable steps to keep the access method safe" which would, of course, involve more arguments and therefore increase the cost of adjudication.

[22] Discussion Paper EFT 1999, above n 3, 3.

In the second EFT Code the model of liability apportionment - no fault for most cases and fault with the burden of proof on the bank to prove it - was similar to the approach used in the British Bankers'Association Code of Banking Practice (see clause 4.14 to 4.16 and 4.8), and the Danish Payment Cards Act 1984 (see Section 21) and the European Commission's Recommendation of 30 July 1997 concerning transactions by electronic instruments (see Article 6).

*Time frames*

The second EFT Code in clause 10 provides that the time for a subscriber to resolve a complaint is 45 days unless there are exceptional circumstances, if the matter cannot be resolved within 45 days then the consumer must be told when a likely decision will be made.

*Incentives for internal dispute resolutions*

If a subscriber does not comply with clause 10, or the liability allocation rules in clauses 5 and 6, an external dispute resolution body – the Ombudsman – can hold that such a subscriber be held liable for the disputed transaction. The aim of this is too act as a spur for subscribers to provide an efficient and sound internal dispute resolution system. This seems a sound approach.

### 3.5.4 Criticism of the second EFT Code's allocation of loss

Before undertaking specific criticism of the second EFT Code in the light of Cooter and Rubin's 'rules' (3.6), some general criticism will first be made.

*Complicated rules*

It is highly debatable that the model for allocation of liability is as simple as claimed. The following flow chart illustrates the extremely complicated path that adjudication must follow:

Has the transaction been carried out by the user
or someone on behalf of the user? [5.1] → If Yes, user liable.

↓

No

Has the loss resulted form conduct of employees/agents
of the account institution or network companies or the merchant
or his employees/agents? [5.2(a)] → If Yes, account holder **NOT** liable.

↓

No

Did loss result from any component of access method
forged faulty expired or cancelled? [5.2(b)] → If Yes, account holder **NOT** liable.

↓

No

Did loss arise from a transaction before user received
PIN or device? [5.2(c)] → If Yes, account holder **NOT** liable.

↓

No

Did loss arise from a transaction being wrongly debited
more than once? [5.2(d)] → If Yes, account holder **NOT** liable.

↓

No

Has account holder notified that device (card) has been lost
or stolen or that security of code (PIN) has been breached?
[5.3] → If Yes, account holder **NOT** liable for unauthorized transactions after notice.

↓

No

Has user been fraudulent or breached 5.6 security
requirements *? [5.5(a)]. (Account holder not liable where
it is clear that user has not contributed to loss – 5.4) → If Yes, was breach dominant cause of loss*? [5.5(a)]

↓

No
Account holder
liable for only $150 ← No ↙

↓ Yes.
Account holder
**IS** liable.

* bank to prove

The above shows that the loss allocation is in fact like a labyrinth with various levels of liabilities (not shown on diagram), replete with ifs and buts and all sorts of qualifications. This makes the task of adjudication more difficult, thus offending the third Cooter and Rubin principle about adjudication rule simplicity.

*Problems of Proof*

The second EFT Code provides in clause 4 that financial institutions should provide ATM receipts, EFTPOS transaction receipts and periodic statements.

> The periodic statement is supposed to show, amongst other things, 'the receipt number, or other means, which will enable the account entry to be reconciled with a transaction receipt' (4.3 (a)(iv).

But Commonwealth Bank of Australia (CBA) ATM receipts, for example, do not have a receipt number – true, they have the card no, date, time and terminal number, sequence number, amount withdrawn and account type plus balance in account. And maybe this is what is meant by 'or other means' in cl 4.3 (a)(iv), enabling thus a reconciliation. But one would have thought that a requirement that there be a receipt number which could be matched against a transaction number would be a simpler solution.

Another confusing thing about receipts is that often the name on a receipt is a business name whereas the name on a credit card statement may be a corporate entity that owns the business name. This makes it very difficult to match up the two. Consumers should be able to match transaction records with statement entries. At the very least the two names and the dates should match up. But having a transaction number and a matching receipt number in addition would make the task of reconciliation easier.

There is no legal compulsion to verify periodic statements in Australia and the EFT Code reflects this too but institutions are allowed to urge their customers to do so ( 4.4). Of course, many consumers elect not to receive an ATM receipt, this option being allowed on the grounds of privacy. However, this places the consumer in an invidious position if the consumer suspects there is something wrong.

The common law rules regarding bank statements will apply presumably apply to EFT statements, so it may be that it may be that a statement may be sufficient to support estoppel if the customer relies on it.[23] But it will not always be viewed as conclusive.[24]

However, the practical utility of periodic statements for customers also depends on the frequency of their receipt by the customer. Clause 4.2 of the EFT Code provides that there be one ‘at least every six months’. This seems far too long, although the option of receiving more frequent statements is also alluded too. However, it is clear that banks would like to get rid of tiresome paper statements. The CBA, for example, in June 2008 announced customers would only receive paper statements once every quarter whereas before they were supplied monthly. Customers were also urged to do away with paper statements and consult statements on line. Obviously the switch from paper to electronic delivery generates considerable savings to banks, a point that should be borne in mind when contemplating the fairness of Cooter and Rubin’s loss spreading principle. If an institution saves money from switching people from paper to electronic delivery this adds to the argument that not only should it be responsible for anything that goes wrong with it but that the profit from it should be weighed up when considering liability.

*Burden of Proof*

One of the major problems with the first code was that banks and other financial institutions argued that a successful first attempt at accessing was proof positive that the consumer must have divulged the PIN to someone.

[23] *Lloyds Bank Ltd v Brooks* (1950) 6 LDB 161.

[24] *British and North European Bank Ltd v Zalstein* [1927] 2 KB 92.

The critical comments of the Banking Industry Ombudsman about the lack of clarity in terms of burden of proof in first Code and the significance of first attempt access led to the following clause in the second Code (5.5):

> In determining if it is unclear whether a cardholder has contributed to the loss, the card issuer will consider all reasonable evidence, including all reasonable explanations for the transaction occurring. The fact that account has been accessed with the correct pin, while significant, will not of itself be conclusive evidence that the cardholder has contributed to the loss.

In the second EFT Code the financial institution has the burden of proof to affirmatively prove that the user was fraudulent, disclosed the PIN, or was negligent in a certain specific ways on a balance of probabilities basis. There is no definition of 'on a balance of probabilities' in the second EFT Code although, admittedly, it is legally well understood concept being the evidentiary standard used in civil cases.[25]

The second EFT Code also makes it clear (5.5a) that the user's fraud or contravention of the security requirements of 5.6 must contribute to the loss. For example, if the user, a busy mother of three children under five, has written the PIN on a piece of paper without any disguise and keeps this in a purse with the card - this is a breach of cl 5.6 (b) - but leaves the card behind at the check out counter at the supermarket and the checkout person has been able to see the PIN when being inserted by the user prior to this, then the breach arguably has not contributed to the loss if the check out person illegally uses the card and PIN. But to what degree, must a contravention contribute?

---

[25] Mark Aronson and Jill Hunter, *Litigation: Evidence and Procedure* (1998) 698-9.

Some idea might be gleaned by what the EFT Code provides where more than one code (eg PIN) is needed. The bar is raised higher for the financial institution where the access method includes more than one code and it is proven on a balance of probabilities that there has been a disclosure of 1 or more of the codes but not all the codes. Here it must be proved on a balance of probabilities that user's contravention was the *dominant* contributing cause of the loss (5.5). Endnote 16 provides 'The dominant contributing cause of the losses is the cause that is more than 50 per cent responsible for the losses when assessed together with all contributing causes'. Although the endnotes do not form part of the code they may be used to interpret provisions (cl 20.3). Hence, it can be deduced that where there is only one code, the more common situation, then the fraud or contravention by the user can be less than 50 per cent of all the contributing causes.

### 3.5.5 Adjudication Problems with Specific Examples of Behavior

In practice, adjudication difficulties often centre on the specific examples of behavior in cl 5.6 that if proved on a balance of probabilities by the financial institution renders the user liable. A user contravenes the Code

- where the access method also utilises a device (eg card), the ***user*** indicates one or more of the codes (PIN) on the outside of the device, or keeps a record of one or more of the codes (***without making any reasonable attempt to protect the security of the code records) on the one article, or on several articles, carried with the device or liable to loss or theft simultaneously with the device***; or

- the user ***acts with extreme carelessness*** in failing to protect the security of all the codes.[26]

The contentious parts in bold italics will now be examined to demonstrate the difficulties surrounding these words.

*User (cl 5.6)*

The word ‘user’ in cl 5.6 can cause problems. User is defined in cl 1 of the EFT Code in these terms:

> “user” means a person authorised by an account institution (and, if the user is not the account holder, also authorised by the account holder) to use an access method to give instructions to the account institution to debit or credit an EFT account and includes an account holder.

Suppose a blind customer (and this is obvious to anyone) accompanied by her daughter applies to the bank for an EFT card and PIN and the appropriate forms are filled out by the daughter and signed by the mother but the daughter is not nominated or authorized as a user on any of the forms. The daughter always helps the mother put the PIN into the ATM because of her sight problems. The blind lady loses her card (she made no copy of the PIN). Money is subsequently withdrawn several times from ATMs before the mother realizes she has lost her card. The bank suspects the daughter. Undoubtedly the mother is a user but has she in the language of cl 5.6 (a) ‘voluntarily’ disclosed the PIN to the daughter? Or is the daughter also a ‘user’ because both the mother explicitly and, in the case of the bank, implicitly, authorized her to use the PIN?

---

[26] Electronic Funds Transfer Code of Conduct as revised by the Australian Securities and Investments Commission’s EFT Working Group (issued 1 April 2001 amended 18 March 2002) Clause 5.6.

*reasonable attempt to protect the security of the code records (cl 5.6)*

This usually consists of some 'translation' of the PIN. Would, for example, using musical notes (Doh= 1, Re= 2 etc) set out on a musical stave written on a piece of paper and carried in a purse with the card be a reasonable attempt to protect the security of the code? Very frequently bank EFT terms and conditions spell out example of an inadequate attempt to protect the security eg. A=1, B=2 etc. This would be fairly obvious to most people but most people cannot read musical notation, so perhaps the former might muster. But the Australian Banking and Financial Services Ombudsman in an early report took the view that translating numbers into radio call signals eg Alpha = 1, Bravo = 2 was not a reasonable disguise.[27] So what amounts to a reasonable attempt to protect the security of the code is not at all clear - some examples in the Code itself would make it clearer.

*liable to loss or theft simultaneously with the device (cl 5.6)*

Some of the cases reported in the Banking and Financial Ombudsman Annual Reports give graphic examples of the problems encountered here. In one case a man had put his PIN (without any attempt to disguise it) into an electronic personal organizer which had a secret password to open it. He kept his wallet containing his ATM card and the electronic organizer in a waist bag that was stolen from his locked car but did not notice the theft until the next day. His accounts were accessed and money removed. It was decided that it was not a reasonable attempt to protect the security of the code and since it was liable to theft simultaneously with the card the decision went against him.[28] This seems a harsh decision and was decided under the first EFT Code.

---

[27] The Australian Banking Industry Annual Report 1995-1996, 26.

[28] Ibid 25.

Arguably the case would not now be decided in this way under the second EFT Code. Clause 5.8 (a) in the second EFT Code further now elaborates on what constitutes a reasonable attempt. It provides

> For the purposes of this clause, a reasonable attempt to protect the security of a
> Cord record includes either or both of:
>
> (i) making any reasonable attempt to disguise the code(s) within the record; or
> (ii) taking reasonable steps to prevent unauthorised access to the code record.

Footnote 20 to cl 5.8 (a) (ii) provides

> Reasonable steps to prevent unauthorised access may involve hiding or disguising the code record among other records or in places where a code record would not be expected to be found, by keeping a record of the code in a securely locked container or *preventing unauthorised access to an electronically stored record of the code*. (italics added)

Arguably keeping an undisguised PIN kept in an electronic organizer which can only be opened with a secret password would now be considered taking reasonable steps to prevent unauthorised access to the code record.

In another case decided under the first EFT Code a husband and wife kept their cards and undisguised PINS in a safe hidden in their home where they were stolen whilst they were away on holidays and large amounts were taken from their accounts. It was decided that the undisguised PINS and cards were liable to theft simultaneously and thus the case was decided against them.[29] Again under the second EFT Code this case might not be decided against them because their course of action would be considered to the equivalent, or better, than ‘keeping a record of the code in a securely locked container’ (see above Footnote 20 to cl 5.8 (a) (ii) of the second EFT Code)..

The sometimes ludicrous cogitations surrounding the Ombudsman’s decisions highlight the difficulties associated with the wording. In one case the card was in a bedroom drawer and the undisguised PIN was in the user’s backpack that she usually carried with her. This led to the Ombudsman having to contemplate whether, if the backpack was in the bedroom, would the two items be liable to loss or theft simultaneously?

To add a further layer of complication the Code has a ‘fall back’ provision where issues of proof are not clear; that is, where the bank cannot prove on a balance of probabilities that that there was fraud or a breach of the security requirements of cl 5.6 or there had been unreasonable delay in notification, then cl 5.5[c] applies with a monetary tier for determining liability. This seems designed to assist the Ombudsman in cases where the evidence is not strong or contradictory.

*Extreme carelessness (cl 5.6)*

Footnote 17 to the second code defines this in the following terms:

> "Extreme carelessness" means a degree of carelessness with the security of the codes which greatly exceeds what would normally be considered careless behaviour. For example, storing the user's usemame and password for Intemet banking in a diary or personal

[29] Ibid 24.

organiser or computer (not locked with a PIN) under the heading "Internet banking codes".

This seems to add very little to the process of allocating liability but seems to have been as yet another fallback provision.[30]

## 3.6 Assessment of second EFT Code allocation rules in the light of the Cooter and Rubin rules

The second Australian EFT Code allocation rules were explicitly worked out on the basis of efficiency. It will be recalled that the Cooter and Rubin rules to assess efficiency of allocation of liability for loss are as follows:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Which party can most easily bear the loss?*

The first Cooter and Rubin rule - which party can most easily bear the loss – is satisfied by the allocation of loss rules in the second Australian EFT Code in the sense that in most cases banks will not seek to contest cases showing that the cardholders are liable since the burden of proving this is substantial, remembering that the burden is on the bank to prove fraud, breach of PIN security requirements or failure to report loss or fraud. It may therefore be cheaper for them to simply bear the cost of it and pass this cost onto other users of the system.

[30] ASIC in Reviewing the ASIC EFT Code consultation paper, January 2007 asked whether the imposition of liability on consumers who acted with extreme careless should be extended – no submissions were received on this and ASIC rejected this as well as an idea to give examples of extreme carelesness: see Review of the Electronic Funds Transfer Code of Conduct 2007/08: ASIC proposals October 2008 (Consultation Paper 90), paras 204-6.

Another factor to bear in mind is that banks have to pay for the Australian Banking and Financial Services Ombudsman scheme - now called the Financial Ombudsman Service - the adjudicator of any EFT disputes. Initially there was talk of contributions be determined by how many cases were brought against individual banks. This was therefore supposed to act as an incentive for banks to improve their performance and, presumably, settle disputes. Whether this proposal was in fact made is impossible to determine from publicly available information. However, there is undoubtedly something of a stigma attaching to reporting EFT cases by the Ombudsman, especially if the decision goes against the bank. In short, the second Australian EFT Code seeks to have the party, the banks, that can most easily bear the loss, assume this.

*Which party can most easily avoid the cause of loss?(cl 5.6)*

In terms of which party can most easily avoid the loss, the second Australian EFT Code, unlike the American EFT Act, seeks to impose penalties where the user breaches PIN security requirements or fails to report loss or fraud. This will be discussed in more detail subsequently. In brief the US stance is to only impose liability for loss when there is a failure to report. Again as already discussed the burden in Australia is on the bank to prove fraud or breach of PIN security and this is, of course, quite a heavy burden to discharge. Nevertheless, despite this burden it may be that assigning loss allocation according to fault, in particular deceit and failure to protect PIN security, acts *in terrorem* to influence consumer behavior.

*Which rule is the cheapest to apply?*

The third Cooter and Rubin rule advocates rule simplicity to promote efficiency in terms of adjudication. Here one would have to say that the rules for allocation of loss in the second Australian EFT Code leave a lot to be desired. They are complex rules written in dense legalese entailing multiple levels of liability. Extra refinements and additions seem to have been added to those of the first Australian EFT Code, like layers of coral that are added over decades.

The approach in the second Australian EFT Code looks not only at failure to report but also whether there has been fraud or a breach of PIN security. As Rubin points out 'The more simple and less fact-oriented the rules, the less often liability will be at issue and more cheaply any suit will be resolved.'[31] This criticism may be somewhat tempered by the fact that since the burden is on the banks to prove this fraud or breach of PIN security on a balance of probabilities basis, they may well choose not to do this. This, of course, prompts the question of its value.

Despite all these criticisms the second Australian EFT Code rules for allocation are infinitely superior in terms of efficiency to those of the first Code.

### 3.7 The third Code proposals

In 2007/2008 the Australian Securities and Investments Commission (ASIC) which administers the Electronic Funds Transfer Code of Conduct (EFT Code) conducted a review of the second version of it in the light of significant changes in the market place for electronic payments, the extent and nature of on line fraud, and the regulatory environment with the objective of producing a third version of the code.[32] In January 2007 ASIC released a consultation paper, *Reviewing the EFT Code* and received over 40 submissions. As a result of this, in October 2008, ASIC produced a series of proposals.

[31] Edward Rubin, 'Efficiency, Equity and the Proposed Revision of Articles 3 and 4' (1990-1991) 42 *Alabama Law Review* 551, 583.

[32] Reviewing the EFT Code, above n 12,

### 3.7.1 Perceived problems relating to fraud

*On line fraud*

ASIC was particularly concerned with the increase in online fraud. Section 3 of ASIC's *Reviewing the EFT Code* paper dealt in some detail with what is collectively referred to as 'phishing'. Some of the most remarkable questions raised were whether consumers should be subject to additional liability for unauthorized transactions arising from malicious software attacks.[33] All the submissions on this issue were opposed to modifying the current rules to accommodate such proposals.

Interestingly enough *Reviewing the EFT Code* paper notes that levels of internet fraud remain considerably lower than other forms of fraud such as cheque fraud and credit card fraud.[34] Nevertheless, it is a significant problem that erodes consumer confidence in internet financial transactions[35] and may even hamper online banking growth.[36] ASIC notes in its *Review of the Electronic Funds Transfer Code of Conduct 2007/08: ASIC proposals October 2008* that financial institutions have introduced a wide range of anti-fraud measures to combat online fraud and that several submissions to its January paper stressed the need to update technological responses to fraud.[37]

*Gift cards*

---

[33] Ibid, questions 29 and 30, 68.

[34] Ibid , para 3.11

[35] Ibid para 3.23.

[36] Ibid para 3. 26.

[37] ASIC proposals, above n 5, para 13.

ASIC proposes special requirements for simple (no electronic lock) gift cards of $100 or less; for example, that there must be provision for checking balances; a right to exchange or refund; and a provision for seeing the expiry date if the product has one. Apart from these it is proposed that the requirements of the EFT Code not apply to such simple 'cash' like products.[38] But it is proposed that the EFT Code and in particular its rules for allocation of liability will apply to expensive gift vouchers and travel cards that can hold thousands of dollars. Unless such products have some sort of PIN or safety system to block unauthorized use it is difficult to see how these rules, apart from reporting loss, will apply.[39]

*A new rule for ATMs ?*

ASIC proposes an amendment that a consumer would be liable for unauthorized transactions that occur because they leave a card in an active ATM which has automatic shut down procedures. The reason advanced for this is that that the ATM user is in the best position to mitigate loss by being careful.[40] This reflects, of course, Cooter and Rubin's rule about loss avoidance: the party who can most easily and cheaply avoid the loss should bear it.

But it is difficult to see why it requires a specific rule. Moreover there are circumstances, admittedly limited, where consumer may leave a card there in circumstances that do not suggest negligence or fault, for example, where the consumer has some medical problem like a coughing fit or vomiting; or where a mother rushes to the aid of her injured child.

[38] Ibid paras 41-5.

[39] Ibid para 45.

[40] Ibid paras 171-172.

A consumer also might leave a card in an active ATM because of a scam, as shown by a bank's closed circuit camera shown on a news program.[41] Rogue 1 positions himself at ATM no 1 and watches the victim put in a PIN in adjacent ATM no 2. The victim then withdraws her money. Rogue 1 then drops a currency note and tells the victim it must be hers. Meanwhile the ATM expels the victim's card and the distracted victim not noticing this, leaves her card in ATM no 2 and bends to take the currency note. Whilst doing this rogue no 2 positioned on the other side of ATM no 2 quickly takes the card and disappears. Rogue 1 and 2 meet up and extract money from ATMs. Although the cardholder left the card in the ATM it was the result of a scam. Who should bear the loss? The proposal as expressed would say the cardholder should be liable in such circumstances.

Unless the proposed amendment expressly states that liability attaches only when the cardholder *negligently* leaves the card in the ATM it would seem unfair that a cardholder could be held liable when they might, for instance, be the victim of a trick or subject to some pressing medical problem.

The imposition of liability on the cardholder also raises the issue of the functioning of ATM machines. With the older 'bank' ATMs the cardholder inserts his card and then proceeds to enter the transaction. The money then appears and then the card is pushed out by the machine. If a cardholder puts in a card but does not enter a transaction the cardholder is prompted to withdraw the card and then 40 seconds later it shuts down. Newer machines require the cardholder to insert the card and withdrew it immediately – a sort of 'swipe' feature whereby the cardholder always has physical control of the card. If the cardholder does not enter a transaction within 15 seconds it closes down.[42] Obviously the 'swipe' feature of the newer machines is safer.

---

[41] South American (Chilean) News, SBS, Sunday 9 November 2008.

[42] ASIC proposals, above n 5, para 173.

Imposing liability on cardholders in the manner proposed by ASIC raises the issue of incentives to improve the safety and efficiency of the system. There is little incentive to switch to 'swipe' machines or reduce the time for machines to shut down if liability is always imposed on cardholders who leave their card in active ATMs as proposed by ASIC which, as it stands, places liability on consumers, irrespective of negligence, if they leave cards in active ATMs. It is submitted that placing responsibility in this context for non negligent behavior of cardholders on financial institutions would have some efficiency merits. Such an idea has been commented upon in these terms:

> …Where losses do not result from negligence, this [placing the liability on the financial institution] may be an appropriate strategy. ….financial and cash networks are likely in better positions to develop and implement anti-fraud technologies than consumers, so that inducing the former to seize their advantage will likely reduce the total costs related to unauthorized payments and precautionary behavior.[43]

This reflects Cooter and Rubin's all important loss spreading principle: the loss should be assigned to the party who can most easily bear it (and pass it onto other users of the system).It might also prompt improvements in ATMs.This principle has been largely ignored in the ASIC proposal as it now stands.

*Book up practices*

[43] Clayton Gillette and Stephen Walt, 'Uniformity and Diversity in Payment Systems' 2008 83(:2) *Chicago-Kent Law Review* 499, 542.

The January 2007 consultation paper reported on a obnoxious practice that is apparently prevalent in some indigenous communities whereby merchants take PINs as part of a 'book up' procedure. Apart from being at best paternalistic it is also probably illegal since merchants would, in effect, be encouraging cardholders to breach their contracts with their banks. ASIC took view in their October 2008 proposals that the cardholder would not be liable in such circumstances for such unauthorized transactions.[44] ASIC proposed that such a practice be explicitly banned.

*Receipts*

Since the advent of the second Code a specific development in regard to receipts bears mentioning, the practice of issuing a receipt number without a name when consumers make payments over the phone. The ASIC October 2008 proposals intend to amend the code so that the merchant is identified by name or a unique number. ASIC prefers the name. But if the 'voice' receipt just has a number rather than a name, the invoice must include both the name and the number on the receipt so that there can be a matching up.[45]

### 3.7.2 Retention of the Loss Allocation Test of the Second EFT Code

ASIC proposes to retain the approach in the current code (the second EFT Code) to allocating liability for unauthorized transactions as set out in clause 5 and 6 of the current code.[46] Given the concern with online fraud this is somewhat surprising. The current allocation of liability is a mixture of Cooter and Rubin's loss spreading principle (this means the banks wear the loss) and the loss avoidance principle (broadly speaking this means the consumer bears the loss if it is demonstrated that the consumer has been

[44] ASIC proposals, above n 5, para 174.

[45] Ibid para 105.

[46] Ibid, pp50-51.

negligent).But it is quite a complex test. In most cases, as discussed earlier, it will mean that banks bear the majority of losses for online fraud. Nevertheless, it is tempting to ask whether placing even more liability on banks would increase their concerns to constantly improve technology to thwart online fraud. [47] A contrary argument would be that flagging consumer confidence in online transactions might in itself supply the necessary spur to do this.

*Unreasonable delay*

Under the current EFT Code - the second one - an unreasonable delay in reporting to a subscriber the loss, misuse or theft of device or the code results in the allocation of liability to the consumer: clause 5.5 (b). The January consultation paper asked whether this should be expended to cover unreasonable delay in reporting on line security breaches. ASIC in its October 2008 proposals paper pointed out that many consumers would not have the skills to be able to be aware of this and that any failure to report should be based on the consumer being aware of the breach. This expansion was therefore rejected as well as any extension of the time period for reporting any breach.[48]

*PINS*

The current EFT Code provides that a subscriber is not liable for losses resulting from unauthorized transactions where consumer have chosen a PIN based on their birthdates or name if the subscriber has instructed them not to do so: 5.6(d). Interestingly most submissions in regard to Question 31 of the January 2007 issues paper asking whether such a restriction is relied

[47] See text around footnote 10 of this chapter.

[48] ASIC proposals, above n 5, paras 211-5.

on by subscribers replied in the negative but advocated its retention to remind consumers not to do this.[49]

*Increase in no fault*

Question 37 - 38 of the January 2007 issues paper asked whether there was a case for increasing the 'no fault' amount of $150. This raises the issue of what purpose the $150 serves. It cannot serve as a deterrent since it is to apply when there is no fault. Is it supposed to cover the costs of investigation? If so, undoubtedly consumers would feel somewhat aggrieved in having to pay this when they have not been at fault. It seems that the amount was increased from $50 in the first code to $150 in the second code as some sort of 'trade off' for placing the burden of proof on banks to prove fraud or negligence.[50] Needless to say the increase was opposed by consumer representatives who undoubtedly felt that putting the burden on the banks was not a great concession to consumers but more in the light of a clarification.[51] The Financial Ombudsman Services proposed increasing the amount to a percentage for higher value transactions and ASIC in its October 2008 proposals and mooted a no fault liability of 5 per cent if the EFT Code were to cover small businesses.[52]

The fundamental issue is why should anyone have to pay anything if they have not been at fault? It serves no deterrent fault, so it could not be said to comply with Cooter and Rubin's 'loss avoidance' principle. It is a cost that should be borne by banks since they can easily bear it and pass it on in accordance with Cooter and Rubin's 'loss spreading'principle. Since it is a significant amount for low income and disadvantaged persons – something

[49] Ibid paras 207-10.

[50] Reviewing the EFT Code, above n 12, paras 7.16, 7.17.

[51] ASIC proposals, above n 5, para 217.

[52] Ibid paras 216-18.

acknowledged by ASIC[53]- it probably only serves to fuel consumer's sense of unfairness. ASIC in its January 2007 Issues Paper noted that "many institutions regard the customer – relations costs of deducing the amount as generally outweighing the benefits of doing so."[54] ASIC proposed not to change the amount.[55]

### 3.7.3 Plain English Allocation Rules?

The current review of the Electronic Funds Transfer Code proposes to redraft the allocation rules as a principles-based code in plain English.[56] The January 2007 Consultation Paper on the EFT Code revealed there was widespread support for redrafting the Code on a more principles, less prescriptive approach.[57]

The wording makes adjudication of the loss allocation like a labyrinth with various levels of liabilities, replete with "ifs" and "buts" and all sorts of qualifications. This in fact makes the task of adjudication more difficult and costly. Although adjudication by the Financial Ombudsman Service is free to the complainant the public finishes up paying for it since the backers will pass on the costs. Therefore, the proposal to have a principles- based and plain English approach seems appealing from an efficiency point of view if nothing else.

But what is meant by a principles-based code? The Review gives no definition but it would be fair to say it means, by way of contrast with the dense and

---

[53] Ibid para 219.

[54] Reviewing the EFT Code, above n 12, para 7.55.

[55] ASIC proposals, above n 5, para 219.

[56] Ibid proposal B6.

[57] Ibid para 80.

knotty rules of the current Code, that it means more simple and fundamental elements rather than complicated rules.

Such an approach seems to involve a choice between rules and standards. There is a good deal of academic literature on these two alternative approaches and the pros and cons of each.

*Rules and Standards*

Kaplow, for instance, defines rules and standards in terms of their impact before and after an individuals acts [58] He contends that the choice between standards and rules involves efficiency considerations. A standard is given content after the individual acts (*ex post*) whereas with a rule its content is provided before the individual acts (*ex ante*). A standard would be something like, for example, s 52 of the *Trade Practices Act* (Cth) 1974 which is broad and all encompassing.

*Standards or principles are cheaper to devise*

Kaplow argues that generally speaking standards are cheaper to devise than rules since they are usually broad and inclusive. On the other hand, standards are difficult to give advice on, assuming that people seek advice, since the legal advisor must go beyond the bare standard and look at precedents (assuming that they exist) to determine its full import and application. This is debatable. Duggan, for example, points out that there is often an intuitive element in many standards and that this in fact means that actors do not necessarily have to even seek legal advice.[59] But this begs the question whether their intuition is right or wrong.

---

[58] Louis Kaplow, 'Rules Versus Standards and Economic Analysis' (1992-93) 42 *Duke Law Journal* 557.

[59] Anthony Duggan, 'Is Equity Efficient?' (1997) 113 *Law Quarterly Review* 601, 650.

*Adjudication of a standard costly*

However, adjudication of a standard will be costly since the adjudicator must look at the behavior in question after the event and all the relevant precedents in question and craft a decision based on this. The bulk of work and therefore costs with a standard occur after the individual acts (*ex post*). Ehrlich and Posner point out that:

> Reliance on standards places an increased emphasis on fact-finding and it allows greater scope for the mounting of arguable defences. The likely consequence is to increase both the complexity and the length of trials. This represents a cost to the parties and also to the state to the extent that the court system is publicly subsidized.[60]

*Work and costs of a rule occur before the individual acts (ex ante)*

With a rule, however, much of the work and costs occur before the individual acts (*ex ante*). Generally speaking a rule will be more precise, complex and targeted. A good example of this might be, say, s 47 of the *Trade Practices Act* 1974 (Cth). Since s 47 is complicated section targeting more specific behavior than s 52 it is arguably much more costly to devise than a standard. (The fact that the section might have been copied or adapted from elsewhere and therefore cheap will be overlooked for the purposes of the argument). Kaplow argues that advice on the application of a rule will generally be cheaper than with a standard since the rule in itself largely will in most cases provide the answers sought.[61] Similarly, adjudication of a rule will be cheaper since it is more precise and targeted at the behavior in question in contrast with a

---

[60] Isaac Erhlich and Richard A Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *Journal of Legal Studies* 257, 264.

[61] Kaplow, above n 58, 564.

standard where the real content has to be determined after the behavior in question.

*When will people seek legal advice?*

Assessing the cost of a rule or standard before the commission of any offending act by a person largely depends on whether a person seeks legal advice on it. People will not seek legal advice unless the cost of the advice is less than their perceived potential loss or liability if they do not know about the law. Legal advice on tax matters, for instance, is often sought since people can clearly see the 'dividends' it pays. On the other hand, a consumer might feel that potential losses or liability arising from EFT payment remote and therefore not worth while seeking legal advice on. From a cost point of view *ex ante* it will not matter whether it is a standard or a rule if people are not likely to seek legal advice, therefore costs should be looked at *ex post*, namely, the cost of adjudication.

*From efficiency point of view which is better: a rule or a standard?*

Needless to say many laws are often a mixture of standards and rules. Moreover, over time a standard which has a lot of precedents to govern its interpretation may play a role that is very like that of a rule. Overlooking this for a moment, which should be chosen from an efficiency point of view, standards or rules?

Standards are sometimes appropriate when the behavior is difficult to particularize in terms of a rule; for example, say a council wants to preserve the Victorian characteristics and 'feel" of a particular suburb, it might pass a building regulation saying that 'any new buildings or alterations to existing buildings must be appropriate having regard to the overall architecture of the suburb' since it would be difficult to *a priori* describe the sort of buildings or alterations that are not wanted; yet everyone knows when a particular example is before them. Erlich and Posner maintain ‘A standard is generally a policy that is devoid of legal artifacts. Many standards have a largely intuitive element which makes them comprehensible without special training.’ [62]

Duggan agrees with Kaplow’s analysis and maintains that equity, for example, given that it is directed to heterogeneous behavior, favors standards. But he points out that that since standards increase uncertainty, the issue is whether this ‘is matched by the benefits that the intervention is supposed to deliver.’[63]

*Standards good for opaque events*

Standards are appropriate when the ill to be legislated about is difficult to predict, seldom occurring or opaque. A good example, of this is s 52 of the *Trade Practices Act* 1974 (Cth). Attorney- General Murphy saw s 52 as a way of ensuring that the law was not ‘continually one step behind businessmen who resort to smart practices.’[64]

*Rules good for repeat conduct*

When behavior is going to be frequent and identical or similar – what Erlich and Posner call ‘homogenous conduct’[65]- a rule might be more appropriate. Take income tax legislation to which millions of persons are subjected and involving billions of transactions, here precise rules are appropriate. By and large electronic funds transfer transactions have recurring characteristics: the system confines, controls and directs behavior. This suggests perhaps rules rather than standards might be more appropriate. This is less true of cheques

[62] Erhlich and Posner, above n 60, 270-271.

[63] Duggan, above n 59.

[64] Parliamentary Debates, 1974, Vol S 60, 547.

[65] Erhlich and Posner, above n 60, 270-271.

where the drawer can with a signature and a few strokes of the pen put into circulation a negotiable instrument whose ultimate destiny is not known: by its very nature the system is unstable. On the other hand, modern electronic systems of payment have architecture and controls that steer a consumer along a certain path. In addition, there are millions of similar transactions. All this suggests that rules would be more appropriate and efficient for EFT transactions.

*Do rules have to be complicated and difficult to understand?*

Rules tend to be complicated since they are dealing with complex situations even though in many cases they are 'repeat' situations. But this does not mean that the rules are necessarily difficult to read or understand. A good example of this is the *Bills of Exchange Act*.[66] The original English *Bills of Exchange Act* 1882 codified nearly two and half thousand cases and 'has been widely acclaimed by both bench and bar as a masterpiece of legal draftsmanship'.[67] Arguably this act deals with more complex legal problems than those thrown up by the EFT Code yet it is rule based, clear and concise and relatively easy to understand.

*Would a 'principles' approach be likely to lead to bad 'translations'?*

Under the current Code account institutions can produce their own versions of the EFT Code couched in their own language as long as it truly reflects the Code- this is almost an admission that the EFT Code is difficult to understand - but they must not include terms that exceed the liabilities and responsibilities of users as set out in the Code. Moreover, they must warrant that there is compliance with the Code.[68]

---

[66] *Bills of Exchange Act 1909* (Cth).

[67] Brian Conrick, MJL Rajanayagam's *The Law of Negotiable Instruments* (1989) 5.

[68] Electronic Funds Transfer Code of Conduct 2001 amended 2002 Clause 2.1.

But there is a danger that if the Code is principles-based account, institutions might interpret them differently since principles are usually broad and more open to different interpretations. This is a danger that is less likely to happen with a rules approach.

A rules based approach need not necessarily produce a Code that is difficult to understand. Nor does it preclude a Plain English approach. Given the nature of EFT transactions it is submitted that there might be considerable problems with a principles- based approach, especially in regards to interpretation and adjudication.

**3.8 Foreign models**

The working group for the second version of the EFT Code headed by Sneddon investigated the allocation rules from a number of sources. The problem at hand, namely, how to efficiently and fairly allocate loss has been already examined by the Americans and solutions crafted taking into considerations the points of view of consumers, banks and others. Therefore, it may be instructive to examine the approach taken in a country which has also inherited the English common law system and where there has also been a long tradition of consumers using cheques.

**3.8.1 The Electronic Funds Transfer Act (EFTA)**

Under American law, the Electronic Funds Transfer Act (EFTA), the credit holder is only liable if he fails to report the unauthorized use of the card to the issuer. [69] Even then the cardholder is only liable for $50. It apparently does not matter that the cardholder has been negligent in losing the card or in not reading statements relating to the card. The burden of proof is upon the card

[69] Codified *15 USC*§ 1693g.

issuer to show that the use was authorized or, if the use was unauthorized, then the burden of proof is upon the card issuer to show that the conditions of liability for the unauthorized use of a credit card have been met.

There is a relatively neat and easy to understand three tier approach in the EFTA, also known as Regulation E, that was implemented in the US in 1978 to establish the rights and liabilities of consumers as well as the responsibilities of all participants in EFT activities The liability allocation regime has been summarized by the US Federal Reserve Board in these terms:

> On an EFT card, your liability for an unauthorized withdrawal can vary:
>
> - Your loss is limited to $50 if you notify the financial institution within two business days after learning of loss or theft of your card or code.
> - But you could lose as much as $500 if you do not tell the card issuer within two business days after learning of loss or theft.
> - If you do not report an unauthorized transfer that appears on your statement within 60 days after the statement is mailed to you, you risk unlimited loss on transfers made after the 60-day period. That means you could lose all the money in your account plus your maximum overdraft line of credit, if any
>
> Example:
>
> - On Monday, John's debit card and PIN were stolen. On Tuesday, the thief withdrew $250, all the money John had in his account. Five days later, the thief withdrew another $500, triggering John's overdraft line of credit. John did not realize his card was stolen until he received his bank statement, showing withdrawals of $750 he did not make. He called the bank right away. John's liability is $50.
>
> - Now suppose that when John got his bank statement he didn't look at it and didn't call the bank. Seventy days after the statement was mailed to

> John, the thief withdrew another $1,000, reaching the limit on John's line of credit. In this case, John would be liable for $1,050 ($50 for transfers before the end of the 60 days; $1,000 for transfers made more than 60 days after the statement was mailed). [70]

The US law builds upon a well established tradition of attaching liability for failure to read bank statements. This probably stems from the fact that in America customers' paid cheques are sent back to them, so it is not unreasonable to expect them to notice anything untoward. In Australia not only are paid cheques not sent back to customers but courts have consistently maintained that there is no obligation on customers to read bank statements.[71]

Despite these differences the idea of fixing liability to notification seems appealing in the sense of simplicity and therefore especially consonant with Cooter and Rubin's third point about efficient adjudication, namely, rule simplicity.

*Deceptive simplicity?*

However, this simplicity may be somewhat overstated if one looks more closely at the issue of what amounts to an unauthorized electronic funds transfer. 15 *USC* § a(11) provides

> the term "unauthorized electronic fund transfer" means an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate such transfer and from which the consumer receives no benefit, but the *term does not include any electronic fund* transfer
> (A) *initiated by a person other than the consumer who was furnished* with the card, code, or other means of access to such consumer's

[70] <http://federalreserve.gov/pubs/consumerhdbk/electronic.htm> at 17/6/08.

[71] *Keptigalla Rubber Estates Ltd v National Bank of India Ltd* [1909] 2 KB 1010; *Tai Hing Cotton Mill Ltd v Lui Chong Hing Bank Ltd* [1986] AC 80.

account by such consumer, unless the consumer has notified the financial institution involved that transfers by such other person are no longer authorized,

(B) initiated with fraudulent intent by the consumer or any person acting in concert with the consumer, or

(C) which constitutes an error committed by a financial institution. [italics added]

What is meant by 'furnished' in (A) above? Could it be argued that a cardholder has 'furnished' someone else with a card and PIN within the meaning of the section if they have just been negligent in keeping these items safely? Probably not. Broadman, attorney for US Consumers Union, makes the point that Congress was adamant that consumers be not made liable for losses resulting from negligence:

> Thus, for example, if a consumer left an EFT card and access code in an unlocked suitcase that was left with individual X for safekeeping, and X rummaged thorough the suitcase, found the card and access code and completed transfers, the consumer would not be deemed to have 'furnished' X with the card and code and would ordinarily only be liable up to $50.[72]

However, Broadman conjectures that 'furnished' might cover a situation where a consumer is relieved of his card and code at the point of a gun and that therefore the consumer would not obtain the benefit of the EFT Act and would be fully liable. If this interpretation is correct it would seem faintly ludicrous given that Congress was determined that consumer liability would not hinge on negligence but would be liable when card and PIN were stolen. It would hardly seem plausible that Congress would intend that consumers be liable for a non negligent involuntary furnishing of a card and code.

[72] Ellen Broadman, 'Electronic Funds Transfer Act: Is the Consumer Protected?' 13 *University of San Francisco Law Revue* 245, 256-7.

*When is a consumer aware of the loss?*

The approach in the US EFTA can also lead to problems in deciding when a consumer is aware of the loss or theft of the device and/or code (eg PIN) and when it should be reported. One case will suffice to demonstrate the difficulties that may arise. In the notorious case of *Kruser v Bank of America*,[73] despite there being provisions for extenuating circumstances,[74] the court found against the consumer who admitted to having being notified in December 1986 by the bank of a $20 unauthorised ATM withdrawal and failed to report it; she then fell sick in January 1987 and recuperated for about 6 months; then in September 1987 she received notice of 47 unauthorised ATM withdrawals amounting to over $9000 – she promptly reported these plus the one from 1986. Nevertheless, the court did not find there were extenuating circumstances and the consumer was liable for the total amount since she failed to report the initial unauthorized withdrawal.

Despite such an anomalous case, the basic thrust of the American EFT Act can be seen as a radical departure from articles three and four of the American *Uniform Commercial Code* – roughly equivalent to our Australian *Bills of Exchange Act* and *Cheques Act* - where liability, as with our legislation, largely depends on assigning liability according to fault.

The US Senate Report sets out three major reasons for the EFTA departure from the fault allocation formula of Articles 3 and 4 of the American *Uniform Commercial Code* (the allocation formula there is broadly similar to the Australian rules for loss allocation with cheques and bills of exchange) : first, the $50/$500 limits act as incentives for consumers to be prudent in regard to access devices (eg cards) and prompt in reporting loss or theft; second, the allocation formula acts as a spur for financial institutions to develop better

[73] 282 Cal Rptr 463 (Cal App 5th Dist, 1991).

[74] Regulation E § 205.6 (6) (4).

systems; and third, financial institutions are in the best position to stop losses in the long run.[75]

One could query whether in fact, the $50/$500 limits would induce prudence in regard to loss or theft. If a person has had their card stolen (assume no carelessness) and reports within 2 business days from learning of the theft as provided by the law, it is difficult to see how the $50 'fine' induces caution. Where the cardholder delays for more than 2 business days the $500 'fine' applies. At least here one can see that the 'fine' might induce the cardholder to report promptly once aware of the theft.

In particular, the chief characteristic of the US EFTA is the dominance of the first and most important of the Cooter and Rubin principles, namely, loss spreading. As one critical commentator, Siegel, noted the Act has a key underlying 'desire to provide all users of EFT with insurance against losses caused by their own negligence.'[76]

### 3.8.2 Comparison of US EFT allocation rules with Australian second EFT allocation of loss rules

Despite the problems with the US approach, it seems infinitely simpler and therefore arguably more efficient than the Australian approach. The emphasis on fault and how it is to be proved, despite the ameliorations of the second Code, make adjudication difficult. It suffices to compare some simple examples to demonstrate the efficiency of the US approach.

Example 1

Professor Smith, a distinguished expert on ancient Chinese has disguised his PIN by writing it in this form. He keeps this in his drawer in a side table next

---

[75] US Senate Report No 915, 95th Congress, 2nd session, 9408.

[76] Jack B Siegel,'The Electronic Fund Transfer Act – A Departure from Articles Three and Four of the Uniform Commercial Code' (1980) *Wisconsin Law Review* 1008, 1024.

to his bed. He keeps his card in his wallet. At night he puts his wallet on a dresser near the side table. Whilst asleep a thief steals his wallet and takes some objects from the drawer next to his bed but does not take the paper with the disguised PIN on it. Money is subsequently withdrawn on the first attempt from an ATM. Professor Smith duly reports the theft to his bank.

The Australian approach would involve the Bank having to prove on a balance of probabilities that Smith had not made a reasonable attempt to protect the security of the code records and/ or whether the card and PIN were liable to loss or theft simultaneously with the device (cl 5.6 of the EFT Code). This would be fraught with difficulties. As noted already the Code itself does not elaborate on what constitutes a reasonable attempt. It is possible that the EFT contract between Smith and the Bank may elaborate on this. The Code makes express reference to banks forbidding the selection of a PIN based on the customer's birthday or an alphabetical PIN based on the customer's name and a breach of this would be a breach of security requirements under cl 5.6.

Of course, banks might go further than this in elaborating what they might consider not to be a reasonable attempt to protect the security of the code records but they, in the words of the ABIO, 'must stop short of elevating the responsibility imposed on the consumer by the EFT Code.'[77] Even if the bank shows that it was not a reasonable disguise it would then be incumbent on the bank to show that the PIN and card were liable to loss or theft simultaneously. Again this would be problematic. The drawer with the PIN had been opened but the paper with the disguised PIN had not been removed. What if the thief had copied the disguised PIN and had been able to read ancient Chinese numerals? Is this covered or must there be an actual asportation of the PIN and card? The EFT Code does not make this clear. Much time and cost would be involved in the adjudication of this problem

[77] The Australian Banking Industry Annual Report 1995-1996, 23.

not to mention prejudication investigation and argument between the customer and the bank.

By way of contrast, the American approach would be very simple: did the customer promptly report the theft once he became aware of it? Answer, yes. Result, the customer is not liable except for $50.

Example 2.

On Monday, John's debit card and PIN were stolen. On Tuesday, the thief withdrew $250, all the money John had in his account. Five days later, the thief withdrew another $500, triggering John's overdraft line of credit. John did not realize his card was stolen until he received his bank statement, showing withdrawals of $750 he did not make. He called the bank right away.

Under American law, as we have seen, John's liability is $50.[78]

The Australian approach, on the other hand, would involve determining whether John had made a reasonable attempt to disguise his PIN or whether the undisguised PIN and card were liable to loss or theft simultaneously. On the face of it the American approach commends itself for its simplicity.

The American rule, failure to report for unlimited liability, is simple and entails a relatively easy justiciable issue. This also then coupled with a low limit for no fault liability. The American approach has been praised by Rubin as a good example of a simple and efficient one. Rubin makes the case in the following terms:

> The EFTA is probably most useful in providing rules for loss allocation. Its basic rule is that the consumer is liable for only $50 in the event of an unauthorized electronic fund transfer. …..The fixed limit on consumer

[78] See text around footnote 70.

> liability is efficient because it induces precautions without imposing undue losses on individual consumers. Losses above $50, which are imposed on the bank, will be spread across the entire customer base through the prices the bank charges for its services. This limit is equitable as well, because it avoids imposing severe but randomly distributed losses on consumers for ordinary mistakes or oversight. In the case of gross negligence, however, where the customer fails to report the existence of an unauthorized debit, the limit is higher or nonexistent. The economic rationale is that the additional liability will induce additional precaution in these circumstances because the problem will be so salient to consumers [79]

**Conclusions**

In this chapter the loss allocation rules of the two EFT Codes have been examined from the point of view of efficiency. Those of the second EFT Code are without a doubt more efficient than those of the first Code and this is presumably why ASIC recommended that they be retained for the third version of the Code. Nevertheless, the continued emphasis on fault and attendant problems begs the question whether the arguably simpler US test might not be more efficient. The justiciable issue boils to one: did the consumer report the lost or theft when the consumer became aware of it? Accordingly it is recommended that

- That the test for allocation of loss be changed to a simple test of failure to report.
- That the test be written in Plain English rules rather than general principles.

[79] Rubin, above n 31, 582.

This would, of course, mean eliminating fault as articulated, such as disclosure of the PIN, in the EFT Code. Assigning liability according to fault is deeply ingrained. Rubin points out that:

> The concept of fault is deeply embedded in our collective sensibility….In fact it is the instinctiveness of these feelings and the persuasiveness of this explanation that makes an economically efficient loss allocation scheme difficult for many people to accept.[80]

However, these feelings may be somewhat placated by remembering that egregious behavior with EFT that amounts to fraud will still be subject to the full rigors of criminal law. It is submitted that the sacrifice of fault as articulated in the EFT Code is the necessary price for an efficient civil allocation of fraud loss.

[80] Ibid 576.

# Chapter 4

## FRAUD LOSS ALLOCATION AND SIGNATURE CREDIT CARDS

### 4.1 Overview

As the Electronic Funds Transfer Code (EFT Code) excludes the use of credit cards using only a signature - this is faintly ridiculous since the system operates electronically - the present chapter deals only with manual use.

In the 1980s experts were predicting the demise of the credit card as EFTPOS systems were beginning to develop. Siegel in 1980, for example, suggested that ‘recent developments suggest that credit cards will probably not exist in ten years’. And he was not alone in making such prognostications.[1] Such dire predictions have not, of course, become true. The credit card has gone from strength to strength, probably as much the result of the huge profits banks make from them as anything else.[2] But consumers also see clear advantages in their use: the convenience of not having to carry much cash, the availability of credit, loyalty rewards, an efficient system of record keeping for tax and other purposes, and the right to charge back an item in the event of a dispute.

Complaints in the category of Consumer Finance category of the Banking and Financial Services Ombudsman (now the Financial Ombudsman Service) consistently list credit card complaints as the main product complained about. The main problem identified is unauthorized use and incorrect debits to the account. [3] The figures are roughly 1000 complaints per year. Given the number

---

[1] Harold D Nilson, ‘The Future of Credit Cards’ (1979) 162 *The Bankers Magazine* 54, 59; David Reistad, ‘Beyond the Credit Card’ (1971) 154 *The Bankers Magazine* 96.

[2] < http://www.abc.net.au/news/stories/2009/07/02/2614436.htm> at 19 October 2009.

[3] Latest reports do not seem to list categories in the same manner as earlier reports. Therefore the latter have been used to give the ‘flavor’ of the problem. The Banking and Financial Services Ombudsman 2002-3 reports that analysis of the product categories of closed cases

of credit card transactions per year this is very small. However, it is probable that many disputes are resolved at the bank level and never come to the Ombudsman. The figures also do not distinguish between electronic use of credit cards, for example, over the phone and internet using only the personal identification number (PIN) and manual use, that is, with a signature.

Figures released by the Australian Payments Clearing Association are somewhat more revealing showing 361,000 fraudulent credit card transactions occurring to end of June 2008.[4] This means credit card fraud is $131 million for 2007-8, that is, $50.19 in fraud for every $1000 spent. 'Card- not –present', where use is via internet or phone, accounted for $63.5 million with 211,000 transactions. This means that there is still a very considerable amount of over the counter signature credit card fraud.

### 4.2 Outline of this Chapter

This chapter will examine whether the allocation of fraud loss with signature credit cards is efficient by addressing the following questions.

- Is there anything in the development of credit card networks that is hostile to efficiency?
- What governs the allocation of liability for loss in regard to credit cards used with a signature?

---

this year was the same as in the previous three years, with disputes about Consumer Finance (29.3 per cent), Housing Finance (21.2 percent) and Deposit Accounts (18.1 percent) representing the majority of cases. The main product complained about in the Consumer Finance category continues to be the credit card account. Disputes about this product have decreased slightly from 1,481 last year to 1,392 this year. The main problems identified with credit cards were unauthorised transactions and incorrect debits to the account. The 04-05 reports the main product complained about in the Consumer Finance category continues to be the credit card account. Complaints about this product have increased from 1,101 last year to 1,189 this year. The main problems identified were the same as last year: unauthorised transactions and maladministration in granting credit.

[4] *The Age*, (Melbourne), 16 December 2008, 4.

- Is there anything to be learnt from American law in terms of efficient allocation of loss?
- Is forgery of the cardholder's signature the major cause of credit card fraud?
- Is the allocation of loss efficient?
- What changes should be made to the law?

## 4.3 Co-operative endeavors, collusion and efficiency

### 4.3.1 Network development

Credit cards have a very long history and certainly predate the modern world wide phenomenon. Many large retailers in Australia offered credit cards to their customers back in the 1960s; for example, Myer and David Jones to name two major stores offered these to valuable customers. These cards offered a revolving credit to customers and made the goods immediately available whereas with lay-by systems the customers did not obtain the goods until payment was made in whole. Most consumers wanted the goods immediately with the option of paying later. Moreover, the lay-by price often had some credit element worked into the price to cover the cost of holding the goods and insurance. Clearly a store credit card was clearly superior to lay-by from the customer's point of view. But there was a risk from the store's point of view, albeit slight, that with the purchase of goods on credit that the customer might sell the goods before paying in full, thus coming within the buyer in possession exception to the *nemo dat* rule. Under this exception to the *nemo dat quod non habet* rule a buyer who has possession of goods, even though the legal title is still vested in the store, may pass a good legal title to bona fide purchaser for value without notice.[5] This was something of a danger but store credit cards were only given to valued customers with a good credit

[5] *Goods Act 1958* (Vic) s 31.

record, so the possibility of fraud was minimal. Moreover expensive items like white goods could be sold on hire purchase which was designed to circumvent the effect of the buyer in possession to the *nemo dat* rule. The store credit card had one obvious disadvantage: it could only be used at the particular store that issued it or at its branches. Nevertheless these cards had two key features of modern credit cards- immediate access to goods or services without cash and access to credit at the same time.

The first credit card on the scene in Australia in 1974 was the bankcard.[6] The first multi- outlet credit card in Australia was Bankcard which was founded in 1974 and was issued by a consortium of banks. A flood of bankcards was unleashed by nine banks which constituted a consortium. In less than a year there were over half a million bankcard holders. These bankcards were not solicited by customers. They were sent out without any written or oral request. The system operated on a paper basis. It was closed down on the 24th April 2007 following the introduction of Visa and MasterCard.[7] The Bankcard system only operated in Australasia.

### 4.3.1 Multi-outlet and international networks

The genesis of the multi-outlet card was said to be the Diners Club Card. A New York business man having discovered that he had forgotten his wallet in a restaurant came up with the idea of a card that could be used at any number of restaurants on Manhattan Island: the Diners Club Card. Thus was born the multi-outlet card. This card was actually not a credit card but a charge card since it did not offer a revolving credit facility, although there was a period of

[6] Alan Tyree, *Weerasooria's Banking Law* (2006) 119.

[7] < http://www.bankcard.com.au/> at 17 September 2008.

time after the cardholder receives the bill before it had to be paid. The addition of a credit facility to a multi-outlet card was the next step in the development of the modern credit card system.

The ‘stand-alone’ systems like Diners or American Express as the name implies do not rely on a network of banks or financial institutions that are franchised to issue cards to their consumer customers and merchant customers.

### 4.3.2 Co-operation versus competition

Does co-operation engender collusion? In contrast to the stand-alone card are those cards like Visa or MasterCard which license their cards to other financial institutions. This means that Visa and MasterCard could plug into existing national bank networks. There are pluses and minuses in this from the point of view of the participating institutions. First, it means that the brand name of Visa or MasterCard may appear prominently on the card issued by banks – the trend has been for this name and logo to appear smaller and smaller. Second, each bank competed with other banks for both merchants and cardholders. On the other hand, the nature of the credit card system involved co-operation and restrictions on competition. This fundamental tension has been the source of endless legal battles overseas and in Australia. What amounts to legitimate co-operation in terms of credit card operating systems and what can be regarded as a fetter upon competition itself is still a very blurred distinction

Both MasterCard and Visa started out as associations- any qualified financial institution could join. Members received the right to issue cards and enter into standard form agreements with merchants and consumers. In keeping with the co-operative nature of the organizations Visa and MasterCard developed and operated systems and advertised on a common basis. Making a profit was not the aim. Outside the agreed common core activities, the members competed with one another for merchants and consumers.

But Mastercard began floating its shares on the market in May 2006 and the float was a huge success.

On the other hand American Express and Diners started out as publicly listed companies in America and the shareholder members were, and still are, only passive equity owners. Shareholders elect directors in the normal way. American Express franchises its operations outside America, but this does not alter the fundamental nature of the organization. Like all publicly listed companies it seeks to give good returns to its shareholders who typically do not have any business relationship with it. It develops its own systems and markets this free from any input by shareholders.

Over the last few years, American Express claimed Visa discouraged its members from issuing cards by other payment processors. This had significant anticompetitive ramifications and there were reports of pending US legal action.[8] Partly in response to this and the commercial success of the Mastercard float, Visa in 2008 decided to go public. Member bank shareholding will be under fifty per cent, thus lowering exposure to legal risks.

### 4.3.3 Collusion

Collusion will also prevent the market from operating properly. There has been quite a lot of this in Australia. The Australian Competition and Consumer Commission (ACCC) is responsible for ensuring that payments system arrangements comply with the competition and access provisions of the *Trade Practices Act* 1974(Cth). The bankcard system introduced in Australia in 1974 had many anti competitive features that were eventually cleared by the then Trade Practices Commission subject to anticompetitive features being dropped

[8] <http://www.echolist.com/business/2006/october/news191456.html> at 24/3/2008.

but the banks therefore had for years de facto immunity stemming from their application before an adverse finding was made against them. [9]

Interchange fees were also in recent times the focus of anti-competitive legal actions. An interchange fee is the fee charged by one bank to process credit and debit transactions made on cards from another bank; for instance, you use your CBA credit card in a shop that has a NAB credit card terminal. The collective setting of such fees posed a problem under the price fixing prohibition under s 45 A of the *Trade Practices Act* 1974 (Cth). Moreover these fees were not transparent. Most cardholders had no idea that these fees were being passed onto them. The Australian Competition and Consumer Commission (ACCC) was concerned that interchange fees would restrict access to ATM and EFTPOS networks. Some participants in ATM and EFTPOS arrangements also suggested that interchange fees were anti-competitive, making making entry to the business difficult. Merchants have expressed concerns that restrictions on membership of credit card schemes place them in a worse competitive position on the fees they bear than is the case for debit card transactions.[10] Following legal action by the Australian Competition and Consumer Commission (ACCC) against the banks and credit card companies and the failure of an appeal in the Federal Court by Visa, Mastercard and Bankcard, the Reserve Bank of Australia (RBA) intervened (there can be no appeal from its decision). The upshot was that banks from November 2003 could only charge interchange fees that reflected true costs. This has just about halved the amount charged. The RBA and the ACCC have also sought to make the market more competitive by allowing in more players.

[9] See Robin Edwards, 'The Australian Payment System and Competition' Law and Economics Association Conference, Melbourne University, July 1997.

[10] Australian Competition and Consumer Commission <http://www.rba.gov.au/PaymentsSystem/Reforms/RevCardPaySys/Pdf/preliminary_conclusions_2007_2008_review.pdf >at 19 October 2009.

American Professor Scott, author of the US still born *Uniform Payments Code*, underscored a correlation, at least in America, between straight out price fixing and risk allocation by pointing out that once banks perceive a risk allocation system not to be in their interests they will try to fix the risks so as to set up the most ‘uncompetitive environment’.[11]

*Conclusion*

In this section it has been shown that the genesis of credit card operations – co-operative endeavor- has in it the seeds of collusion and that this has, at times, produced anti competitive behavior which is by its very nature inimical to efficiency. Although arguably not directly relevant to the efficiency of loss allocation it does, however, suggest a certain malevolent potential to exploit situations to garner benefits to financial institutions at the expense of consumers.

### 4.4 How allocation of liability for loss in regard to signature credit cards is governed

#### 4.4.1 Electronic Funds Transfer Code (EFT Code) does not cover credit cards used with signature

One might legitimately wonder what warrants a separate chapter on credit cards used with a signature rather than deal with the topic under the chapter dealing with EFT transactions given that nowadays even credit cards used with a signature depend on electronics for their functioning. The reason for the separate treatment is that the EFT code does not apply to cards used with a signature despite the fact that typically the credit card is swiped with an electronic reader and the cardholder (and sometimes even the merchant!) pushes the credit card button on the reader before he or she writes their signature on the voucher. It is, however, this very signature that is said to

[11] Hal Scott, ‘The Risk Fixers’ (1978) 91 *Harvard Law Review* 737, 742.

distinguish such a transaction from an electronic one where, for example, the cardholder merely inserts a PIN into the electronic reader. The fact that the EFT code does not cover manual use is somewhat confusing for cardholders. To further complicate the scenario several banks in Australia have facilitated the use of a credit card with a PIN. Cardholders will have a choice: pen or PIN. From the point of view of the merchant probably the use of a PIN is quicker and therefore more desirable. If a PIN is used with a credit card then the EFT will Code apply (this was covered in the last chapter).

### 4.4.2 Contract and Code of Banking Practice

The primary means of allocating liability is the contract between the cardholder and the card user. The next most important legal impact is arguably the Code of Banking Practice. (This will be dealt with more fully in regard to chargeback rights in a later chapter.)

In regard to a credit card used manually the cardholder is usually only liable for purchases made with the cardholder's signature or authorized by the cardholder. The evidentiary problems associated with PINS are therefore absent since each signature is unique to the signer, thus forgeries can be tested by a cryptologist if necessary. In broad terms, it echoes the common law position on negotiable instruments- a forged signature is a nullity.[12]

*Problems with signatures*

Nevertheless, even signatures can give rise to problems. Consider these examples that, needless to say, consumers consider fraudulent:

> **Example 1**.You hire a car in West Australia while on holiday but return it 2 days later because it's defective and you refuse to sign an imprint that the

[12] *Price v Neal* (1762) 3 Burr 1354, 97 ER 871; *National Westminster Bank v Barclays Bank* [1975] 1 QB 654 at 666. The common law rules in respect of negotiable instruments like bills of exchange and cheques have been codified respectively in the *Bills of Exchange Act 1909* (Cth) s 29 and the *Cheques Act 1986* (Cth) s 32.

hire car company has already taken from you for the full amount. You get a credit card bill which lists the full amount. The car company purports to have signed as your agent.

If the hire car company agreement has a clause allowing it to sign as agent of the cardholder then the cardholder, setting aside for consideration until later the effect of chargeback rights, you will have to pay the bill. In theory the cardholder may be able to bring an action on the underlying contract against the car hire company but since the amount involved is small it does not usually warrant legal action. Usually the contract between the cardholder and the bank does not prohibit the cardholder having the imprint signed by an agent.

**Example 2**. Jill has paid for a flight with credit card. On the bill it shows a much greater amount than she agreed to. The sales voucher has SOF (signature on file) in place of signature.

Again this works in a similar manner to where the merchant signs on behalf of the cardholder. In this case, however, the purchase of a plane ticket always has a clause that the amount can increase between 'time of purchase' and when the flight leaves. This explains the common use of SOF which in effect allows the travel agent to increase the amount.

The contract between the merchant and its bank may also play a role too. An example will suffice to explain this.

**Example 3.**[13] Mrs. Edwards, a 65 year old widow, received an unsolicited credit card from the bank which she cut up.[14] Two months later she received a credit card bill from the same bank listing the purchase of a frock for $300 from 'Young Things Fashions'. She rang up the bank and

[13] This happened shortly after credit cards were introduced in Australia. On file with author.

[14] Sending unsolicited credit cards is now illegal under the *Trade Practices Act 1974* (Cth), s 63A.

> denied liability, explaining she destroyed the card. At her insistence the bank eventually provides a photocopy of the credit card voucher. The signature was radically different from that of Mrs Edwards, something the bank should have been aware of since she operated a cheque account with it. It transpires that the merchant had a credit card voucher on which the credit card number of a young Mrs. Edwards swiped was blurry due to the swipe machine not working properly. The merchant rang up the bank and was given the old Mrs. Edwards credit card number, even though she had destroyed the card .This was in breach of the agreement between the merchant and the bank – the bank should have not revealed the number to the merchant in this manner. The claim against the elderly widow was ultimately dropped but only after several months of argument.

The above example demonstrates that even in terms of a relatively infallible authorisation device, a manual signature, the cardholder is in an invidious position since the bank will rely blindly on its system, a system to which the cardholder does not have a right of access.

*Imbalance of bargaining power*

Not only do cardholders not have the sophistication or economic clout to counteract the role of the financial institutions in determining the terms of the contract, it is also evident that they do not have the time or the ability to realize the consequences of credit card contracts they sign. Even sophisticated employees who sign for 'employee' American Express credit cards do not readily appreciate that if the employer company goes into liquidation they can be made liable on the contract they have signed, even if it has only been used for purchases for the business of the employer. True, they will have subsequently a right to prove in the liquidation but this is cold comfort.[15] Or

[15] Robin Edwards, 'Credit Cards: Conundrums and Cures (with Words and Music)' (2003) 77 (12) *Law Institute Journal* 55.

take another common situation, husband and wife credit cards. The wife's credit card is a subsidiary card. The marriage breaks down and the wife departs running up substantial bills with her credit card. Prima facie the husband is liable. The Code of Banking Practice improves the situation somewhat.[16] It provides:

> 27.2 When accepting a Customer's instructions to issue a subsidiary credit or debit card, a Bank shall:
>
> (i) provide general descriptive information to the primary cardholder on his or her liability for debts incurred by the subsidiary card holder by use of the card; and
>
> (ii) inform the primary card holder of the means by which a subsidiary card may be cancelled or stopped and the fact that this may not be effective until the subsidiary card is surrendered.

The Code of Banking Practice is an improvement; but it still expressly points out that the primary cardholder may still be liable until the subsidiary card is surrendered. This is rather difficult if the ex spouse is in India with a new paramour and the subsidiary card. The Code of Banking Practice, of course, only applies to banks.

All of the above supports the notion that the terms of the credit card contract including allocation of liability are largely dictated by financial institutions.

*Conclusion*

In this section it has been shown that allocation of liability for unauthorized transactions depends on contract and that signature is a good biometric indicator of authenticity. However, contract allows banks to extend what is meant by 'authorization' and this can lead to abuses.

[16] There was a Review of the Code of Banking Practice 2007-8 but it left untouched the treatment of subsidiary cards.

### 4.5 American Law and fraud allocation

In America liability for unauthorized use of a credit card is covered by *Truth-in- Lending Act* (TILA) §133(a)(1)(B).[17] Basically the credit holder is only liable if he or she fails to report the unauthorized use of the card to the issuer. Even then the cardholder is only liable for US $50. It does not matter that the cardholder has been negligent in losing the card or in not reading statements relating to the card. The burden of proof is upon the card issuer to show that the use was authorized or, if the use was unauthorized, then the burden of

---

[17] Codified *15 USC § 1643*. Liability of holder of credit card

(a) Limits on liability

(1) A cardholder shall be liable for the unauthorized use of a credit card only if –

(A) the card is an accepted credit card;

(B) the liability is not in excess of $50;

(C) the card issuer gives adequate notice to the cardholder of the potential liability;

(D) the card issuer has provided the cardholder with a description of a means by which the card issuer may be notified of loss or theft of the card, which description may be provided on the face or reverse side of the statement required by section 1637 (b) of this title or on a separate notice accompanying such statement;

(E) the unauthorized use occurs before the card issuer has been notified that an unauthorized use of the credit card has occurred or may occur as the result of loss, theft, or otherwise; and

(F) the card issuer has provided a method whereby the user of such card can be identified as the person authorized to use it.

(2) For purposes of this section, a card issuer has been notified when such steps as may be reasonably required in the ordinary course of business to provide the card issuer with the pertinent information have been taken, whether or not any particular officer, employee, or agent of the card issuer does in fact receive such information.

(b) Burden of proof

In any action by a card issuer to enforce liability for the use of a credit card, the burden of proof is upon the card issuer to show that the use was authorized or, if the use was unauthorized, then the burden of proof is upon the card issuer to show that the conditions of liability for the unauthorized use of a credit card, as set forth in subsection (a) of this section, have been met.

(c) Liability imposed by other laws or by agreement with issuer

Nothing in this section imposes liability upon a cardholder for the unauthorized use of a credit card in excess of his liability for such use under other applicable law or under any agreement with the card issuer.

(d) Exclusiveness of liability

Except as provided in this section, a cardholder incurs no liability from the unauthorized use of a credit card.

proof is upon the card issuer to show that the conditions of liability for the unauthorized use of a credit card have been met. Nevertheless, there is some incentive to notify the loss or theft in order to reduce liability even below US $50: see TILA§133(a)(1)(E). Moreover, some major cards in the US, notably, Visa and MasterCard provide that if cardholders promptly report lost or stolen card there will be no liability at all for unauthorized use.[18]

There has, however, been one court decision that, despite the TILA provisions, has decided that the cardholder was so negligent the cardholder should be liable beyond US$50. In *Minskoff v American Express Travel Related Services Co,*[19] Minskoff Equities, a real estate firm, hired a Susan Schrader Blumenfeld to check invoices and credit card statements including the one for the corporate account. This was something that Minskoff in the past, the president and chief executive officer, had done. Blumenfeld incurred close to US $30,000 as a cardholder on the corporate account for her own benefit and subsequently arranged for corporate cheques to be drawn to pay for this. Minskoff did not check any of this. Blumenfeld then arranged for platinum cards to be issued in her name (not telling him about this) and also in Minskoff's name, falsely telling him it was an upgrade of his existing card. She then ran up about US$250,000 on her platinum card. She arranged for corporate cheques to pay the credit card charges to pay for these and other charges. Numerous credit card bills were sent to the company address and listed Blumenfeld and Minskoff as the cardholders and listed all the items. The company's financial controller eventually discovered the fraud. Mahoney, one of the Circuit Judges, made the following point:

> We are not dealing in this case with an occasional transgression buried in a welter of financial details. In our view, once a cardholder receives a

[18] http://usa.visa.com/personal/student/credit_101/credit_protection.html at 20 November 2009; http://www.mycccu.com/images/pdf/ccagreement09.pdf at 20 November 2009.

[19] 98 F 3d 703 (2d Cir 1996).

statement that reasonably puts him on notice that one or more fraudulent charges have been made, he cannot thereafter claim lack of knowledge.[20]

The court's finding of negligence, however, should perhaps be viewed in the light of the long held US tradition of imposing on customers an obligation to read bank cheque statements. Notwithstanding this, the case seems to take away a great deal of the protection offered by the TILA if it were to be used as a precedent in consumer transactions.

### 4.6 Forgery of signature by itself is not the major cause of fraud with manual use of credit cards

Skimming is probably the main source of credit card fraud.[21] A rogue, using a small hand device, for example, a waiter in a restaurant, swipes the card and takes all the information on magnetic stripe on the bank of the card. A new bogus card is then created with a forged signature on the back. Thus when the card is swiped at a merchant's terminal and a signature is required on the voucher there is a perfect match between the one on the card and the voucher. An even more daring version of the scam is when the 'skimmer' attached to an ATM and a small concealed camera reads the cardholder's PIN. There have been widespread media reports of these scams.

Credit cards with a microchip only cannot be skimmed because the information in the chip cannot be read out without interacting with the chip and card skimmers, for the present, cannot do this. However, the problem is that most chip-enabled credit cards still have a magnetic strip on them to be compatible with older style ATM and point of sale readers. Banks in Australia are said to be exploring microchip only credit cards but the cost is significant

---

[20] Ibid, 710.

[21] Angus Kidman, *Minimising The Risk Of Credit Card Fraud* <http://www.lifehacker.com.au/minimising_the_risk_of_credit_card_fraud/> at 22 January 2009.

and one presumes that the amounts lost to skimming are less than the cost of installing chip technology.[22] Cardholders are not concerned as long as skimming fraud is not directly paid by them. However, reports of Australian magstrip credit cards being blocked overseas because of skimming may also act as a spur to the introduction of microchip only cards.[23]

It goes without saying that fraud over the phone or internet using the information is even easier since the more sophisticated skimmer can also record the security numbers on the back of the card which are not on the magnetic strip. In 2006-07, Australian Payment Clearing Association figures suggest domestic and overseas CNP (card not present) fraud on Australian-issued cards reached $40 million. The statistics on skimming (over $11 million with Australia and nearly $30 million overseas using Australian issued credit cards) do not show how much can be attributed to the use of bogus credit cards used with signatures. But it would seem that CNP (card not present) using the phone and the internet is the preferred option for rogues.

*Card present fraud*

One would have thought that with 'card present' fraud resulting from skimming, a photo on the credit card and a requirement that a driver's license with a photo be shown, might act to deter this sort of fraud. However, a determined rogue might also be able to reproduce such a driver's license; admittedly, this might entail the risk that a merchant might make a copy of it and thus there would be a photo of the rogue.

---

[22] *The Australian IT* 26 February 2008 'Credit Card Security Does Travel Well': <http://www.australianit.news.com.au/story/0,,23273223-24169,00.html?from=public_rss> at 12/03/08.

[23] The Australian IT Feb 26, 2008 'Credit Card Security does travel well': <http://www.australianit.news.com.au/story/0,,23273223-24169,00.html?from=public_rss>.at 12/03/08.

'Card present' abuse from skimming requires a signature and is therefore not any different from lost or stolen cards from the point of liability since both require a signature. Since the signature will be a forgery prima facie the cardholder will not be liable. Where a credit card has been skimmed, however, the card holder may not become aware of the abuse until receipt of the credit card bill.

*Conclusion*

The simple nature of the standard credit card facilitates 'skimming', the major source of fraud. The inevitable conclusion is that the profits from credit card operations must be great enough to absorb this cost.

### 4.7 Cost efficiency of the rule for manual use of signature credit cards

In this section the following Cooter and Rubin 'rules' to assess efficiency of allocation of liability for fraud loss will be used:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Loss bearing*

Generally speaking efficiency theory supports the idea that the parties will, all other things being equal, arrive at an efficient agreement. It could hardly be supposed that a cardholder, for example, would freely agree to being made liable if the signature on the voucher were not genuine. Thus, in so far as agreements and card issuers are concerned, the basic mechanism that determines liability is, of course, a genuine signature on a voucher. Thus, the loss seems to fall on the banks, the party that can most easily bear the loss.

This does not differ therefore from the position with cheques. It will be recalled that the codification of the common law, however, provides that a forged or unauthorized signature can still bind if there is ratification or if estoppel is established.[24]

There is also likely to be qualifications on the card issuer bank's liability for paying out on forged signatures on credit card vouchers. Typically, the contract will make the cardholder liable for unauthorized use until the bank is notified that the card has been stolen or lost up to a certain amount, usually a low one.[25]

The banks in theory could impose greater liability on cardholders since it is mainly a matter of contract, with the banks having the whip hand but competitive pressures act as something of a restraint. But the bank must also bear in mind the impact of unconscionability in equity and provisions in the legislation, Part 2, subdivision C of the *Australian Securities and Investments Commission Act* 2001(Cth) dealing with unconscionability. If, for example, the cardholder were made liable for a very large percentage of a loss stemming from unauthorized use of a credit card including forgery, for example, unlimited liability, because the cardholder failed to report it after becoming aware of it, then this might be considered unconscionable. The provision that the cardholder notify the bank as soon as they are aware of loss or theft of the card is unobjectionable if the penalty for failing to do so is reasonable in size; it should be enough to act as an incentive to report but not amount to a penalty.

*Loss avoidance*

The genesis of the fraud is the loss or theft of the card. Is not the cardholder in a good position to avoid the loss? In the case of loss, yes, perhaps. In the case of theft this is dubious. Would locking the house suffice? Or should one place

[24] *Cheques Act 1986* (Cth) s 32.

[25] Alan Tyree, *Banking Law in Australia* ( 2005) 325.

the card also in a locked drawer? Or perhaps the card is only secure from theft in a safe? This is somewhat reminiscent of the arguments raised by the banks in the *Hokkit* case in favor of a duty of care on customers in safeguarding cheque books. The difficulty of calculating the costs was noted by Mahoney P:

> The Court has no evidence to show what would be the cost to the customer of doing what such an obligation involves. That cost may be large or small depending on, e.g. the size and circumstances of the customer and its business. But the obligation, if it is to be imposed, is to be imposed on each customer, large or small.
>
> It is relevant to consider also what benefit would flow from the imposition of such an obligation on the customer. It is appropriate to consider the relationship between the burden imposed and the benefits likely to flow from the imposition. The evidence does not assist the making of such an assessment. But, in my opinion, it is proper to think that such reasonable precautions will not prevent all forgeries: some will occur despite what the customer does.[26]

The writer's current Commonwealth Bank of Australia(CBA) Conditions of Use for Credit Cards are worthy of comment.[27] For a start it is not particularly clear which parts apply with electronic use and which parts apply when the card is used with a signature. This stems from the fact that the EFT Code only applies when the card is used electronically, for example, the card number over the phone or by using the card with a PIN. But the CBA conditions apply to both EFT use and manual use. This is confusing but understandably banks did not wish to issue two separate conditions for use, one for manual use and one for electronic use. Condition 29 provides that the card holder will be liable for losses resulting from unauthorized use (burden on bank to prove on balance of probability) that a user contributed to the loss

[26] (1996) 39 NSWLR 377, 391.

[27] CC2 131207, current and viewed March 2008.

"(a) …

(b) resulting from a user's unreasonable delay in notifying us after the user became aware of the misuse, loss or theft of a card forming part of the access method,[28] or that the security of all the codes forming part of the access method has been breached . We recommend that you check entries on your statement as this will assist us in detecting fraud and lessen the chance of fraud occurring."

The cardholder is liable for the actual losses occurring before the bank was notified that the card had been misused lost or stolen but not for any portion of the loss on any one day that exceeds the daily transaction limits.[29]

It may be possible for cardholders to extricate themselves from liability if there has been fraud or gross negligence on the part of the merchant. In one 'old' 1945 American case *Gulf Refining Co v Williams Roofing Co*[30] the agreement between the cardholder (Williams) and issuer (Gulf) attempted to make the cardholder liable for all unauthorized transactions prior to notification. Williams had written "Good for Truck only" on the card. The rogue had used the card a couple of hundred times and not using a truck before Williams became aware of it. There was also some evidence that some of the merchants were aware that the person using the card was not entitled to do so. It was held that Williams could not be made liable by Gulf, the issuer.

Under the CBA conditions a cardholder's basic obligation is to notify the bank once aware of the misuse theft or loss. If the cardholder does not do this he or she will be liable for the loss. It is to be noted that that there is no $50 limit as there is in the US. The Australian conditions also exhort the cardholder to

---

[28] "access method" is defined as 'a method we make available to users to allow them to give us instructions. Use of the access method is our mandate to act on these instructions …" CC2 131207, current and viewed March 2008.

[29] Condition 30 (b). CC2 131207, current and viewed March 2008.

[30] (1945) 186 SW2d 790.

check credit card statements (but do not actually make liability depend on this). The American position is therefore on the face of it much more consumer protective.

In a seminal article Brandel and Leonard suggested a figure of $50 to differentiate between small “cash “like transactions and true credit transactions. [31] This might have some logic in regard to the issue of whether defences should be able to be set up by the cardholder against the merchant but it is difficult to see its immediate relevance to forgery or unauthorized use other than, perhaps, to act as some sort of spur to make cardholders guard against loss theft or misuse. This is indeed how Cooter and Rubin see the $50 ceiling: it puts the obligation on the party who can avoid the loss at the lowest cost (Cooter and Rubin rule 2). [32] Professor Mann argues in favor of the $50 ceiling on liability on the basis that chargebacks - a reversal of payment from the merchant - would be more likely to be abused in regard to small transactions.[33] But Professor Rosenberg points out that logically there would be more likely to be an abuse of chargeback rights in regard to big ticket items – why would a rogue go to the trouble of making a bogus chargeback if it was not financially worthwhile?[34]

If the raison d’etre of the US $50 ceiling is to make credit card holders report lost or stolen cards, then the Australian CBA conditions take it a step further since the cardholder can be made more liable than $50 if she or he unreasonably delays reporting - up to the actual loss or the daily limit.

[31] Roland Brandel and Carl Leonard, ‘Bank Charge Cards: New Cash or New Credit’(1971) 69 *Michigan Law Review* 1033.

[32] Robert D Cooter and Edward L Rubin, ‘A Theory of Loss Allocation for Consumer Payments’ (1987) Vol 66 *Texas Law Review* 63, 97.

[33] Ronald Mann,‘Making sense of Payments Policy in the Information Age’ (2005) 93 *The George Town Law Journal* 633, 667.

[34] Arnold Rosenberg,‘Better than Cash? Global Proliferation of Payment Cards and Consumer Protection Policy’ (*2006*) 44 *Columbia Journal of Transnational Law*, 520.

The other issue that could be questioned in terms of efficiency is what amounts to authorization. Usually the contract between the cardholder and the bank make some reference to this; for example, the Commonwealth Bank Conditions of Use for Credit Cards[35] provides in s 16:

> You have to pay us
>
> - amounts you authorize a merchant to charge on your card if certain events occur.

Merchants can make it a part of the contract between themselves and the cardholder that they can sign vouchers as agents on behalf of cardholders. Efficiency and fairness would support the idea that this should be transparent. Most cardholders, however, only become aware of this after the event either because they do not read the contract or because they have no latitude in negotiating the terms. In the event of a dispute the merchant has, in effect, the key to the cardholder's money because the merchant can sign for the cardholder. The cardholder's only practical remedy may be to try and avail themselves of chargeback rights.

It could be said that contract law that provides that the cardholder is only liable for vouchers signed by the cardholder is, in theory, unobjectionable in terms of efficiency. However, since the cardholder-card issuer contract allows cardholders to 'authorize' others to sign vouchers on their behalf, it is open to abuse by merchants and may lead to cardholders being made liable when contractually, between the cardholder and the merchant, and there may be no liability at all.

As for liability for subsidiary cards this would seem to be a crude but effective attempt by financial institutions to make as many people liable as possible. It is somewhat reminiscent of guarantees whereby the bank tries to make a third

[35] CC2 131207, current and viewed March 2008.

party liable for the borrower's debt; but with cards, of course, there is an absence of equity's concern.[36] If the subsidiary cardholder cannot be made liable the bank attempts to make the prime cardholder liable. The Code of Banking Practice - apart from just applying to banks - is feeble protection since it still provides that liability of the prime cardholder is ultimately dependent on the subsidiary card being returned.

Efficiency theory posits that the parties will arrive at a contract whereby there is an efficient allocation of loss. This assumes that the parties have the same level of knowledge and bargaining power. The above examples, demonstrate that this is not the case.

In terms of efficiency the bank in the best position to bear the loss as it can pass it on to other users. And that is basically what happens when there is an obvious forged signature on a credit card voucher. The bank may be able to recover the money from the merchant via chargeback but whether it can do this will depend on the contractual terms of the credit card network reflected in the terms of agreement between the merchant and the acquirer bank (the bank that acquires the signed vouchers or electronic equivalent – the merchant's bank). Where there is manual use of a credit card network rules usually provide that the issuer bears the loss as long as the merchant has checked the signature and the transaction is authorized, the merchant is thus assured of payment. (The situation with 'card not present' for example, over the internet does, however, allow for chargebacks for unauthorized transactions[37] – this will be dealt with in a subsequent Chapter).

In terms of checking the signature, the agreement between the merchant and the 'accepting' bank usually provides that the merchant must use reasonable

---

[36] Of course, banks will argue it merely reflects joint and several liability. Be that as it may, couples are usually offered credit cards on a 'principal and subsidiary basis' rather than as separate cards.

[37] Ronald J Mann, *Payment Systems and Other Financial Transactions* (2003), 137.

care to detect forged or unauthorized use or forgery.[38] So whether there can be chargeback or not depends on whether the merchant has taken such reasonable steps. This seems to make sense in terms of Cooter and Rubin's second rule about loss avoidance. The merchant can check the signature of the rogue against the one on the card. In theory this not difficult to do but in practice pressure of work give employees only scant time to check signatures. However, there may be other indications that there is a fraudulent transaction afoot, for example, demeanor of the rogue etcetera. The merchant can also ask for proof of identity. (The issuer bank will also have a copy of the cardholder's signature but it will not receive the vouchers until later after the merchant's account has been credited by the acquirer bank (the merchant's bank), so it is not in the same proximity to the fraudster.)

Probably the most important Cooter and Rubin 'rule' is about loss spreading: which party can most easily bear the loss? It is also worthwhile reflecting on the contract between the merchant and the bank. In one way it behooves merchants to increase the amount of credit card transactions to obtain a better deal from the banks but this may have the effect of reducing the incentive for the banks to reduce fraud, for example, by putting photos on credit cards, since they are making so much money. Arguably it is easier for the banks to write off any losses stemming from fraud and charge the merchants more.

Where there is a forged signature the merchant has lost the goods and may not be paid if the merchant has not taken reasonable care to detect the forged signature. The agreement between the bank and merchant usually provides that the bank determines this.[39] If the merchant is an individual or a Small Business and there may be recourse to the Banking and Financial Services Ombudsman – since 2008 called the Financial Ombudsman Service -if the merchant is dissatisfied that there has been a chargeback. In addition the merchant may

[38] General Conditions ANZ Merchant Services cl 6 (vi) 2008-10-02.

[39] General Conditions ANZ, above fn 38.

very well have to pay a chargeback fee and transaction fees for a sale. Therefore if there is a clear example of forgery on a credit card voucher the bank may be able to pass the loss onto the merchant who must absorb it or, in turn, pass it on to his customers in terms of the price of goods and services and/or claim it as a tax loss. This perhaps may have unintended consequences for the merchant since suspicion about credit cards may in fact turn away consumers with valid cards.

Putting the loss on the merchant where there is a detectable fraudulent signature on credit card vouchers also removes any incentive for the banks to improve safety of credit cards in card present situations, for example, by having a photo on the card or thumb print recognition. In most cases, however, the fraudulent signature on the credit card voucher will not be obvious and therefore, as long as the merchant has made a bona fide attempt to check it against the card, most merchant/bank card agreements provide that the merchant will be paid. This means that the loss will be borne by the issuing banks which are in an excellent position to spread the loss, thus according with Cooter and Rubin's first rule.

*Rule efficiency*

What determines allocation of loss resulting from forgery with signature credit cards is ultimately the contract between the cardholder and the bank. In theory, at least, conditions between banks can vary a great deal. The Financial Ombudsman Services is ultimately going to have to adjudicate on these terms and conditions as they are impacted by legislation and the Code of Banking Practice and each case with a different bank conditions presents problems of different interpretations. It would be simpler if there was one rule for all financial institutions that put primacy on the loss spreading principle. This would also act as a spur for credit card safety improvement. The American position therefore is advocated.

*Conclusions*

There are some serious reservations about what amounts to authorization and liability in regard to subsidiary cards – this facilitates abuse and fraud. The allocation of loss for forgery is also somewhat dubious in terms of efficiency: the cardholder whose signature on a voucher will usually not be liable; the bank may be able to recover the payment from the merchant by way of chargeback if it is an obvious forgery- the merchant will in turn attempt to pass on the cost of the loss, thus facilitating loss spreading. However, if this happens there is absolutely no incentive for banks to improve safety of cards. On the other hand, if the loss of the forgery falls on the banks – the current situation with a non apparent forgery- it could act as a spur to improve the safety of the credit card. The falling of the loss on the banks would facilitate loss spreading and therefore improve efficiency.

**Summary**

To improve efficiency this thesis advocates the following:

- The adoption of a law like the American *Truth in Lending Act* whereby the credit holder is only liable if he fails to report the unauthorized use of the card to the issuer.
- A low threshold of $150 for failure to report which might induce caution on the part of the cardholder in regard to loss.

# Chapter 5

# ALLOCATION OF LIABILITY FOR FRAUD WITH CHEQUES

## 5.1 Overview

This chapter will examine the rule regarding forgery rule and assess whether it is efficient in the light of the principles outlined in Chapter 2. Despite the fact that cheque law, derived from bills of exchange law is ancient there are still many areas where the law is still unclear and even controversial. Uncertainty is, of course, an enemy of efficiency: people cannot arrange their affairs with confidence; assessment of legal outcomes, if it is sought, will be complex and hedged with qualifications; and litigation, if it occurs, will be uncertain and costly.

## 5.2 Outline of this Chapter

This chapter will examine whether the allocation of fraud loss with cheques is efficient by addressing the following questions.

- Who bears liability if the drawer's signature is forged and is the allocation of the loss efficient?
- Will the bank always bear the loss if it fails to obey the customer's mandate (*Ligget's* case) and is this exception efficient?
- What is the liability of parties subsequent to forgery of the drawer's signature and is this efficient?
- What is the position of the drawee bank and the collecting bank in regard to forged indorsements and is the allocation of liability efficient?

One of the important Cooter and Rubin rules in favor of efficiency is the 'rule' that the best rule is the simple rule. If the law is unclear or unduly complicated then it will offend this principle. To appreciate whether this is the case it is necessary to examine the legislation and cases relevant to forgery.

**5.3 Legislative background**

In Australia the law relating to bills of exchange is contained in the *Bills of Exchange Act* 1909 (Cth) which is based upon the English *Bills of Exchange Act* 1882 with some minor differences. The English *Bills of Exchange Act* is a summary or condensation of the principles deriving from 2500 English judicial decisions. This Act also governs the law relating to promissory notes. Since 1986 the law relating to cheques has been contained in the *Cheques Act 1986* (Cth). Prior to this the law that governed cheques was the *Bills of Exchange Act* 1909 (Cth). Many of the provisions relating to cheques and bills of exchange are the same or very similar.

Before looking at these 'rules' it should be noted that although the main elements of the rules, the skeleton, are well established, the articulations and sinews are not so well defined. Despite the fact that the legislation has been around for more than two centuries and the case law even longer, there are still a number of controversies surrounding facets of these rules. The area has proved to be a worthy ground for battles between customers and banks.

**5.4 The forgery rule**

In this section the forgery rule and the estoppel and ratification exceptions will be examined as well as how banks have tried to use the estoppel exception to their advantage; and how banks have tried to shift the loss to the customer by arguing that the customer has a duty to guard against forgery.

### 5.4.1 The drawer's signature

According to s 32 of the *Cheques Act* 1986 (Cth) a forged signature on a cheque is totally inoperative and therefore the drawee bank has no right to debit the customer's account unless the customer has ratified the unauthorized signature. It does not matter that the forgery is a clever one, that is, difficult for the drawee bank to detect. If there is a forgery the drawee bank has no mandate to pay.[1] The only other circumstances where a drawee bank will be entitled to debit an account will be where there has been a forgery of the customer's signature and estoppel can be established.

The above paragraph refers to forgery but s 32 of *Cheques Act* 1986 (Cth) actually merely refers to unauthorized signatures, a forgery being encompassed by this wider concept. Many unauthorized signatures will be saved by the apparent authority concept, outlined below.

For example, in *Liggett (B) (Liverpool) Ltd v Barclays Bank Ltd* [2] Wright J in the King's Bench Division had to decide whether a bank that had paid without the mandate of its customer was liable to the customer for the payment. The plaintiff company had two original directors, Liggett and Melia, though the articles allowed the directors at any time to appoint an additional director. The bank was instructed to honour cheques signed by both of the two directors, although sometimes cheques were signed only by Liggett when Melia was away, and Melia had to be called in later to add the necessary second signature after the cheques had been paid. Melia was not happy with the way Liggett

[1] *National Westminster Bank v Barclays Bank International Ltd* [1975] QB 654.

[2] [1928] 1 KB 48.

had conducted the company's affairs and instructed the bank not to pay cheques without his signature until he had been communicated with. In September that year, Liggett as chairman of the board falsely informed the bank that his wife had been appointed as an additional director, without Melia's knowledge. Later the bank honoured cheques signed by Mr and Mrs Liggett. In an action by the company against the bank to recover as money had and received the amount paid out by the bank without authority, the bank sought to rely on the 'indoor management rule' also known as the rule in *Turquand's* case.[3] Under this rule the outsider dealing with a company can assume that the internal proceedings of the company were properly carried out. The most important exception to the rule in *Turquand's* case arises where the outsider is put upon enquiry by the circumstances of the case and fails to make inquiries. The jury found that, because of the concern expressed by Melia of the way in which the affairs had been conducted by Liggett, the bank should have made inquiries to satisfy itself that Mrs Liggett had been properly appointed, and as it had not, it could not rely on the indoor management rule. However, had the bank not been put upon enquiry the court would have undoubtedly found that the signature, although not authorised, was binding upon the company customer because of the indoor management rule.

By way of contrast, in *Majesty Restaurant Pty Ltd (in liq) v Commonwealth Bank of Australia Ltd* [4] Majesty's cheques were supposed to be signed by two directors and a large number were in fact signed by just one director, Liu. However, Liu was appointed the only Director and Liu was authorized by the company to issue cheques on behalf of the company to pay trade creditors. Majesty argued that, notwithstanding Liu's authority, the bank had no mandate to honor cheques that were drawn on the account and only signed by Liu. Majesty claimed damages for the value of the cheques, alleging that they were not made in accordance with the mandate which stipulated signature by two

[3] *Royal British Bank v Turquand* (1856) 6 E & B 327.

[4] (1998) 47 NSWLR 593.

directors. Hunter J decided that the director had the authority to sign the cheques vis-à-vis the payees. This meant that the debts were discharged and the claim for damages against the bank failed.

Would the application of ostensible authority lead to the same result in similar circumstances even if the signature on the company cheque were a forgery? Given the reasoning in *Majesty* it might be so argued. The word forgery can be used in a number of ways. [5] If forgery is used in the sense of signing where the agent or officer of the company has no authority to do so, then even though the person might be acting fraudulently, there is little doubt that the indoor management rule will apply and the principal will be bound.[6] Forgery in the sense of an actual counterfeit signature is more problematic. The case of *Ruben v Great Fingall Consolidated*[7] is often put forward as authority for the proposition that at common law the indoor management rule has no application where there is a forgery.[8] However, Gower comments that:

> The truth seems to be that there are no reasons why the fact that there is a forgery should exclude the *Turquand* rule. All the decisions can be explained on the ground either that the forged document was not put forward as genuine by an officer acting within his actual or apparent authority or that the person was put on inquiry.[9]

---

[5] Section 32 of the Australian *Cheques Act 1986* (Cth) refers to unauthorised signatures rather than forgery and provides that they are totally inoperative subject to estoppel and ratification, but s 3(6) defines unauthorised signature as including forgery**.**

[6] *A L Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775, 791-792; *Lloyds Bank v Chartered Bank of India, Australia & China* [1929] 1 KB 40; *Uxbridge Permanent Benefit Building Society v Pichard* [1939] 2 KB 248; *Alliance and Leicester BS v Edgestop* Ltd [1993] 1 WLR 1462.

[7] [1906] AC 439.

[8] See also *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146.

[9] Lawrence Gower, *Gower's Principles of Modern Company Law* (1979) 205.

Whatever the position is at common law, s 128(3) of the *Corporations Act* 2001 (Cth) would seem to overrule *Ruben's* case even if one assumes the case does establish that the indoor management rule does not apply to forgery. It provides as follows:

> The assumptions [referring to a statutory version of the indoor management rule] may be made even if an officer or agent of the company acts fraudulently, or forges a document in connection with the dealings.

This appears to be a legislative adaptation of the rule in *Lloyd's v Grace Smith & Co*[10] that establishes the principle that the principal can be bound by the acts of an agent that are within the scope of actual or apparent authority notwithstanding that the agent is acting fraudulently or in pursuance of his own interest. The predecessor provision of s128 (3) was applied in *Story v Advance Bank Ltd*[11] where a director of a company forged his co-director's signature on a mortgage. Given that the mortgagee had no knowledge of the forgery and was not disqualified by the statutory analogues of the put upon enquiry exception, it was held that the bank was entitled to assume that the mortgage was duly sealed and valid.

At the very least it is arguable that a forgery on a company cheque may still bind a company customer.

*Estoppel*

Once the customer knows that his or her signature has been forged he or she should notify the bank - failure to do so may raise an estoppel against the

[10] [1912] AC 716.

[11] (1993) 10 ACSR 699.

drawer. This is known as the *Greenwood* duty. [12] Greenwood operated a trading account at his bank in his name alone. His wife forged her husband's signature on 44 cheques. Mr. Greenwood had known of this for some time and told his wife to stop doing it; however she continued and he threatened to tell the bank of the forgeries. Mrs Greenwood committed suicide. Mr. Greenwood subsequently argued that his account should be re-credited with the sums paid out by the bank on the forged cheques. The Court held that Mr. Greenwood was under a duty to his bank to disclose the forgeries to the bank when he became aware of them. His deliberate silence led the bank to act to its detriment in honoring these instruments when they were presented for payment. Accordingly, the Court held that Mr Greenwood was unable to deny the genuineness of the forged signatures due to his actions and therefore he suffered the loss, not his bank.

The *Greenwood* duty extends to notifying the bank of any unauthorized transaction on the account of which the customer is aware[13]; but there is no duty on the customer to read his cheque statements let alone be bound by them.[14] Nor does it appear that the customer has to go out of his way to discover forgeries.[15]

It may be possible to establish estoppel through agreement. In *Tai Hing Cotton Mill Ltd v Lui Chong Hing Bank Ltd* [16] an accounts clerk employed by a textile manufacturer forged the managing director's signature on 300 cheques and made off with HK$5.5 million over a six year period. It was agreed between the manufacturing company and its bank that it would notify them if there was

[12] *Greenwood v Martins Bank Ltd* [1933] AC 51; *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80, [1985] 2 All ER 947.

[13] *West v Commercial Bank of Australia* (1935) 55 CLR 319.

[14] *Keptigalla Rubber Estates Ltd v National Bank of India Ltd* [1909] 2 KB 1010.

[15] *National Bank of New Zealand Ltd v Walpole and Patterson Ltd* [1975] 2 NZLR 7.

[16] [1986] AC 80, [1985] 2 All ER 947.

any error on the monthly cheque statement otherwise they were deemed to be confirmed. This had not been done. The banks argued that the customer owed them a duty of care to object to the forged cheques which appeared on the bank's periodic statements. The Court rejected this view indicating that the failure of the company to object to these statements cannot be interpreted as a representation to the banks that the relevant signatures were genuine. Thus the banks were held liable to reimburse the company. Of course had it been established that the company was aware of the forgeries, the decision in *Greenwood's* case, above, may have been followed. It therefore seems that 'verification' clauses will only be effective if the full import of them is understood by the customer.

In Canada in *Arrow Transfer Co v Royal Bank of Canada,*[17] the Supreme Court of Canada upheld the effectiveness of 'verification' agreements.

However, sometimes 'estoppel' agreements can produce perverse effects. The typical agreement will say, for example, that the customer will be bound by debits shown in the statement unless the customer notifies the bank within X days. The scenario in *Tai Hing*
is typical, namely, a rogue employee who forges the employer's signatures on cheques. The rogue does this in a modest way to begin with, and then works up to larger sums as time goes by. If the 'estoppel' agreement is legally binding then the customer will be estopped from denying liability on those debits on earlier statements that the customer did not respond to but will not be bound by the debits shown on the last statement, assuming the customer reports it within X days, even though the sum on the last statement might be larger than the sums reported on previous statements.

[17] [1972] SCR 845, 873.

### 5.4.2 Banks argue for a more extensive duty for the customer

So far discussion has been confined to a duty to examine bank statements and whether the customer is bound by these. Clearly there is a duty on the bank not to pay out on forgeries but is there a wider concomitant duty on the drawer to guard against forgeries? Banks throughout the world have tried to argue this. The argument by the banks is along the lines that the customer should be careful in terms of guarding the cheque book and vetting those people who have access to it, amongst other things. In the *Tai Hing* cotton case in the Hong Kong Court of Appeal it was found that the company customer owed such a duty of care in tort in regard to cheques. This decision was overturned by the Privy Council that denied the existence of any such duty. In Canada in *Arrow Transfer Co v Royal Bank of Canada*,[18] Laskin J, the dissenting judge, although finding that a verification agreement was ineffective because of its wording, did find that the company customer's careless methods precluded it from later complaining about large numbers of forged cheques that the bank had paid, thus apparently recognizing a wider duty. His views on this point were adopted at first instance in *Canadian Pacific Hotels Pty Ltd v Bank of Montreal*[19] but rejected on appeal by the Supreme Court of Canada.

Banks in Australia have also tried to establish this wider duty. In *National Australia Bank Limited v Hokit Pty Limited* [20] the bank contended unsuccessfully that the burden of forgery should be borne by the customer unless the customer had taken against the forgery precautions; for example, by safeguarding the cheque book, or by being careful which employees could fill out cheques. However, the Court decided that the weight of authority was against the bank in asking the Court to change the law. Mahoney P said, making direct reference to the principle of loss spreading:

---

[18] [1972] SCR 845, 873.

[19] (1987) 40 DLR (4d) 385.

[20] (1996) 39 NSWLR 377.

> I am of the opinion that the Court should not impose upon the bank customers the duties proposed by the Bank. As I have indicated, the existing law operates, to an extent, to impose upon a bank the burden of a default, namely, forgery, for which it was not responsible and which, in many instances, it cannot detect. However, the size of that burden is not apparent. *The Bank may relieve itself, overall, of the burden by taking into account the economic effect of it in determining the fee to be charged to customers for the management of their current accounts. It may - as far as the evidence before the Court indicates - place the burden of it upon customers by a term of its contract with them*. [Italics added][21]

It is interesting to note that the judge expressly refers to the burden of forgery for which the bank is not responsible but states that the 'size of that burden is not apparent'. One would have though this was a perfect opportunity for the bank to adduce evidence to demonstrate this. The fact that the bank did not do this surely leads to an inference that it may not so great as banks contend. Clarke JA agreed with Mahoney P and rejected the notion that it was appropriate to impose some sort of tortious duty on customers without there being clear policy reasons for so doing.

The idea of a tortious duty has been raised in a number of cases. In a sense this is strange given that the basis for the banker-customer relation has always been contract, this basis having been decided and clearly set out in *Joachimson v Swiss Bank Corporation* [22]long before the decision in *Donoghue v Stevenson*[23] let alone *Hedley Byrne & Co Ltd v Heller & Partners.*[24] In *National Australia*

[21] Ibid , 392.

[22] [1921] 3 KB 110.

[23] [1932]AC 562 .

[24] [1964] AC 465.

*Bank Ltd v Nemur Varity Pty Ltd* [25] Batt JA came to the conclusion that the bank's duties in its paying capacity had to be looked at solely in the light of contract law and approved of the following passage from Lord Scarman's judgement in *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [26]

> Their Lordships do not believe that there is anything to the advantage of the law's development in searching for a liability in tort where the parties are in a contractual relationship. This is particularly so in a commercial relationship. ...[T]heir Lordships believe it to be correct in principle and necessary for the avoidance of confusion in the law to adhere to the contractual analysis.

Callaway JA agreed with this approach to the paying bank's liability and said[27]

> I agree with Batt, JA that, putting statute and equity to one side, the duties of a bank to its customer with respect to cheques and telegraphic transfers lie in contract and not in tort. The relationship is too complex, and affected by settled commercial expectations, to be subverted by negligence.

The issue of a tortious duty was also raised in the case of *Westpac Banking Corp v Metlej*.[28] Here one partner signed cheques in blank and left them with the other partner, Metlej, to fill in and sign when needed (the mandate with the bank required both partners to sign). Metlej used to leave the cheque book in his lunch box at a building site. Cheques were stolen, filled in and Metlej's signature added and cashed by the rogue. The court decided that it was not really necessary to decide whether there was a general duty to look after the

---

[25] [2002] VSCA 18, 9.

[26] [1986] AC 80, 107.

[27] [2002] VSCA 18, 9.

[28] (1987) Aust Torts Reports 8-102.

cheque book; but even if there was, there was no breach of such a duty on the facts. The court also frowned on *Tai Hing* case pointing out that Privy Council decisions were not binding on Australian courts and that banks could impose such a duty by contract if they so wished.

Even if there is a contractual term placing a burden on the customer to be careful it will be strictly construed against the bank. A sense of how such a contractual term might be interpreted can be gleaned from some cases on travellers' cheques. In *Braithwaite v Thomas Cook Travellers Cheques Ltd*,[29] a case involving stolen travelers' cheques, there was a clause in the purchase contract providing that the purchaser was to safeguard the cheques against loss or theft. The court said that mere momentary inadvertence resulting in theft would not have disentitled a refund despite the clause. Moreover, the court said that there would have to be a causal connection between the inadvertence and the loss. On the facts, however, the clause worked and the purchaser did not obtain a refund since he was found to have fallen asleep on the London tube after heavy drinking at several pubs and the cheques were in a bag where a carton of cigarettes was visible. On the other hand, in *El Awadi v Bank of Credit and Commerce International SA Ltd*,[30] another case involving travellers' cheques, there was no clause expressly exonerating the issuer if the purchaser was negligent. Despite the court finding that the purchaser was extremely careless (he left the cheques in a plastic bag in an unattended car for long stretches), the court refused to read into the contract an implied duty to be careful and ruled that the issuer had to refund the purchaser.

Many banks issue cheque books which contain advice on filling out cheques and recommending that the customer should safeguard the cheque book; but this, in itself, would not be regarded as part of the banker customer contract since the cheque book is usually given after the banker customer relationship

---

[29] [1989] QB 553.

[30] [1990] QB 606.

is established and there is, moreover, usually no allusion to such warnings. As Mahoney P in the *Hokit* case noted it is open to banks to make it an express term of the banker-customer contract that the customer, for example, is to safeguard the cheque book; but a bank in doing this would place itself at a competitive disadvantage if other banks did not do likewise.

In addition, there may be something a technical difficulty in using contract law to shift the burden onto the customer. Section 6(2) of the *Cheques Act* provides that the provisions in s 32 relating to unauthorized signatures including forgery cannot be altered by agreement.[31] Does this mean that an express verification clause in the banker customer contract would be ineffective? At first blush, yes, but this may be doubtful as s 32 itself refers to estoppel as preventing a person from denying the genuineness of the signature or the existence of the authority for the signature. *Quaere* whether the reference in s 32 to estoppel excludes estoppel by agreement.

In several countries the possibility of shifting some of the burden onto the customer has been mooted. The Jack Committee in the United Kingdom, for example, advocated:

> A statutory provision whereby, in an action against a bank arising from an unauthorized payment, contributory negligence may be raised as a defence, but only if the court is satisfied that the degree of negligence shown by the plaintiff is sufficiently serious.[32]

This would mean that the customer would have imposed on him or her a broad duty to prevent forgeries as well as detecting them. To date this recommendation has not been taken up.

[31] Wikrema Weerasoria and Isaac Dallen 'National Bank's Appeal in *Hokit;* Tailoring Common Law to the Banker's Needs' (1995) 11 *Australian Banking & Finance Law Bulletin* 64.

[32] R B Jack (Chairman), *Banking Services Law and Practice – Report by the Review Committee* (HMSO, 1989), 43.

### 5.4.3 Ratification

The other qualification of the bank's absolute duty not to pay out on forgeries is the reference to ratification. This qualification did not exist under the previous legislation in Australia governing cheques, namely, the *Bills of Exchange Act* 1909 (Cth).[33] Section 29 of that act refers to forgery or unauthorised signatures. There may have been concerns with the implications in criminal law for ratification of the crime of forgery. The current s. 32 of *Cheques Act* 1986 (Cth) merely refers to unauthorised signatures, a forgery being encompassed by this wider concept. The express reference to ratification seems to have been copied from American legislation.[34] Ratification will therefore apply to situations where an agent has exceeded his actual authority and the principal wants to be bound by the signature (the principal will, of course, be bound anyway by the signature if it comes within the agent's apparent authority). Ratification may be express or by implied by the actions of the principal.

*Conclusion*

In this section it has shown that the forgery rule has been challenged many times by the banks in an effort to make customers liable for forgery. In these efforts the banks have not been very successful but could, in theory at least, use contractual conditions to impose more liability on customers.

### 5.5 Cost efficiency of the forgery rule as regards the drawer's signature.

In this section the following key Cooter and Rubin 'rules' will be used to assess efficiency of allocation of liability for loss:

[33] Section 29 *Bills of Exchange Act 1909* (Cth).

[34] Explanatory Paper on proposed Cheques Bill prepared by the Attorney-General's Department, February 1984, para 164-7.

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

As we have seen, the *Cheques Act* 1986 (Cth) adopts a strict liability rule as regards forgery - it does not matter how good or bad the forgery is or whether the bank is negligent or not. There are only two exceptions to this, estoppel and ratification. As has been shown Australian courts have shown a marked reluctance to read into the banker-customer contract any duties of the customer beyond this or any tortious duty of care.

In theory at least the *Cheques Act* 1986 (Cth) provides that the person who bears ultimate liability for the forgery of the drawer's signature is the forger himself. In practice forgers are difficult to find and are often men or women of straw. Therefore disputes over forged signatures tend to be between banks and customers or between banks and payees.

### 5.5.1 Loss spreading

In terms of the first principle of efficiency, the 'loss spreading' principle, the forgery rule declares that the bank should wear the loss. According to Cooter and Rubin the loss spreading principle assigns liability to the party that can achieve risk neutrality at the lowest cost and ' the party that can achieve risk neutrality at the lowest cost is the one that has greater economic resources and is in a position to spread the loss most effectively.'[35] This makes good sense in so far as bank can absorb the loss and that means that ultimately that the public bears the loss. As Professor Geva has pointed out 'in the common law jurisdictions, the objective mostly implemented by the loss allocation scheme

[35] Robert D Cooter and Edward L Rubin, 'A Theory of Loss Allocation for Consumer Payments' (1987) 66 *Texas Law Review*, 71.

[in regard to forgery of the drawer's signature] is that of loss distribution.'[36] This is undoubtedly true of Australia.

### 5.5.2 Loss avoidance

In terms of the second principle, the loss avoidance principle, the message to the banks is clear: you have the capability to detect forgeries. But the banks will argue that with millions of cheques that this is impossible. However, banks will know the incidence of forgery and therefore might, for example, only verify signatures on cheques above, say, $10,000. Undoubtedly, Mahoney P in *Hokit* was coyly alluding to the fact that banks rely on the details on the MICR code (magnetic ink character recognition code) and do not bother to verify signatures on cheques below a certain figure when he said:

> It may be that it has been concluded that no purpose will be served by checking signatures and that it should, for the purpose of testing the genuineness of a cheque, rely upon the fact that the cheque is, for example, marked electronically or otherwise, so that it may be identified.[37]

Banks therefore must make some calculation based on the incidence of forgery as to what figure below which they will not verify signatures on cheques. By imposing primary liability on the bank, it may act as an incentive for them to develop technology that may cheaply scan signatures to detect forgeries. In America some banks use pattern recognition software to help detect forgeries that use an algorithm to recognize unusual transactions (somewhat similar software is used by the Australian Taxation Office to detect tax evasion). So-called 'positive pay' software is also used in America – here the drawer

[36] Benjamin Geva, 'Allocation of Forged Cheque Losses – Comparative Aspects, Policies and a Model for Reform' (1998) 114 *Law Quarterly Review* 250, 251.

[37] (1996) 39 NSWLR 377; (1996) Aust Torts Reps 81-391, 63,432.

transmits electronically details of validly signed cheques to the bank which only pays such validated cheques.[38] Banks are in the best position to determine the extent of the problem of forgery and, as banks, can best craft a solution if it is a significant problem.

Allocating losses to banks therefore satisfies the loss spreading principle as well as, to a certain extent, the loss avoidance principle.

Moreover, the strict liability rule is in truth tempered somewhat by the estoppel principle. In addition a bank that pays out on a cheque on which the signature has been forged may still be able to maintain the debit thanks to the *Ligget* principle (to be discussed shortly). On the other hand, if the payment does not discharge a debt of the customer, then the bank may still be able to recover the payment from the holder on the basis of a mistaken payment.

*US law*

In contrast in the United States if the paying bank can demonstrate that the customer was negligent, then some or all the loss can be shifted to the customer.[39] Therefore in the United States the rule sends a strong message to the customer: the customer should be cautious up to the level of the expected

[38] Brian Tracey, 'Banks Employ Innovative Methods to Help Combat Check Fraud' (1994) 17 *American Banker* 24.

[39] § 3-406. Negligence contributing to forged signature or alteration of instrument.

(a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

(b) Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

(c) Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.

loss of the cheque. Since the value of cheques will be different reasonable precautions will vary and therefore courts have to determine the bounds of reasonable care on an individualised basis. Thus ‘ordinary care’ is a standard that involves giving it content after the individual acts (*ex post*). Section 3-103(a)(7) of the American *Uniform Commercial Code* (UCC) defines "ordinary care" in general terms but the question is left to the court or the jury for decision in the light of the circumstances in the particular case including reasonable commercial standards that may apply. This would seem to reflect a legislative view that the persons and the circumstances are variable. The down side of this from a cost point of view is that it is more expensive to adjudicate and advise on.

### 5.5.3 Rule simplicity

*Split liability*

Banks in Australia have argued for more liability to be placed on customers – so far without much success. It will be recalled that the third principle of Cooter and Rubin for efficient loss allocation is the simple rule is the least costly to enforce. The American system that splits the losses among the parties according to their level of fault makes for complex adjudication where every fact becomes important. In fact s 3-405 and 3-406 of the UCC contains a comparative negligence provisions if both bank and customer are at fault. Professor Rubin makes this point about the American legislation when he writes that the American system based as it is on fault ‘requires a complex, fact-based adjudication that will rapidly devour the amount at issue in all but the largest cases.’[40]

[40] Edward Rubin, ‘Efficiency, Equity and the Proposed Revision of Articles 3 and 4’ (1991) 42 *Alabama Law Review* 551, 569.

In Australia ratification (easy to ascertain) and estoppel (more difficult to ascertain) do introduce a degree of complexity to adjudication but the US comparative negligence provisions would seem to involve a greater degree of difficulty.

*Objections to split liability*

One of Mahoney P's objections to the bank's argument in the *Hokit* decision that the burden, or at least some of the burden, should be shifted to the customer in the case of forgery was along the lines that it would be impossible to define this. He pointed out:

> The problem of deciding what precautions constitute "reasonable care" is one cast upon all potential defendants in negligence. And I am conscious that answers, partial or total, may be available in respect of any example taken. But the point remains that, to prevent the various kinds of forgery which may be envisaged, the customer would be required to take precautions of various kinds and of various degrees of complexity. The Court has no evidence to shown what would be the cost to the customer of doing what such an obligation involves. That cost may be large or small depending on, e.g. the size and circumstances of the customer and its business. But the obligation, if it is to be imposed, is to be imposed on each customer, large or small.
>
> It is relevant to consider also what benefit would flow from the imposition of such an obligation on the customer. It is appropriate to consider the relationship between the burden imposed and the benefits likely to flow from the imposition. The evidence does not assist the making of such an assessment. But, in my opinion, it is

> proper to think that such reasonable precautions will not prevent all forgeries: some will occur despite what the customer does.[41]

As we have seen the American position purports to implement a loss reduction policy: some of the burden for forgery on the customer is supposed to induce a degree of caution that would reduce the risk of the loss. This involves the second principle for efficient loss allocation, namely, loss avoidance. However, if a system of loss allocation induces too much caution, it is inefficient. Professor Rubin makes this point in regard to the revised UCC provisions which now have been accepted by the great majority of the states:

> To begin with, the UCC fault principle imposes unnecessarily large losses on consumers-larger than is necessary to induce them to take whatever precautions they are likely to take. For example, consumers can avoid losses by taking precautions against the theft of checkbooks, and they will do so if they are at risk of losing some meaningful some of money, for example a hundred dollars, and of undergoing the inconvenience of closing their old account and opening a new one. Providing that they can lose the entire balance, as the UCC's fault principle does (§ 3-407), is unlikely to induce any additional precaution.[42]

Moreover, assigning some of the burden to consumers implies some strategy or planning on the part of consumers or some weighing up of the risks involved. By way of contrast, there does not seem to the same expectations of banks in regard to plans to reduce forgeries. Although the *Cheques Act* has allowed for truncation since its inception in 1986, meaning that the salient details are forwarded electronically or any other means by the collecting bank to the paying bank rather than just sending the paper cheque for payment purposes, banks seem to have only made limited progress in regard to imaging

[41] (1996) 39 NSWLR 377, 391.

[42] Rubin, above n 49, 568.

which appears to be the most expeditious way of handling the problem, despite the fact that it would seem to be in their interest to do so.[43]

The idea of placing some of the burden on customers to safeguard against forgery is superficially appealing since it may seem, especially to banks, that the forgery may not have happened if the customer had taken adequate precautions. However, changing consumer behavior is probably a great more difficult than changing corporate behavior since consumers include the uneducated and unsophisticated in the society. It is submitted therefore that putting a burden on consumer customers to read bank statements and the like, that is, to go beyond the *Greenwood* and *McMillan* duties, in an apparent effort to reduce the incidence of forgery would not be efficient in terms of Cooter and Rubin's three fold test since, first, it would make some inroads into the first Cooter and Rubin rule, namely, loss spreading; second, in terms of their second test, loss avoidance, it is uncertain whether putting more of a burden on the consumer customer would be effective to reduce the incidence of fraud ; third, it would lead to a much more complicated adjudication than at present, thus offending against the third Cooter and Rubin test, that the simple rule is the best rule.

*Conclusion*

Ii is submitted that the legal rule in Australia as regard forgery of the drawer's signature is both at once efficient and fair: efficient, since the emphasis is in the main on loss spreading – the most significant of Cooter and Rubin's principles; fair, since the law reflects what sort of contract the parties would have arrived at if they both had full knowledge, namely, the bank is to bear the loss for an unauthorized signature except where the customer is estopped or if the customer ratifies it.

[43] 'CBA Introduces Cheque-imaging System', *Australian Banking and Finance,* 31 March 2001.

### 5.6 Failure of bank to obey mandate - the Ligget defence

In this section the controversial *Ligget* defence and difficulties in reconciling it with the principle that the bank should not debit the customer's account without authority will be examined.

What happens if the bank fails to obey the mandate, for example, fails to notice that the signature on the cheque is forged or unauthorized or fails to obey a stop order on the cheque? This brings to the forefront the controversial *Ligget* defence set out in *Liggett (B) (Liverpool) Ltd v Barclays Bank Ltd* . [44] The decision is controversial for two reasons: first, it implicitly involves the proposition that the paying bank can in certain circumstances disobey the mandate with impunity, for example, when there is a forgery or unauthorized signature; second, the theoretical basis for the defence, is far from clear.

The facts in *Liggett's* case essentially were that the defendant bank contrary to its mandate paid cheques of the plaintiff company that had only been signed by one director. However, the cheques in dispute went to pay trade creditors of the plaintiff company. In an action by the company to recover as money had and received the amount paid out by the bank in respect of unauthorized cheques Wright J held that despite the fact that the bank had no mandate to pay the cheques the bank was entitled to a credit in respect of the trade debts under the equitable doctrine that a person who pays the debts of another without authority is allowed to take advantage of the payment.

It should be emphasized that the *Liggett* case was not a case brought against the bank for breach of contract. It was to recover the debt, the credit balance that the bank owed the customer. Hence the bank had to establish a defence.

[44] (1928) 1 KB 48; [1927] All ER Rep 451.

Wright J in *Liggett's* case described the equitable principle thus:

> …the question now is whether the equitable principle does apply to the facts of this case. The equitable principle has been applied beyond question over and over again to cases where an agent without the authority of his principal has borrowed money as on behalf of his principal. In those circumstances at common law the principal cannot be sued and cannot be made to repay the amount so borrowed, but in equity it has been held that to the extent that the amount so borrowed has been applied in payment of the debts of the principal, the quasi lender is entitled to recover to that extent from the quasi borrower.[45]

The bank is the agent of the customer when it pays cheques. In paying cheques the paying bank is, if the account is in credit, effectively paying a debt (which it owes to its customer) to a third person, the payee, at the direction of its customer. The fact that the paying bank is regarded as the agent of the customer is explicitly recognized in legislation dealing with cheques; for example, the bank's authority to pay is terminated by countermand of payment.[46]

*Clashes with mandate principle?*

One of the criticisms of the *Liggett* doctrine is that it seems at odds with the proposition that a debt to be discharged by an agent must be done with the authority of the principal.[47]

[45] (1928) 1 KB 48, 61.

[46] *Cheques Act 1986* (Cth) s 90. The collecting bank when it collects a cheque for its customer is also acting as an agent: *Cheques Act 1986* (Cth) s 95.

[47] Alan L Tyree, 'When Rules Collide: Ligomettt Meets Simms' (1990) 1 *Journal of Banking Finance Law and Practice* 213.

Some writers [48]are therefore of the view that there is a serious clash between the *Barclays Bank Ltd v W J Simms Son & Cooke (Southern) Ltd)* [49] and *Liggett's* case. Professor Tyree writes:

> There is a serious conflict between the *Liggett* line of cases and the *Simms* and *Murphett*[50] cases on the repayment of money paid under a mistake of fact. These latter cases held that, when a bank pays a cheque overlooking a countermand, the debt owed to the payee of the cheque is not discharged since the bank paid without authority. On the other hand, the operation of the *Liggett's* principle clearly requires that the debt be discharged. [51]

It should be pointed out that the *Simms* was a case where the bank sued the payee, whilst *Liggett* was a case where the customer sued the bank. In both cases the issue arose as to whether the payment discharged the debt owed by the customer to the payee. The perceived conflict arose as a result of the different answers in each case being given on this issue.

In the *Simms* case a housing association drew a cheque for a large amount payable to a building company. When the housing association found out that a receiver had been appointed to the company it countermanded payment of the cheque. The bank overlooked this stop order and paid the cheque. The amount was recoverable from the building society by the bank on the basis of a mistaken payment.

But in *Majesty Restaurant Pty Ltd (in liq) v Commonwealth Bank of Australia* Hunter J found that the trade creditors (the payees on the cheques) were entitled to rely upon the ostensible authority of the bank as an agent of the

[48] Eliahu Peter Ellinger and CY Lee, 'The Liggettt Defence: A Banker's Last Resort' (1984) *Lloyd's Maritime and Commercial Law Quarterly* 459.

[49] [1980] QB 677.

[50] [1983] 1 VR 489.

[51] Alan L Tyree, *Banking Law in Australia* ( 1998), 237.

company in paying the company cheques. In Hunter J's view the *Simms* case proceeded on the erroneous basis that payment had been made without a mandate. He quoted comments from Professor Goode in support of his argument to the effect that the payee is entitled, despite countermand of payment, to assume that payment of such a cheque is within the paying bank's apparent authority.[52]

The idea of apparent authority as an explanation of the *Liggett* has, however, been criticized by one of the judges in *Lloyds Bank Plc v Independent Insurance Co Ltd.*[53] Here an insurance agency lodged some cheques with its bank with instructions to pay a sum of money to an insurance company. The insurance agency customer was told that the cheques would have to clear before payment was made. The insurance company was notified by the customer that the monies were forthcoming via the bank. Employees of the bank thought there were cleared funds and made an electronic payment to the insurance company. It transpired that one of the major cheques lodged by the customer was dishonoured and the bank sought to recover from the payee on the basis of mistake. Counsel for the payee made out an argument based on the idea of apparent authority. He maintained that there had been a representation by the customer to the payee that the bank would make a payment to the payee; that the payee relied on the bank being authorised by conducting their business on the basis that the payment was valid; and that all of this was sufficient to lead to the conclusion that as between insurance company and the customer of the bank, the payment must be treated as authorised, and the customer's debt to the insurance company discharged; and thus there could be no liability to restore the payment to the Bank. Lord Justice Waller judge said:

[52] *Majesty Restaurant Pty Ltd (in liq) v Commonwealth Bank of Australia* (1998) 47 NSWLR 593; see also Professor R Goode, 'The Bank's Right to Recover Money Paid on a Stopped Cheque Law' (1991) 97 *Law Quarterly Review* 254, 257-8.

[53] [2000] 1 QB 110.

> I am thus unpersuaded that as between the Bank and Independent it is open to Independent [the insurance company] simply to assert that because the Bank were held out (if they were) as being persons authorised to pay a certain sum and because Independent received that payment and treated it as valid, as against the Bank the debt must be treated as discharged.[54]

The Court eventually found that the payment was made with the actual authority of the customer on the basis that when a customer writes out a cheque without there being funds in the customer's account or an agreed overdraft, the cheque is to be treated by the bank as a request for an overdraft for that amount – the bank can reject this request but if it pays the cheque it must be seen as acceding to the request. This means that the customer's debt was discharged because it came within actual authority.

Consequently, Waller LJ's comments on the 'apparent authority' explanation of the *Ligget* defence are strictly speaking *obiter dictum* but, nevertheless, cast some considerable doubt on it.

In the case of *Crantrave Ltd (in liquidation) v Lloyds Bank* [55] there was some similarity with *Liggett's* case in the sense that the customer was trying to recover from the bank

In the *Crantrave* case the bank, in anticipation of a garnishee order being made absolute, paid the money to the judgment creditor out of its customer's account. The customer via a liquidator sought to recover the money paid away by the bank. The bank argued that by making the payment it had discharged an existing debt of Crantrave and therefore Crantrave suffered no loss (the *Liggett* defence). But Crantrave did not request the payment. Moreover, the bank had

[54] Ibid, 115.

[55] [2000] 3 WLR 877.

no authority from Crantrave to do this. Crantrave also did not ratify the bank's actions. The case is not like *Liggett's* case that involved a cheque drawn by the customer and the bank paying out on it contrary to the mandate. It was held that Crantrave was therefore entitled to the full-unreduced credit balance of the account since the bank had unilaterally paid away the monies.

The *Crantrave* case, relying on the earlier authority of *Re Cleadon Trust*,[56]seeks to explain the *Liggett* principle on the basis that the equity is only allowed if the agent has the actual authority to pay the customer's debts creditors. However, the ratio decidendi of the *Crantrave* case itself is very simple: between the agent, the bank, and the principal, the customer, there was no authority - actual or ostensible- to pay the monies. The customer did not hold out the bank as having any authority to pay. The bank's action was unilateral.

None of the theoretical explanations for the *Ligget* defence – subrogation,[57] unjust enrichment,[58] a sui generis defence,[59] apparent authority,[60] unconscionable conduct [61]– are particularly satisfying. It is, nevertheless, a powerful defence if a bank pays out a cheque without authority.

---

[56] [1939] Ch 286.

[57] Wright J in the *Ligget* case (1928) 1 KB 48, 60 rejected the notion that it involved subrogation: 'The ground is sometimes put in this way, that the lender or quasi-lender is subrogated to the right of the creditor who has been paid off. That, obviously, is not precisely true, because no question of subrogation to securities can arise in such a case.

[58] In *Re Cleadon Trust Ltd* [1939] 1 Ch 286, 301 Greene MR, in a dissenting judgment in that case, thought that the cases were moving in the direction of a general doctrine of unjust enrichment. He said:

> … equity will assist a person who has no right at law but is able to show that money belonging to himself has gone to swell the assets of the person to or for whose benefit he has paid it.

[59] Sir Wilfred Greene MR in the *Cleadon* case [1939] 1 Ch 286, 306 said:

> It is, I think, fair to observe that the precise ground upon which the equity is based has not been fully stated. It may be that it is a mere anomaly.

[60] *Majesty Restaurant Pty Ltd (in liq) v Commonwealth Bank of Australia* (1998) 47 NSWLR 593.

[61] The *Liggett* principle is used as a defence whereas the doctrine of unconscionability is normally used to set aside a contract or transaction. But the joint judgement of the High Court

*Similarity with US law*

The *Ligget* defence bears some resemblance to the statutory American banks' rights to be subrogated to the payee's rights against the 'drawer' who either stops payment or does not sign the cheque in the first place, the two most likely reasons for claims that the account should not have been debited. This subrogation right can be set up as a defence by the bank to the bank's prima facie obligation to reaccredit the account.[62] American Justice Lytton in *McIntyre v Harris* explained the right thus 'we must determine whether the bank can become subrogated to the rights of another to prevent unjust enrichment.[63]

The Official Comment to this American statutory right of subrogation gives an example of the sort of fraudulent situation that might be covered by such a right:

> If, for example, the payee was a fraudulent salesman inducing the drawer to issue his check for defective securities, and the bank pays the check over a stop order but reimburses the drawer for such payment, the bank should have a basis for getting the money back from the fraudulent salesman.

However, it appears that such a right of subrogation is not always utilized by banks in America. Professor Mann wrote:

---

of Australia in *Garcia v National Australia Bank* (1998) 155 ALR 614 does recognise unconscionability as an equitable basis for refusing to enforce legal rights. Of all the explanations of the basis for the *Liggett* defence, the unconscionability one is perhaps the best, if for no other reason than that the others are not very convincing.

[62] Uniform Commercial Code (1990 version) §4-407.

[63] *McIntyre v Harris* 709 NE 2d 982 (Ill App 1999).

> Whatever the theoretical propriety of the limits that subrogation places on a bank's obligation to remedy erroneous payments, the practical significance of the legal rule is debatable. In many cases the costs to the bank of demonstrating the customer's continuing obligation are likely to dwarf the amount of the check. In those cases the bank's statutory right will go unasserted. Thus, in the end, the most common result in cases of wrongful honor is likely to be a windfall to the payment-stopping drawer: The payee keeps the payment it received from the payor bank, the payor's account is recredited, and the bank's failure to stop payment results in a loss by the bank in the amount of the check.[64]

Of course, the *Ligget* defence is unlikely to be used where there has been a straight out forgery as opposed to an unauthorized signature. In the case of a blatant forgery it is unlikely that the person whose signature has been forged will have received any benefit from the payee, such as goods or services. Therefore no rights of subrogation will probably arise. It is not, however, impossible. Suppose X does some landscaping for Y but Y does not pay X. Therefore X's wife who works for Y, irritated with the delay in payment, steals one of Y's cheques and forges Y's signature on it. The bank pays the cheque. Should the bank be allowed to maintain the debit to Y's account on the basis that Y was indebted to X? *Ligget* would seem to say, yes.

### 5.7 On the issue of cost efficiency of the *Ligget* defence

In this section the following key Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss will be used:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

[64] Ronald Mann, *Payment Systems and Other Financial Transactions* ( 2003) 18.

*Loss bearing –is there a loss?*

The *Ligget* defence applies when there is a forgery of the drawer's signature if the payment goes to discharge a debt owed by the customer. Clearly, the defence allows the bank to maintain a debit that it has no authority for and shifts the 'loss' onto the customer. The bank, the party that can most easily bear the loss, is let off the hook. But from the bank's point of view there is no 'loss' for the customer since it goes to pay a legitimate debt of the customer. But it is payment without the customer's consent. The point is brought out clearly when one considers a customer's countermand. The bank overlooks the stop order and pays out on the cheque. Of course, in theory a bank has to show that it has authority to pay before it can debit the customer's account. But in practice the burden is on the consumer to bring a legal action against the bank which merely maintains the debit. Assuming the customer can demonstrate that the countermand was effectively communicated, the bank can still invokes the *Ligget* defence saying that the payment went to discharge a debt that the customer owed a third party. To hold otherwise would mean that the customer would reap a windfall profit from the bank's mistake: the bank would have to reaccredit the customer's account while the customer has the benefit of having a debt owed to third party paid off. Thus, some argue that the justification for the *Ligget* defence lies in the doctrine of unjust enrichment.[65]

*Loss avoidance*

Of course, it could be argued that if the *Ligget* defence was disallowed, this would act as a severe punishment of the bank, thus deterring it from disobeying the mandate. This brings us to the second of Cooter and Rubin's rules, loss avoidance. However, although the bank can take precautions to avoid the loss by making sure it obeys the mandate by not paying out on forgeries, the exceptional defence of *Ligget* can be justified on efficiency

[65] Carl Baker, 'Recovery of Mistaken Payments Under the Liggett Doctrine: a Banker's "Plan B"' (2002) 13 *Journal of Banking and Finance Law and Practice* 259, 260.

grounds in that it obeys the market rule that debts should be paid by the persons who owe them. The trouble with this is that the payment is done without the authority of the debtor.

It is often argued that the law should uphold bargains that the parties would have arrived at freely with necessary knowledge. This idea has been expressed as follows:

> legal rules should be designed to reallocate costs in a manner that approximates the contract that the parties would have reached had they possessed the necessary information.[66]

It is difficult to imagine that customers would agree that banks could pay a debt without the customer's authority. Most customers would surely argue that it is up to them to decide who to pay and when. Pill LJ in the *Crantrave* case pointed out some of the dangers in allowing too generous an application of the *Ligget* defence:

> It is a startling proposition that bankers can pay sums to a third party out of a customer's account because they believe the customer to be indebted to that third party. I see no difference in principle between a judgment debt and other perceived debts. As against a customer, a contrary principle would place the bank in a position to act as debt collector for creditors of the customer. It would be for a customer who contested a creditor's claim then to seek relief. The bank could decide in what priority the claims of creditors were to be met out of the sums in the account, without the customer having recourse against the bank. A

[66] Rubin, above n 40, 561.

> bankruptcy or liquidation may occur shortly after a payment, as in this case, with possible effects on the rights of creditors generally.[67]

This is something of argument *ad absurdum*. The *Ligget* defence implicitly requires the bank to be acting in good faith and not just paying away its customers monies willy-nilly. Moreover, Pill LJ's comments do not surely override the argument that to not allow the debit to be maintained would allow the customer a windfall profit.

*Rule simplicity*

In terms of simplicity of rules, the third Cooter and Rubin rule, the *Ligget* defence is complicated. But from the bank's point of view it seems simple – it just waits for the customer to legally challenge the debit, then it is up to the bank to establish the defence. As has already been pointed out this might raise difficulties for the bank in demonstrating that the customer was indeed indebted to the payee. If the cheque is for small amount it may not be worthwhile for the bank to do this.

*Conclusion*

*Ligget's* case can only be seen as efficient in the sense that it results in legitimate debts being paid. Here efficiency rubs up against fairness. Most people would think that it is up to the debtor to decide when to pay debts – surely a fundamental idea of the free market system; and it should not be when an agent, the bank, acts without authority. Thus *Ligget* in a way rewards the person who can most easily avoid the loss and punishes the person, the customer, who has done no wrong. This may be seen as giving the wrong message. It should always be remembered that the person who most easily bear the loss, the bank, can always seek repayment from the payee on the basis

[67] *Crantrave Ltd (in liquidation) v Lloyds Bank* [2000] 3 WLR 877, 883.

of mistake and the parties would be then be put back to where they were. The fairness path is, however, a complicated one. Nevertheless, overall the *Ligget* defence allows a somewhat unfair shortcut that is efficient. In short, fairness is trumped by efficiency.

### 5.8 Liability of persons subsequent to forgery of drawer's signature

What happens when an order cheque on which the drawer's signature has been forged is validly indorsed? A diagram will aid in the explanation.

Diagram: 1

MegaBank date

Pay Alan Fagin or order
Thirty five thousand dollars $35,000.00

*S.JONES*

Date

*Pay Golam*
*Alan Fagin*

Back of cheque

J (forgery)→ F (valid indorsement) → G (innocent third party who gives value).

The payee, Alan Fagin, innocently receives the above cheque on which the drawer's signature has been forged. He transfers the cheque by negotiation to Golam by indorsing it to him in exchange for goods. Golam, the indorsee, takes the cheque in good faith and without knowledge that the drawer's signature has been forged.

*No acceptor*

In the case of a forgery of the drawer's signature on a cheque there is, of course, no acceptor and the remote party cannot use the estoppel in s 59 (b)(ii) of the *Bills of Exchange Act*. If it is an order cheque and the drawer's signature has been forged then the remote party, Golam, may use the statutory estoppel in s 74 (1) (a) of the *Cheques Act* against the indorser, Alan Fagin.

*Liability of indorser*

Such an indorser is according to s 74(1)(a) of the *Cheques Act* estopped from denying to a *holder in due course* the genuineness and regularity**,** in all respects, of the drawer's signature. But how can a remote person qualify as a holder in due course if the drawer's signature is forged? It is interesting to note that s 74 (2) explicitly explains away the apparent contradiction of the reference to holder in due course in s 74 (1) (a) when there has been a forgery of the drawer's signature. Like the *Bills of Exchange Act,* s 10 of the *Cheques Act* says a cheque must be "signed by the person giving it" - if there is forgery of the drawer's signature on an instrument it is not a cheque. Ipso facto there cannot be a holder in due course on such an instrument. However s 74(2) sensibly provides that

> The reference in paragraph (1)(a) to a holder in due course includes a reference to a person who, but for a signature being written or placed on the cheque without the authority of the person whose signature it purports to be, would be a holder in due course.

The Explanatory Paper on the *Cheques Act* makes the point that this serves to make it clear that the reference to 'holder in due course' in regard to the indorser's estoppel includes a remote person who takes under a forgery.[68] This

[68] Explanatory Paper, above n 34, para 413.

is consistent with the common law interpretation of the acceptor's estoppel with bills of exchange and, by parity of reason, with that of the indorser.[69]

If the cheque on which the drawer's signature is forged is a bearer cheque and transferred by delivery to an innocent third person who gives value, that is, someone other than the payee, what is the position? Again such a person does not qualify as a holder in due course due to the forgery. But s 77 (3) of *Cheques Act* provides that the transferor by delivery warrants to his immediate transferee that the cheque is what it purports to be and that the transferor is not aware of any fact that renders the cheque valueless. This in effect means that the transferee can only make his immediate transferor liable.

Thus rights on an order cheque are against all prior indorsers while the rights on a bearer cheque are only against the immediate prior transferor.

### 5.9 Cost efficiency of subsequent parties' liability for forgery of the drawer's signature

In this section the following key Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss will be used:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Loss bearing*

Whether any party subsequent to the forgery of the drawer's signature is in a position to absorb or pass on the costs of the loss will depend on the financial

[69] *Bank of England v Vagliano* [1891] AC 107.

standing of the parties and this is impossible to predict. (The position of the banks will be explored subsequently.)

*Loss avoidance*

As has been seen, the *Cheques Act* through a series of warranties and estoppels puts the liability for loss on the first transferee from the forger, typically the payee. The apparent reason for this seems to be that this person is the first person to take the risk that the drawer's signature is forged before setting it adrift on the seas of commerce. Such a person deals with the rogue. This accords with Cooter and Rubin's second principle of efficiency, loss avoidance: the loss should be allocated to the party that can most easily avoid it but who fails to do so. This is efficient in the sense that the 'first taker' has a better possibility of detecting forgery than subsequent persons who have no dealings with the rogue. However, the *Cheques Act* does allow an indorser to limit or negate his or her liability on the indorsement, [70] thus shunting liability onto another indorser who does not do this; for example, A receives a cheque on which the drawer's signature is forged, A indorses it to B but adds 'without recourse', B indorses it to C, C indorses it to D Thus we have receipt by A of cheque on which the drawer's signature is forged, A then (indorses it 'without recourse') → B (indorses it)→C (indorses it)→D. D can sue C and B but not A.

This is inefficient since A is the person in the best position to detect the forgery. The indorser's ability to negate or limit liability has been copied from the *Bills of Exchange Act* s 60(2). But the context is completely different: on a bill the acceptor 'guarantees' the genuineness of the drawer's signature and the indorser further 'guarantees' the drawer's signature. On a bill of exchange, typically the acceptor will be the person in the best position to identify forgery of the drawer's signature because of dealings with the drawer, thus a

[70] *Cheques Act 1986* (Cth) s 17(2).

concession is made to indorsers who have subsequent liability in terms of 'guaranteeing' the drawer's signature - they can therefore negate or limit their liability. However, with an order cheque the person having dealings with the rogue will be the payee/first indorser – the person in the best position to detect the forgery of the drawer's signature on the cheque yet this person can negate liability. This is inefficient.

In the case of a bearer cheque on which the drawer's signature is forged and which is transferred to another, s 77 (3) of the *Cheques Act* provides that the transferor by delivery warrants to his immediate transferee that the cheque is what it purports to be and that the transferor is not aware of any fact that renders the cheque valueless; for example, A receives a bearer cheque on which the drawer's signature is forged, A gives it to B, B gives it to C, C gives it to D. Thus we have receipt of forged cheque by A (transfer) →B(transfer) →C(transfer) →D. D can only sue C not B and A.

The transferor by delivery cannot limit or negate their liability. Of course, C can sue her immediate transferor B and, likewise, B can sue A. So eventually liability is sheeted home to the party who is in the best position to detect the forgery. This is therefore efficient. (The practical reason why the ultimate transferee on a bearer cheque cannot sue prior transferors other than his immediate transferor is because he or she will not normally know who they are since there will be no indication on the back of the cheque as there is with an order cheque.)

*Conclusion*

The ability of the immediate indorser after the forgery of the drawer's signature to negate his or her liability is inefficient since that person is in the best position to detect the forgery. This inefficiency stems from copying provisions from the *Bills of Exchange Act* where such a right was, in the context of bills of exchange, efficient. On the other hand, the liability of persons subsequent to a forgery of the drawer's signature on a bearer cheque is efficient.

### 5.10 Forgery of indorsement on an order cheque and the positions of the drawee bank and the collecting bank in regard to forged indorsements

What is the position of the respective banks when there is a forgery of an indorsement? Again a diagram may help the explanation.

Diagram: 2

MegaBank date

Pay Alan Fagin or order
Thirty five thousand dollars $35,000.00

*S,JONES,*

Date

*Pay Golam*
*Alan Fagin*

Back of cheque

Assume that the drawer's signature on cheque is valid and that a thief stole the cheque from Alan Fagin and, forging Alan's indorsement on the cheque, transfers the cheque to Golam who takes it innocently and gives value. Thus we have Jones (valid drawer's signature) → Fagin (invalid indorsement) → Golam (innocent & gives value).

In the case of a forgery of an indorsement on a cheque, a subsequent indorser 'guarantees' the genuineness of prior indorsements. As noted already s74(2) of the *Cheques Act* makes it clear that the 'holder in due course' privilege is only for the purposes of the indorser's estoppel in s 74(1). On the facts of our case there is no indorser after the thief forged Fagin's signature but Golam could, of course sue, the thief on the signature even though it is not the thief's real name.[71] Had Golam indorsed the cheque to another party, say Holden, who took it innocently and gave value, then Holden could use the estoppel in s 74(1) against Golam.

Golam is not a holder in due course since he is not even a holder since holder is defined to include an indorsee.[72] But one cannot become an indorsee on a forged indorsement.[73] Golam is merely a possessor. He has rights against the forger on the signature as if it were his own.[74] Fagin is still the true owner of the cheque.

*Liability of the paying bank*

It makes sense that the drawee bank should not pay out on a forged or unauthorised signature of the drawer since it has a specimen of the signature. It has, however, no specimens of the signatures of all the persons who indorse or who should indorse the back of an order cheque; so, why should there be an issue of the drawee bank honouring an order cheque where an essential indorsement is lacking, irregular or unauthorised? The basis of liability has been explained as follows:

> Payment to a person taking under a forged indorsement could not qualify as payment in due course to a holder; and, at common law, the consequences of making such a payment were extremely onerous: the

[71] *Cheques Act 1986* (Cth) s 33(2).

[72] *Cheques Act 1986* (Cth) s 3.

[73] *Cheques Act 1986* (Cth) s 32(2).

[74] *Cheques Act 1986* (Cth) s 32(2).

> bank would be debarred from debiting its customer's account, not having paid in accordance with its mandate. The ground of liability was that the banker had disregarded his customary duty to pay a cheque drawn to order only to the payee or to a person who presents the cheque duly indorsed by the payee.[75]

The same type of liability in regard to absence of indorsements and forged indorsements can be traced through the provisions of the Act. An order cheque is not discharged or paid in due course to a holder, a holder of an order cheque being defined in s 3 as the payee or indorsee, if the indorsement is forged or lacking. Therefore if such a cheque was paid by the drawee bank it could be compelled to pay again to the true owner.[76]

*Concession to paying bank*

The *Cheques Act* makes a tremendous concession to drawee banks.

First, where the indorsement is placed or written on the cheque without authority including forgery, then, if the paying or drawee bank pays it without negligence (failure to concern itself with the genuineness of or lack of authority not being regarded as negligence) to a bank or otherwise it will be deemed to have paid it in due course.[77]

Thus, even if the drawee bank in paying an order cheque to the rogue on which a rogue has forged the payee's indorsement it would be regarded as having paid the cheque in due course. It will not be compelled to pay again to the payee. This does not mean, of course, that the rogue is the legal owner. The

[75] Denis Cowen and Leonard Gering, *Cowen on the Law of Negotiable Instruments in South Africa*, ( 1985) 375.

[76] *Cheques Act 1986* (Cth) ss 78,79.

[77] *Cheques Act 1986* (Cth) s 94(1).

legal owner is the payee who must seek the money from the rogue. He cannot say, however, to the bank "you are not discharged, make payment to me."

It is noted that the section governing this situation applies to both crossed and open cheques where there are unauthorised indorsements including forgery, but only if the drawee bank acts in good faith and without negligence.

The second situation is where the indorsement is lacking or irregular, then, if the drawee or paying bank pays it in good faith and without negligence (failure to concern itself with the absence or irregularity of indorsement not being regarded as negligence) to another bank or itself, it will be deemed to have paid it in due course.[78]

Thus the provision governing this situation applies prima facie to crossed cheques where there is an absence of or irregularity in the indorsement, but only if the drawee bank acts in good faith and without negligence. For example A has an order cheque which is crossed. A's name appears as that of the payee. It is lost. B finding it pays it into his bank account. There is no indorsement by A nor does B endeavour to forge A's indorsement. The drawee bank pays the proceeds of the cheque to B's bank, the collecting bank. What is the position?

The drawee bank is discharged. A cannot ask the drawee bank to pay him again. A's remedy will be to recover the proceeds of the cheque from B, the rogue, or sue B's bank for conversion since it has not concerned itself with the absence of indorsement on a cheque where the name of the payee is different from that of the customer.[79]

In practice the protection afforded by the Act to a drawee bank paying cheques

[78] *Cheques Act 1986* (Cth) s 94(2).

[79] *Cheques Act 1986* (Cth) s 95(2).

lacking indorsements or with irregular or unauthorised indorsements means that responsibility is shifted to the collecting bank.

*Collecting bank*

Failure by the collecting bank to concern itself with indorsements on third party cheques, i.e. where the name of the payee is different from that of the customer, is an instance of negligent behaviour, rendering the collecting bank liable to the true owner for conversion.[80] But this will not always make the collecting bank liable since the concern is with irregular indorsements, for example, payee's name, Peter Jones, indorsement simply, Jones. The other concern is with lack of indorsement. However, it is perfectly possible for an indorsement to be regular even though it is forged. In such a case the collecting bank would not be liable for conversion.

## 5.11 Efficiency of allocation of liability for forgery of an essential indorsement

In this section the following key Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss will be applied:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Subsequent indorsements*

Assume the drawer's signature on an order cheque is valid but that one of the indorsements is forged. The person that ultimately takes this cheque cannot obtain a good title to it. However, such a person can use the statutory estoppels

[80] *Cheques Act 1986* (Cth) s 95.

to obtain compensation. Any indorser who indorses after a forged indorsement is estopped from denying to a holder in due course the genuineness and regularity of previous indorsements.[81] It is efficient that an indorser is estopped in terms of the immediate previous indorser since he or she is in a position the best position to identify forgery because of dealings with this person. This accords with the second Cooter and Rubin cost efficiency rule, namely, who can avoid the loss most cheaply.However, the estoppel extends not only to the immediate previous indorser but also to any previous indorsers. If an order cheque is indorsed by the payee A → B (forgery of indorsement)→ C →D→ E→ F (ultimate holder). C, in theory, is responsible to F for the forgery of B's signature even though C had no dealings with F since F can sue anyone who indorses after the forged indorsement. This therefore seems inefficient. In practice though, F would most likely sue E on his indorsement, then E would sue D, D would sue C, C would then try and sue the forger of B's signature if this were possible (it is most likely that the forger will not be found or if found will be insolvent). In practice therefore, the loss for the forgery would fall upon C, the person closest to the forgery, the person in the best position to detect the forgery or take precautions to avoid the loss. However, since the act allows an indorser to negate liability the chain of indorsements may be broken, so that the person that is closest to the forgery may not always bear ultimate liability. Moreover, the insolvency of an indorser might also result in this outcome too. Therefore, one cannot say with any degree of certainty that the rule is efficient in terms of allocating liability to the person that is in the best position to avoid the loss, viz, the person who takes from the forger of the indorsement.

*Drawee bank*

As to the efficiency of allowing the drawee or paying bank not to be concerned with forged indorsements, s 94 makes a remarkable concessions. It could be

[81] *Cheques Act 1986* (Cth) s 74(1).

argued that it goes against the loss spreading principle – the paying bank is let off the hook and the loss will fall on the owner of the cheque unless such an owner has a case against the collecting bank. Here again there is a tremendous concession to collecting banks: they will only be liable in conversion if they cannot show they have acted without negligence - failure to detect the absence or irregularity of an essential endorsement will be regarded as evidence of negligence.[82] It should be noted that the collecting bank will therefore not always be liable for a forged indorsement; it is only if it looks irregular and they do not notice this. The nature of the defence prompted Professor Tyree to write that:

> The banks make large profits from the cheque system and there seems little reason why the risks inherent in the system should be placed upon those individuals who are unfortunate enough to have cheques stolen. A more rational approach would be for the risks to be borne equally by all the users of the cheque system or, alternatively, by those who are demonstrably careless.[83]

In referring to risks 'to be borne equally by all the users of the cheque system' Tyree is impliedly referring to the first of Cooter and Rubin's principles, namely, loss spreading: if the loss fell upon the banks for forged indorsements rather than on the true owner this would spread the risk to all users of the system since banks would pass on the cost of having to bear the risk. The other alternative suggested by Tyree, having the risk borne by 'those who are demonstrably careless' is impliedly referring to the second of Cooter and Rubin's principles, namely, loss avoidance. But in many cases the risk of the loss will indeed not be borne by the careless party when there is a forged indorsement.

---

[82] *Cheques Act 1986* (Cth) s 95.

[83] Tyree, above n 51, 275.

The usual genesis of a forged indorsement on a cheque is the theft of the cheque, quite frequently by an employee. Harking back to diagram no 2 above, assuming the drawer's signature is valid, Alan Fagin, the payee, has his indorsement forged by a rogue employee who has access to the cheque and the cheque is negotiated to Golam, an innocent party. Thus we have a valid cheque given by Jones → F (forged indorsement) → G. The person that is arguably careless is Fagin who has allowed access to the cheque by an employee. Golam who is completely innocent gets no title and only has a case against the rogue on the forged indorsement. This is not efficient or fair.

*The collecting bank*

Assume Golam takes the cheque to his bank (the collecting bank). Assuming that the forged indorsement is regular and there is nothing untoward, the collecting bank will be protected from an action in conversion by Alan Fagin, the true owner, thanks to s 95. Nor will Alan Fagin have an action against, the paying bank since s 94 will protect it. Of course, Golam has no right to the money since he was not even a holder, let alone a holder in due course. Alan Fagin can sue Golam to recover the money. The loss will therefore fall upon Golam, the person closest to the forgery. Some would say Golam is a person in a position to detect the forgery or take precautions to avoid the loss. This is therefore consistent with Cooter and Rubin's second principle, assigning the loss to the party who can most easily avoid the loss. But here, of course, the other person that could have played a role in avoiding the loss is the true owner, Alan Fagin, especially if has allowed others easy access to the cheque. Indeed, of the two innocent parties, Alan Fagin is arguably in a better position to avoid the loss. But here again we are in familiar territory to that relating to arguments about whether there should be a duty on the customer to guard against forgery of his drawer's signature. How much caution should the owner of an order cheque made out to his name have to exercise? Would precautions always prevent theft anyway? Such a change in the law would be difficult to frame and would undoubtedly make adjudication more difficult, thus offending against Cooter and Rubin's third principle, namely, simple rules are the best since they are the easiest and least costly to adjudicate.

### *Absence of liability of banks*

What is most noteworthy in the above scenario is the complete absence of liability of the banks thanks to legislative changes instigated to protect the banks. The effect of s 94 has already been noted. Moreover, banks in Australia usually provide pre-printed forms to customers with the words 'or bearer' after the space for the payee's name in an apparent effort to dissuade customers from using order cheques: paying banks are nearly always going to be able to say they have obeyed their customers order if the cheque is paid to a bearer. This is, however, subject to the so-called *Selangor* duty, that is, if the bank has knowledge or suspicions that the monies are being paid for uses other than those contemplated by the customer, then the bank owes a duty, at the very least, to make enquiries to clarify the customer's wishes.[84] Usually paying banks are not so close to their customer's business that this presents much of a problem.

On the collecting side, banks are also given a great deal of protection in regard to third party order cheques (that is, where the cheques are going into an account other than that of the payee) – they will only be liable for conversion to the true owner where the forged indorsement is irregular or absent.

### *Conclusion*

[84] *Selangor United Rubber Estates v Craddock* (no 3) [1968] 1WLR 1555; [1968] 2 All ER 1073.

The exculpation of the banks in both their paying and collecting capacities in regard to forged indorsements is surely an egregious example of breach of Cooter and Rubin's first and arguably most important efficiency principle, namely, loss spreading. In many cases banks are not going to bear any liability at all in regard to forged indoersments.

## General conclusions and reforms

Generally speaking the allocation of liability is efficient but more emphasis needs to be made on the loss spreading principle instead of losses falling on particular individual.

*Forgery of the drawer's signature*

First, as regards the forgery of the drawer's signature, the emphasis on the first Cooter and Rubin principle, namely, loss spreading is efficient. Banks make considerable profits from cheque operations otherwise they would not engage in them. They are in a good position to spread the losses stemming from forgery. Attempts to impose duties beyond the statutory exceptions to forgery, namely, estoppel and ratification, have been wisely rejected by the courts in Australia on the basis that it would be difficult to craft such a duty. Moreover, the banks themselves have not adduced any evidence of the magnitude of the problem. What about the second Cooter and Rubin principle, namely, loss avoidance? Does this loss spreading emphasis ignore this completely? Not completely. The duty to notify the bank once the customer becomes aware of the forgery covers estoppel by representation or conduct by negligence or by contract. This covers quite a lot. Thus estoppel by representation or conduct covers not only forgeries that the customer knows about but also suspected forgery.[85] Estoppel by negligence covers situations where the customer does

[85] *Greenwood v Martins Bank Ltd* [1953] AC 51; *Ontario Woodsworth Memorial Foundation* [1966] 58 DLR 21.

not know of the forgery but should because of a duty imposed on him. The source of this duty has been a matter of debate. It appears to stem from an implied term of the banker and customer.[86] It is, however, a narrow duty (the *Greenwood* duty) and the customer 'has no duty to the bank to supervise his employees, to run his business carefully, or to detect frauds.'[87] Yet is precisely these sort of broad duties that banks via the courts have unsuccessfully sought to impose. As Rubin has pointed out, in an efficient system:

> The customer would generally be assigned enough of the loss to give it an incentive to take reasonable precautions but no more. Assigning excessive liability to the customer is inefficient. It may induce the customer to take excessive precautions against the loss- that is, precautions that are more costly than spreading the loss among all the customers.[88]

Therefore it is concluded that the balance between loss spreading and loss avoidance is efficient since the principle of loss spreading is the dominant one. Moreover proposals like those put forward in the *Hokit* case would greatly complicate adjudication, thus offending against Cooter and Rubin's third principle, namely, efficiency in allocating the loss. The ancillary rule in *Ligget's* case, although difficult to reconcile with the principle that the bank should not pay a cheque without a mandate (and many would see it as an unjustifiable concession to the banks) can be seen as efficient in the broad sense that contractual debts should be paid.

---

[86] Harold Luntz, 'Banker and Customer: Reciprocal Absence of Duty of Care' (1996) *4 Torts Law Journal* 99, 102.

[87] *Big Dutchman (South Africa) v Barclays National Bank* 1979 (3) SA 267, 283.

[88] Rubin, above n 40, 564.

*Liability of persons subsequent to the forgery of the drawer's signature*

Second, as regards liability of persons subsequent to the forgery of the drawer's signature, aspects of this are inefficient, namely, the liability of indorsers. Here we are primarily concerned with allocating liability between persons; so, the loss spreading principle does not so readily inform the choice. Allowing indorsers to negate liability offends the loss aversion principle as does making indorsers who are distant from the forgery of the drawer's signature liable. On the other hand, the transferor by delivery's liability since it is immediate is more efficient.

*Forged indorsments*

Third, as regards forged indorsments, the legislative concessions to the banks in ss 94 and 95 of the *Cheques Act* mean that the loss spreading principle is virtually ignored. This is therefore inefficient.

*Possible reforms to achieve efficiency*

Points two and three above bring us to a relatively easy solution to some of these problems and concomitant inefficiencies: why not make cheques not transferable? The Manning Committee estimated that seventy seven per cent of cheques went into the payee's account.[89] And, undoubtedly, at that time, 1964, the percentage that did not go into the payee's account would have included Commonwealth social security payments and the like that were cashed across the counter or went into other people's accounts, for example, publicans' accounts. The percentage going directly into payees' accounts now is probably even greater than seventy seven per cent because more people have bank accounts. Moreover social security payments are now paid directly into accounts.

[89] Review of the *Bills of Exchange Act 1909-1958*, 1964 (Manning Committee Report) paras 27 and 55.

On the face of it, the commonly used "account payee only" crossing seems to indicate that only the payee is to receive payment; in other words, the cheque is not transferable. Yet the courts have, even prior to the *Cheques and Payment Orders Act* 1986 (Cth), recognized that the 'account payee only' crossing does not prevent the transfer of the cheque. The Privy Council in *Universal Guarantee Pty Ltd v National Bank of Australasia*,[90] on appeal from the Supreme Court of NSW, made this point. Clearly the words "account payee only" contradict the words "or bearer" or, if it is an order cheque, the words "or order". Hence they have always been interpreted as not preventing transfer. It was, of course, possible under the *Bills of Exchange Act* 1909 when it governed cheques to make a cheque not transferable by writing the words 'only' after the payee's name or by writing the words 'not transferable' on the cheque. However, the *Cheques Act* 1986 expressly provides in s 39(2) that a cheque may be transferred by negotiation notwithstanding anything written or placed on the cheque. Given the statistics referred to above, one wonders about the logic of this. The reasons for this are not hard to find:

On the issue of the above Rhind J in the Hong Kong case of *Zanda Investments Pty Ltd v Bank of America National Trust and Savings Association* said:

> Banks do not, however, like the highly effective, 'Not Transferable' crossing, nor the insertion of, 'only' after the payee's name on a cheque, since they will then almost certainly lose the protection of section 86 (equivalent to s 95 CA)if they make a collection for other then the true owner.
>
> As many a litigant has found out, too late, to his cost, the so-called 'safest crossing', 'Not Negotiable A/C Payee Only', is not really all that safe, since the cheque still remains

[90] (1965) 65 SR (NSW) 102,106.

> transferable, and a bank which collects for the party, other than the named payee, can escape liability to the true owner under section 86 (s 95 CA) it is can prove it acted in good faith and without negligence. Paying banks enjoy similar avenues of escape.[91]

The report of the U. K Jack Committee was not in favor of giving legislative recognition to the words "Account Payee only" since it recommended the creation of a new non-transferable instrument.[92]

The option of a new non-transferable instrument was never taken up by the U.K Government since it was opposed by the banking community which viewed the idea of an 'account payee only' on a non-transferable basis as being the lesser of two evils.

The U.K *Cheques Act* 1992 was accordingly amended by the insertion of the following:

> When a cheque is crossed and bears across its face the words "account payee" or "A/C payee", either with or without the words "only", the cheque shall not be transferable but shall only be valid as between the partners thereto.[93]

A clearer and better option that would eliminate the problem of forged indorsements and its complicated consequences would be to make all cheques not transferable: s 39(2) of the *Cheques Act* would thus also need to be repealed. An exception for a special 'transferable' crossing for those few

---

[91] (1994) 2 HKC 409; 1993 HKC Lexis 178; Derek Roebuck, Srivastava and Zafrullah *Banking Law in Hong Kong* (1995) 421.

[92] Jack Report, above n 32, paras 7.18-7.20.

[93] Now *Bills of Exchange Act 1882* (UK) s 81A.

drawers who want their cheques to be transferable might also be allowed. It is difficult, however, to conceive why drawers would want this. Indeed, most drawers want cheques to go directly into the payee's account so they have proof that the payee has been paid.

The inefficiencies in allocation of liability for fraud stem from two sources: first, the complicated provisions that related historically to bills of exchange and their transfer – completely unnecessary given that the vast bulk of drawers do not want their cheques to be negotiable, witness, the wide spread erroneous use of the little understood 'not negotiable' crossing; second, they also stem from provisions inserted in the legislation at the behest of the banks. The amendments proposed above would help eliminate some of these inefficiency problems

**Summary of conclusions and recommendations**

- The forgery rule as regards the drawer's signature and the ancillary *Ligget* rule are basically efficient.
- The forgery rule regarding indorser's signature is inefficient - making cheques not transferable would go a long way in eliminating this inefficiency.

# Chapter 6

# ALLOCATION OF FRAUD LIABILITY RESULTING FROM ALTERATION OF CHEQUES

## 6.1 Overview

In the previous chapter allocation of liability resulting from forgery was examined. In this chapter it is proposed to look at the fraudulent alteration of cheques. Again the law here is complicated and there are still many unclear points.

## 6.2 Outline of this Chapter

This chapter will examine whether the allocation of fraud liability associated with the alteration of cheques is efficient by addressing the following questions:

- What sort of alterations are illegal?
- Between the drawee bank and the drawer who bears liability for alterations made by a rogue?
- Should employers be liable for employing rogues who alter cheques?
- What is the liability of parties subsequent to the alteration?
- What is the liability of the collecting bank?
- What can be learned from American law in regard to alterations?
- Is the allocation of liability for alterations efficient?
- What changes should be made?

Needless to say, current law needs to be looked at to determine whether it is unduly complex or unclear as this would offend Cooter and Rubin's third 'rule' about simplicity and efficacy.

### 6.3 Material alterations must also be fraudulent

The stance adopted by the *Cheques Act 1986* (Cth) is that where there is a fraudulent and material alteration to the cheque by the holder it is discharged.'[1] Discharge of the cheque means basically that all the rights on the cheque come to an end.[2]

The Act provides that an alteration of a cheque is a material alteration if it alters, in any respect, a right, duty or liability of the drawer, an indorser or the drawee bank.[3] However, there are no examples given of what may constitute a material alteration. This may be contrasted with s 69 (2) of the *Bills of Exchange Act* 1909 (Cth) which provides a non-exhaustive list of alterations that could be considered material, viz, any alteration of the date, the sum payable, the time of payment, the place of payment, and, where a bill has been accepted generally, the addition of a place of payment without the acceptor's assent.

Under the *Cheques Act*, not only must the alteration be a material one, it must also, to discharge the liabilities of the parties on the cheque, be fraudulent. The customer must demonstrate that it is not only a material alteration (which is easy to do where the amount has been increased) but that it is also a fraudulent one. The dual burden of proof on the customer may be difficult to discharge. This should be contrasted with s 69 of the *Bills of Exchange Act* 1909 (Cth) which merely talks of material alterations. Clearly the *Cheques Act* reference to ‘fraudulent’ favour the banks.

There may be cases of innocent yet material alterations, for example, where A owes B two sums of money, $20 and $100. Being short of funds A draws a

---

[1] *Cheques Act 1986* (Cth) s 78(2).

[2] *Cheques Act 1986* (Cth) s 82.

[3] *Cheques Act 1986* (Cth) s 3(8).

cheque for $20, naming B as the payee. B thinks that A must have made a mistake and alters the amount to $120. There is no doubt that this is a material alteration; however, it is probably not fraudulent. Thus one could argue that A is liable on the altered cheque and that A's bank could rightfully debit the account or refuse payment for lack of funds.

Similarly, alteration of the date on a cheque could be viewed as a material alteration, yet it could be altered innocently; for example, X postdates a cheque because he has no funds in the account. Y, thinking that X has made a mistake, alters the date to the present date and presents it for payment. It is doubtful whether X would have any cause for complaint against his bank for his embarrassment when it refuses payment for lack of funds since the alteration is not fraudulent and therefore the cheque binds the drawer.

The Act does not define what fraud is, but it has been held, in the context of S 35(2) of the *Bills of Exchange Act* that fraud involves the quality of being deceitful and includes an act or instance of deception, a dishonest trick, or a fraudulent contrivance.[4]

### 6.4 Liability of the drawer versus liability of the drawee bank

The drawee bank has no right to debit the account of the customer, if there is a fraudulent and material alteration to the cheque by a holder. However where a drawee bank in good faith and without negligence pays such a cheque to the holder the drawee bank may rightfully debit the drawer's account according to the tenor of the cheque as originally drawn. Thus if, for example, the drawer wrote the cheque out for $5.00 and a holder fraudulently altered it to $50.00, the Act provides that the drawee bank is legally entitled to debit the account

---

[4] *Hasan v Wilson* (1977) 1 Lloyds Rep 431. Quaere whether alterations to the MICR (magnetic ink character recognition) code constitutes a material alteration of the instrument or is this code merely an administrative convenience for the financial banks to expedite clearance of cheques?

for $5.00. This is a rather remarkable concession to the banks given that a cheque is discharged by the fraudulent and material alteration.[5] The drawee bank's right to debit the account to the tenor of the cheque as drawn is also "without prejudice to any other rights that it may have against the drawer".[6]

It is now beyond doubt that the drawer of the cheque owes a duty to the drawee bank to fill out the cheque in such a way so as not to facilitate alterations. The principle, following the English line of decisions, was applied in *Commonwealth Trading Bank of Australia v Sydney Wide Stores Pty Ltd* [7]. In that case the drawer wrote out cheques for payment to "Computer Accounting Services", but, instead of inserting the full name, wrote "Pay CAS or order". The cheques were crossed and marked "not negotiable" and the words "A/C Payee only" also appeared on the face.

A rogue employee added "H", thus making the cheques read '.'Pay CASH or order", and obtained payment of the money. (Arguably this was not even a cheque as s 8 of the *Bills of Exchange Act* required required cheques to be made out 'to or to the order of a specified person or to bearer'.) The drawer sued the drawee bank for wrongfully debiting the account and paying the wrong person. The bank, however, argued that it was not liable since the drawer owed a duty of care to fill out the cheques in such a way so as not to make it easy for a rogue to make alterations and that writing "CAS" without a full stop following it was careless. The High Court agreed with the drawee bank's defence that there was a duty of care on drawers and the case was remitted to the lower court for a decision on the facts.

---

[5] *Cheques Act 1986* (Cth) s 78(2).

[6] *Cheques Act 1986* (Cth) s 91.

[7] (1981) 148 CLR 304.

The High Court thus reaffirmed the principle established in *London Joint Stock Bank Ltd v MacMillan and Arthur*.[8] This raises the interesting question of what is the position if the customer has breached this duty of care but the drawee bank has also been negligent? In essence this was what happened in *Varker v Commercial Banking Co of Sydney Ltd*.[9] The plaintiff paraplegic had been expressly told by the bank not to leave spaces in the cheque or to facilitate alterations. There was also a written warning to this effect in the cheque book. The plaintiff had breached this contractual duty. Nevertheless, the court found that the defendant bank had been guilty of contributory negligence since the cheque was made out to 'cash or bearer' and the bank was aware that the plaintiff because of his physical condition could be easily cheated. Moreover the bank had in the past contacted him about dubious cheques. Therefore the court found that the plaintiff was entitled to succeed since the defendant bank had been guilty of contributory negligence.

It is to be noted that this decision was made before the *Sydney Wide Stores* case. However, it is suggested that the decision would still be the same since the customer's duty not to facilitate alterations was found to be established on an express contractual basis in *Varker's* case rather than on the basis of an implied term as the *Sydney Wide Store* case established.

### 6.5 Employer carelessness and alterations

This brings us to a rather curious situation in regard to employers and rogue employees, often the setting for this type of fraud.

The case of *Young v Grote*[10] in 1827 seemed to establish that there was a duty on the customer to fill out the cheque properly so as not to facilitate alteration.

[8] [1918] AC 777.

[9] [1972] 2 NSWLR 967.

[10] (1827) 4 Bing 253.

There was, however, some doubt as to its exact *ratio decidendi*. The drawer, Young had given some signed cheques to his wife for wages while he was away. One of them was supposed to be for 50 pounds. An employee showed her how to fill it out; but there was a space left between the pound symbol and the first numeral of the digit, thus enabling the insertion of the numeral three, so making it read 350 pound. This was then cashed by the rogue at the defendant drawee bank. The court seemed to decide that the drawer's negligence was in leaving it with his inexperienced wife rather than the leaving of the space. The *MacMillan* case, however, finally established that the negligence consists in filling it out carelessly rather than delivering carelessly to a person to complete.[11]

*Inchoate instruments versus materially altered ones*

Often employers will sign a cheque and give it to an employee to fill in the details of the payee. But where a person, for example, an employee is given a signed incomplete instrument with authority to fill up the instrument and the employee exceeds that authority, such an instrument cannot be enforced by the payee (this assumes that the payee is not a holder in due course as the cheque has not been negotiated to the payee).[12] If, however, such a cheque is negotiated to a third party who qualifies as a holder in due course, such a party can enforce the cheque against the employer drawer even though the rogue employee has exceeded the authority.[13] And this so even if the employer has been careless in trusting the employee to fill it out properly.

There are some differences in outcome where the cheque has been carelessly filled out by the employer. Let us say, the employer himself signs the cheque and fills it out carelessly, for example, by allowing spaces in regard to the

[11] [1918] AC 777.

[12] *Cheques Act 1986* (Cth) s 18(2).

[13] *Cheques Act 1986* (Cth) s 18(4).

figures and words denoting the sum, thus facilitating its alteration by a rogue. The cheque is then negotiated to an innocent third party: prima facie this person cannot enforce it against the drawer since it is has been fraudulently and materially altered.[14] The fraudulent and material alteration discharges the cheque. Indeed, the alteration of the cheque means that the innocent third party is not a holder in due course.[15] However, the act makes some concessions to this unfortunate third party – he or she is treated as a holder in due course, even though technically incorrect, so as to enable an action to be brought against the person who made the alteration (the rogue) or any person who assented to the alteration or indorsed after it.[16] In addition, if it is a clever alteration, that is, not easily discernable, then the third party can even enforce it against the drawer but only for the original sum.[17]

The position of the third party is thus not hopeless but it is not as strong as that of the holder in due course who takes a cheque that has been signed by the employer but fraudulently filled out by an employee – in this situation there is no fraudulent and material alteration and the holder in due course can make the employer drawer fully liable.

*Conclusions*

To sum up as regards the drawee bank, two legal principles frequently clash in regard to fraudulent material alterations: first, the drawee bank, has no right to debit the drawer's account for a fraudulently altered amount, it can only debit for the original amount; second, the drawer owes a duty to the drawee bank to write out the cheque in such a way so as not to facilitate alterations. If there is

---

[14] *Cheques Act 1986* (Cth) s 78(2).

[15] *Cheques Act 1986* (Cth) s 50.

[16] *Cheques Act 1986* (Cth) s 82(3)(a).

[17] *Cheques Act 1986* (Cth) s 82(3)(b).

a breach of this duty by the drawer the drawee bank is entitled to debit the account for the fraudulently altered amount.

Further it will be recalled that the bank's right to debit the drawer's account for the original amount on a fraudulently altered cheque (provided it acts in good faith and without negligence), is without prejudice to any other rights that the drawee bank may have against the drawer.

This raises the possibility that a bank could attain rights from a contract entered into with a customer to draw the cheque in a careful manner; for example, it could be a term of the agreement with the customer that the latter agrees to amounts mentioned in the bank statements being debited unless the customer notifies the bank within 14 days. If the bank explained the import of such a clause to a customer, it might confer a right on the bank to debit the account for a fraudulently altered amount.[18]

### 6.6 Liability of parties subsequent to the alteration

The Act allows a person who takes a cheque which is fraudulently and materially altered to enforce payment of the cheque as altered against the person who made the alterations, or against a person who authorized or agreed to the alteration, or against a person who indorsed the cheque after it was altered.[19] In addition the cheque may be enforced according to its original tenor if the alteration is not apparent.[20]

[18] *Tai Hing Cotton Ltd v Liu Chong Hing Bank* [1986] AC 80;[1985] 2 All ER 947.

[19] *Cheques Act 1986* (Cth) s 82(3).

[20] *Cheques Act 1986* (Cth) s 82(3)(b).

## 6.7 Liability of collecting bank and altered cheques

Normally altered cheques usually involve the paying bank and its customer because the cheque has been paid and the paying bank cannot recover the money from the payee. The customer objects to the debit saying that the cheque was discharged by dint of the fraudulent and material alteration. The paying bank, in turn, tries to argue that the customer has breached the *MacMillan* duty. Usually the collecting bank does not enter the picture. There are hardly any cases on the issue.

But a recent English case *Smith and Hayward v Lloyds Bank TSB* [21]decided by the Court of Appeal does, however, illustrate how the collecting bank can be involved. The claimants were the liquidators a company in creditors' voluntary winding up. Under the English Insolvency Regulations 1994, monies received or paid out in the course of a creditor's voluntary liquidation are routed through the Insolvency Services Account ("The Account") held by the Department of Trade and Industry ("DTI") with the Bank of England. Monies in the account are held by the DTI as trustees for those entitled to them, including the Liquidator and unsecured creditors. A cheque in favour of the English Inland Revenue was supposed to be sent by post by DTI to the liquidators. The cheque at the request of the claimants was indeed sent by post. The liquidators were then apparently going to send it to the payee. The cheque was crossed and marked "account payee only" and made out to Inland Revenue only. The cheque was stolen from the liquidator's office and the rogue fraudulently changed the name to "Joseph Smitherman". The cheque was deposited with a branch of Lloyds Bank into an account in the name of Joseph Smitherman and the monies withdrawn when the cheque was paid by the paying bank. The liquidators on behalf of the company in liquidation claimed to the true owners. It was they who requested the cheque be sent to them. Does this mean they became the true owners when it was put in the

[21] [2001] QB 541; [2001] 1 All ER 424.

post? The contractual rule that the post office is regarded as the agent of the person who requests payment by post also applies to cheques: *Channon v English, Scottish and Australian Bank*. [22] But on the facts it appears that the liquidators actually had received the cheque. If this were the case they would be clearly the true owners.

The true owner argued that a fraudulently and materially altered cheque is not a complete nullity since, amongst other things, the holder can, in the case of a clever alteration to the amount, enforce the cheque according to its original tenor. The true owner of the cheque argued that the section in the English *Bills of Exchange Act* 1882 dealing with alterations, s 64 (very similar to s 82 (3)(b) of the Australian *Cheques Act* 1986), was intended to protect the drawer of the cheque and should not be construed to deprive the true owner of compensation. The Court of Appeal rejected this argument.

It held that a materially altered cheque was a worthless piece of paper. Pill LJ said:

> The piece of paper is no longer a cheque and no action can be brought upon it as a cheque. The cheque is invalidated and no distinction can be drawn between parties who, but for the material alteration, would have had contractual rights based on the cheque. No party can bring an action for damages in conversion for its face value because it no longer represents a chose in action for that amount. [23]

The true owner argued that an altered cheque is still a chattel capable of being converted. The instrument is “avoided”, it was argued, against any party to it but, if payment was made upon a conversion, the value remains the face value. It was further submitted that the collecting bank, having obtained the face

[22] (1918) 18 SR (NSW) 30.

[23] [2001] 1 All ER 424, 434.

value of the cheque, was estopped from asserting that the cheque had only a nominal value.

The Court of Appeal rejected these arguments. It held that it was a worthless piece of paper and held that:

> Moreover the consequence of invalidity cannot in my judgement be avoided by alleging an estoppel. The cheque is rendered invalid by section 64 and, by presenting it under normal banking arrangements, the collecting bank was not asserting its validity.[24]

The true owner also tried to argue that a collecting bank could be liable for on a cheque on which there is a forged indorsement; therefore, by parity of reason, a collecting bank could be liable for conversion on a cheque that has been materially altered. The Court of Appeal also rejected this argument.

This appeal case establishes that a claim for conversion in respect of cheque which at the date of conversion has been materially altered (which is the relevant date at which to assess the value of the chattel) will not lie against the collecting bank as it has no value as a piece of paper and no value as a chose in action.

The logic of the decision in practical terms is this. The drawer of the cheque that has been materially altered by a rogue is protected since the paying bank cannot debit his account unless the bank can establish a breach of the *MacMillan* duty by the customer. The altered cheque is a nullity. The "owner" (usually the payee) of such an altered cheque cannot sue a collecting bank if it collects the cheque for someone.

[24] Ibid.

## 6.8 What can be learned from American law in regard to alterations?

In some respects American law is very similar to Australian law in regard to alterations. For instance, the paying bank has no right to debit the customer's account on a cheque which is materially and fraudulently altered but can debit the account for the amount as originally written.[25] This is virtually identical to the Australian position. There is also a sort of US equivalent of the *MacMillan* duty. The 1950s version of the *Uniform Commercial Code* (still used by some states including NewYork) provides in §3-406:

> Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorised signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or to the payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business.

This seems to suggest that if negligence can be attributed to the drawer, then the loss will fall on the drawer. The Official Comments point out that the section does not make the negligent party liable in tort for damages but rather estops him from asserting it against the holder in due course or the drawee (Usually the extent of the loss includes the faint possibility of recovery from the wrongdoer that cannot be assessed at the time of litigation – if the drawer is the negligent party he can sue the wrongdoer and the bank is protected by the estoppel.) On the other hand, if the bank, the drawee, takes an altered cheque that normal banking standards would require it to refuse then it cannot take advantage of the estoppel. Thus, the section seems to establish that either the drawer or the bank ultimately bears the loss since litigation against the wrongdoer rarely results in damages.

There was no definition of negligence for the purposes of §3-406. Frequently courts viewed failure of manual inspection of cheques to amount negligence

[25] UCC § 3-407[c].

on the part of banks and thus the loss would fall on banks.[26] Of course, banks wanted to rely on automatic scanning with occasional manual checks on cheques for large amounts.

The section, indeed the whole of Article 3 of the *Uniform Commercial Code*, was revised in 1990 and a definition of 'ordinary care' was inserted which, in effect, 'allowed' for scanning. The relevant part of the 'new' § 3-103(7) reads as follows:

> 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 not disapproved by this Article or Article 4.

Moreover, §3-406 was revised to provide a rule of apportionment of the loss whereby failure to exercise reasonable care on the part of both substantially contributes to the loss.[27] One commentator, Burke, suggested that this change means that now the loss will fall on customers rather than on the banks which was the case under the earlier version.[28] Rubin was even more damning: apportioning loss according to contributory negligence leads to long and costly

---

[26] *Medford Irrigation District v Western Bank* 66 Ore App 589; 676 P 2d 329 (1983).

[27] (a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

(b) Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

(c) Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.

[28] John J A Burke 'Loss Allocation Rules of the Check Payment System with Respect to Forged Drawer's Signatures and Forged Indorsements: An Explanation of the Present and Revised UCC Articles 3 and 4' (1993) *Uniform Commercial Code Law Journal* 41.

litigation where every fact is important, thus imposing unnecessary costs.[29] The result is that consumers will not be able to litigate. Banks are given too much power under the changes and Rubin urged that the 'new' revisions not be adopted. (In fact most states have adopted the 1990 version).

However, it could fairly be said that the US Article 3 is not much of a model for efficient allocation of fraud loss resulting from alterations on cheques. Ruben maintains that it continues a one sided pro-bank policy at the cost of any social policy.[30] It therefore seems that there is little to learn here from an efficiency point of view.

### 6.9 On the efficiency of allocation of liability for alterations

In this section the following key Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss will be applied:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Similar problems, dissimilar treatment*

One is immediately struck by the similarity with the problem of forgeries, outlined in chapter 3, and alterations, outlined in this chapter. Both involve fraudsters, yet there legal treatment is dissimilar. The courts have set their face in Australia against going beyond the *Greenwood* duty (estoppel) to impose liability on drawers of cheques in regard to forgery; yet, the courts do not seem to have any difficulty in imposing on customer a duty to draw cheques in a

[29] Edward Rubin, 'Efficiency, Equity and the Proposed Revision of Articles 3 and 4' (1991) 42 *Alabama Law Review* 551, 569.

[30] Ibid 592.

way that does not facilitate alterations. This is because of the nature of the layout of cheques: there is nothing, like boxes for numerals, for example, that lessens the possibility of alterations.

Presumably customers frequently break this duty since the Martin Committee referred to a study in adult literacy according to which thirty nine per cent of those surveyed could not fill out a cheque properly.[31] One can perhaps happily assume that such carelessness must not frequently lead to fraudulent and material alterations.

*The loss spreading principle*

As regards the first Cooter and Rubin principle, the loss spreading principle, the 'alteration rule' prima facie places the loss on the bank since a fraudulent and material alteration discharges the cheque and this means that the bank cannot debit the account. But s 91 of the *Cheques Act* somewhat undermines this by providing that the bank can maintain the debit for the cheque as originally written if the only fraudulent and material alteration is to the amount. This seems an unwarranted erosion of the loss spreading principle given that a fraudulent and material alteration is supposed to discharge the cheque. The *Marshall* case which was over-ruled in the *Sydney Wide Stores* case was a case that favored loss spreading and prompted Murphy J to ponder the issue of loss spreading in regard to over-ruling the *Marshall* case:

> In terms of social policy, there is a real question whether it would be better to let the loss continue to fall on the banking industry [the effect of the *Marshall* case].Although the standard of care habitually observed by cheque drawers may fairly be described as low, I am not satisfied that any considerable burden has been imposed on bank by the application of the *Marshall* decision. *If in practice , the losses, which to individual bank*

[31] House of Representatives Standing Committee on Finance and Public Administration (Chairman Steven Martin) *A Pocket Full of Change: Banking and Deregulation* (1991) [22.13].

> *customers would be onerous, are cumulatively only slight for the banking industry in comparison with the vast amount of business done by cheque, a sensible system of loss spreading would be to continue as before. Further if the cumulative losses are now slight, it would be absurd to impose a standard of care such that every drawer of cheques would have to regard employees and associates as potential forgers.*[32] (Italics added)

It is noteworthy that Murphy J was clearly articulating the idea of loss spreading long before Cooter and Rubin's seminal article. It is worthwhile setting out a later explanation by Rubin of the loss spreading principle which might be viewed as a form of 'bank bashing'.

> When we assign liability to a bank, we are not imposing a loss on that 'person' as an individual entity. Instead, we are deciding the loss should be spread across the entire customer base, instead of letting it fall on the particular customers who happen to be victimized.[33]

Nevertheless, Murphy J was in favor of over-ruling the *Marshall* case, although it clearly favored loss spreading. Nevertheless, he was of the opinion that 'the negligent drawer should be liable, but no high standard of care should be required.'[34] Presumably, the latter was referring to a duty of care that encompassed carefully choosing employees and associates. Of course, no evidence of the 'burden' on banks was adduced as evidence in the *Sydney Wide Store*, so it is not possible to conclude to conclude whether Murphy J's observations were accurate, but they certainly accord with Cooter and Rubin's general idea about loss spreading.

*The loss avoidance principle*

---

[32] (1981) 148 CLR 304, 317

[33] Rubin, above n 29, 551, 566.

[34] (1981) 148 CLR 304, 318

The loss spreading principle is, however, more than counter balanced by the rule that the customer owes a duty to the bank to draw the cheque in such a way so as not to facilitate alterations, the so called *MacMillan* rule. This reflects the second Cooter and Rubin principle, the loss avoidance principle. Obviously this works in favor of banks. It will be recalled that the rule provides that the loss should be attributed to the party who can most easily avoid the loss. The *MacMillan* rule seems to encapsulate this rule. But unlike the sort of wide duties that banks would like to impose on customers to avoid forgeries, it is a fairly narrow rule. Nevertheless, it clearly means that the burden of fraud is thrown on customers. However, given the high levels of consumer ignorance of how to effectively fill in cheques[35] it is pertinent to ask whether the rule detracts too much from the loss spreading principle. Moreover, it adds a degree of complexity to the adjudication process that is arguably undesirable given that Cooter and Rubin's third principle is that the best legal rule is the simple rule. It could also be asked whether or not the configuration and signing of cheques could not be improved by banks so as to lessen fraudulent alterations; for example, by banks supplying special lock-up pens to be used on cheques or by providing boxes for each numeral. As banks do not provide any statistics on the incidence of fraudulent alterations is difficult to gauge the magnitude of the problem. It is clear that there is no incentive for them to do anything along these lines as long as the *MacMillan* rule throws the burden on the customer.

*Legal rule simplicity*

In terms of the third Cooter and Rubin principle, legal rule simplicity, the provisions regarding the rights of the ultimate holder of a fraudulently and materially altered cheque surely must win some prize in terms of complexity. The act even has to create some legal fictions to provide some remedies to the holder – the holder is deemed to be a holder in due course! If it is not an

[35] Martin *A Pocket Full of Change* above n 31.

apparent alteration the holder can sue the drawer for the original tenor of the cheque as if it had not been altered, another legal fiction.[36] And there are anomalies to boot. If the holder takes a fraudulently and materially altered order cheque from an indorser, or even via an indorser, he or she has an explicit right to seek recompense from the indorser but, on the principle of e*xpressio unius personae vel rei*, *est exclusio alterius*, not against transferors by delivery if it is a bearer cheque.[37] These rules require complex findings of fact and make for complex adjudication. It is not difficult to imagine a holder, assuming the holder could obtain competent legal advice, recoiling from litigation in the face of the complexity involved. Moreover, the services of the Financial Ombudsman Service would not be available as it would not normally involve the holder's bank.

As to the collecting bank, the *Smith and Hayward* decision completely exonerates the collecting bank. The gist of the decision is that the altered cheque is a worthless piece of paper despite the fact that s 82 (3)(b) confers valuable rights of redress on the holder. The fairness of the decision is also questionable. Counsel for the bank argued that on the facts there was no unfairness since the true owner was in fact the customer of the paying bank. The cheque was not in the hands of the payee (the Inland Revenue). The customer could therefore ask the paying bank to reaccredit the account because of the alteration. In short, the paying bank had no mandate to pay. The Inland Revenue could then ask for another cheque.

However, let us imagine that the cheque had been delivered to the payee who is now the true owner and that the alteration by the occurred at some point in time after this. Payment on a cheque does not occur until it is honored[38] and the presumption is that acceptance is conditional on payment.[39] Suppose the

[36] *Cheques Act 1986* (Cth) s 82(3)(b).

[37] *Cheques Act 1986* (Cth) s 82(3)(a).

[38] *Re Hone* [1951] Ch 89.

[39] *Re Romer & Haslam* [1893] 2 QB 286.

paying bank notices the alteration and does not pay. If the payee asked the drawer for another cheque the drawer might say ‘I gave you a valid cheque upon which you could have obtained payment. It is not my fault it was purloined by a rogue whilst in your possession and altered.’ Then the payee would have to threaten to sue the drawer on the underlying contract alleging non payment despite the valid tender of the cheque and the conditional acceptance of the same. In such circumstances one assumes the drawer would then have no objections to handing over another cheque.

But if the payee, the true owner, proceeds against the collecting bank for conversion *Smith and Hayward* says there is no remedy.

*Conclusions*

The law in regard to alterations is inefficient since in the main it ignores the loss spreading principle and places too much emphasis on the loss avoidance principle and therefore there is little incentive for banks to devise cheques and ways to fill them out that would minimize fraudulent and material alterations.

**6. 10 General conclusions and reforms**

As regards alterations, the law gives primacy to the loss spreading rule in so far as the drawee bank should not pay out on a fraudulently and materially altered cheque. The addition of the element of ‘fraudulently’ altered detracts somewhat from the efficiency of the alteration rule. The prima facie rule that the bank should not pay out is tempered by the *MacMillan* duty which casts a duty on the drawer to fill out the cheque properly. This qualification reflects the loss avoidance rule. But given the difficulty that customers seem to have in filling out cheques properly it hardly seems justified in practice.[40]

The inefficiencies in allocation of liability for fraud mainly stem from two sources: first, the nature of cheques – they are not devised in any way to

[40] Martin *A Pocket Full of Change* above n 31.

prevent alteration (for example, by having special lock up cheque pens issued by the bank); second, customer carelessness may also be source. The latter, it is suggested is facilitated by the way cheques are pre-printed by banks. Carelessness is addressed by loss avoidance but it is submitted that loss spreading is under-weighted by current loss allocation. It would therefore be more efficient if the total loss fell on the banks. This might induce them to devise more tamper proof cheques.

As to the liability of parties subsequent to an alteration and the complication it adds to adjudication, this could in the main be eliminated by making cheques not transferable. It is to be noted that both the UK and NZ have given a statutory interpretation of the "Account Payee only' to make it mean that the cheque is non transferable.[41]

Recommended changes are therefore:

- Paying banks to bear total loss for fraudulent and material alterations with a right, of course, against the person who has made the alteration.
- Subsequent party liability, for example, that of indorsers, to be eliminated by making cheques not transferable.

[41] *Bills of Exchange Act 1882* (UK) s 81A; *Bills of Exchange Act 1908* (NZ) s 7B.

## Chapter 7

# FRAUD INVOLVED IN THE ISSUE OF BANK CHEQUES AND ALLOCATION OF LIABILITY

### 7.1 Overview

This chapter will examine non payment in regard to bank cheques (also known as financial institution cheques) where there has been a failure of consideration for their issue. This usually involves fraud. Essentially here the concern is with disputes between the issuing bank and, usually, the payee on the bank cheque and how the law works out where the loss falls. It is proposed to assess whether these allocation rules for loss are efficient in the light of the Cooter and Rubin principles outlined in Chapter 2. There will also be some comments as to whether this allocation is fair. Although some of these fraud issues are the same with ordinary cheques the special nature of bank cheques gives them a different dimension and gives rise to special problems. This arguably may call for different rules for allocation of liability. Many of the doctrinal issues are far from clear when great certainty is required in regard to such cheques.

### 7.2 Outline of this Chapter

This chapter will examine whether the allocation of fraud loss with bank cheques is efficient by addressing the following questions.

- What is a bank cheque and why are they used?
- What parties are likely to impugn the validity of the bank cheque?
- What arguments are used by banks to justify non payment of bank cheques when consideration for their issue has failed?
- What is the American position in regard to bank cheques?

- What steps in Australia have been taken to engender confidence in the pay worthiness of bank cheques?
- Are the Australian rules for allocation of loss efficient?
- What changes should be made to assure reliability and hence efficiency of bank cheques?

Uncertainty is, of course, an enemy of efficiency and with bank cheques certainty of payment is paramount. Hence the current law needs to be examined to determine whether it is clear and not unduly complicated as this would offend Cooter and Rubin's third 'rule' about simplicity and efficacy.

### 7.3 What is a bank cheque?

Bank cheques are widely used for consumer property settlements and for consumer purchases of motor cars. A bank cheque is commonly understood as a cheque drawn by a bank upon itself.[1] This is not, however, a term of art. Under the previous legislation *(Bills of Exchange Act* (Cth)1909) there was considerable doubt whether these instruments were cheques at all and therefore whether they attracted the coveted protective provisions relating to paying and collecting banks.[2] The fact that a bank cheque was drawn by itself on itself arguably created a problem under s 10 of the *Cheques and Payment Orders Act* 1986 (Cth) as originally enacted since a cheque was supposed to be addressed by 'one person to another person'. That is, there had to be two persons. This was not, of course, the case with a bank cheque. Arguably it was not a cheque and therefore not covered by the Act. This perceived problem was eradicated in 1994 by s 5 (4) which now provides as follows:

[1] A~~lan~~lan ~~-~~Tyree, *Wee asooria's Banking Law* (2006)~~,~~ 139.

[2] *Fabre v Ley* (1973) 127 CLR 665.

> A reference in subsection (1) or (3) to a cheque drawn by a financial institution on itself is a reference to an instrument that would be a cheque if the drawer and the drawee were not the same person.

Bank cheques as such are not defined in the Act. However, s 5 (1) now provides that a reference in the Act to a cheque includes a reference to a cheque that a financial institution draws on itself. Thus a cheque drawn by a credit union or a building society upon itself would come within this definition as well as a cheque drawn by a bank upon itself. But a cheque drawn by a financial institution on another financial institution does not come within the definition although arguably the drawer here is just as worthy a paymaster as with a cheque drawn by a financial institution on itself.

Since cheques drawn upon banks themselves are the most common this thesis will talk about bank cheques but what is said about these also applies to a cheque that a financial institution draws on itself. It should also be noted that bank cheques in Australia are typically  bearer instruments and crossed 'not negotiable'.

The Act now provides that bank or financial institution cheques are treated, in general,[3] as ordinary cheques so that the rights, duties and obligations of the parties in relation to customer cheques apply equally to bank cheques.[4] One is immediately puzzled why a cheque that is widely regarded as a cash equivalent is dealt in the same manner as ordinary cheques. Apart from some minor exceptions[5] the provisions of the *Cheques Act* do not set out any specific ways in which financial institution cheques are to be treated. There is thus a

---

[3] See minor exceptions set out in ~~s 5 of~~ the *Cheques Act* 1986 (Cth) s 5.

[4] *Cheques Act* 1986 (Cth) s 5.

[5] *Cheques Act* 1986 (Cth) s 5(2).

**Formatted:** Font: 10 pt

**Formatted:** Font: Italic

**Formatted:** Normal, Indent: Left: 0 cm, Hanging: 0.63 cm, Space Before: 6 pt, After: 6 pt

**Formatted:** Font: 10 pt

**Formatted:** Font: Italic

**Formatted:** Normal, Indent: Left: 0 cm, Hanging: 0.63 cm, Space Before: 6 pt, After: 6 pt

**Formatted:** Font: Italic

tension between perception of financial institution cheques as being a sort of safe cash equivalent and the provisions of the Act which are applicable to all cheques.

The definitional expression of financial institution cheque does not encompass cheques drawn by financial institutions upon other financial institution which are surely just as reliable as financial institution cheque drawn upon themselves. All financial institutions are covered by the same prudential regulation; yet the *Cheques Act* 1986 (Cth) treats them in the main as ordinary cheques despite the fact that they are regarded as reliable cash substitutes.

## 7.4 Why bank cheques are used and how they impact the bargaining process

Certain payment instruments, bank cheques being a classic example, are often required by payees since they viewed, rightly or wrongly, as guaranteeing payment. They appear to have some of the characteristics of letters of credit: the risk of non payment is apparently removed from the payee. Payment comes from an autonomous source.  But what is by autonomous and what are the implications?

*Autonomous payment instruments*

To ensure the seller that payment is certain the buyer will often make use of a third party payment instrument or mechanism. It may take the form of a bank cheque or draft, or it may be a credit card, or some form of electronic payment. In all these instances a third party apparently guarantees payment. However, it is not a guarantee in the strict legal sense of the word since the provider of the payment instrument or the payment system itself involves primary liability. In reality, all parties know that the payment constitutes payment on behalf of the buyer. The appeal to the seller is self evident: the seller is, in the absence of fraud, assured of payment even if there is a dispute about the goods or services supplied under the contract.

The oldest and most developed body of law relating to payment mechanisms is the law relating to negotiable instruments. Even here though, the law does not – as will be explained more fully subsequently - deal satisfactorily with one of the fundamental problems affecting the independence of payment instruments, namely, whether disputes between the buyer and the seller have any impact on the third party payer's obligations, or whether the payment instrument is autonomous. Nor is it particularly clear where there has been a failure of consideration for the issue of a bank cheque – this usually involves fraud - on whom the loss falls.

*Certainty of payment*

The major reason for clearly autonomous payment instruments such as letters of credit is to guarantee payment and to avoid defences that the buyer may be able to set up against the seller. If the seller is successful in negotiating an autonomous payment instrument in his favour, then the seller is not subject to these defences in regard to immediate payment. If the buyer decides that there is a breach of the sales contract the buyer can bring an action for breach of contract but the seller in the meantime has, of course, the money.

Financial institution cheques including bank cheques are widely regarded as being tantamount to cash. This is demonstrated by acceptance of these instruments as payment at property settlements and for the purchase of motor vehicles. The Australian Paper Clearance System web site also makes the following claim:

> Financial institution cheques have the following key advantages over ordinary cheques:

▪ because a financial institution cheque is drawn by the financial institution on itself, any associated risk with non-payment for lack of funds is vastly reduced relative to ordinary cheques drawn by customers of financial institutions. The drawee financial institution would have to be effectively insolvent for the cheque not to be paid for lack of funds in the account; and

▪ financial institutions have agreed among themselves only to dishonour financial institution cheques for a limited range of reasons compared with ordinary cheques issued by customers of financial institutions.[6]

Even judges have taken the view that they are tantamount to cash. In the New Zealand case of *Ricky Yan v Post Office Bank* the court said:

> Post Bank must be taken to be aware of the fact that bank cheques are commonly relied upon in commercial transactions as being almost equivalent to cash, and that the purpose of obtaining a bank cheque, rather than the customer proffering his own cheque, is to enable the payee to have the added assurance of payment.[7]

In *Sidney Raper Pty Limited v Commonwealth Trading Bank of Australia* Moffit P was more circumspect and said:

> A bank cheque, in common with other types of negotiable instruments, according to the financial dependability of those who are liable upon it or them, in practical terms closely approximates in many respects to monetary currency. For this reason many persons have little reason

[6] <http://www.apca.com.au/Public/apca01_live.nsf/WebPageDisplay/Payment_Cheques_Info> at 28 September 2009.

[7] *Ricky Yan v Post Office Bank* [1994] NZLR 155, 162.

> other than to regard them as the equivalent of or as good as cash, but these circumstances do not change the nature of the bank cheque or other negotiable instrument. A bank cheque or any other cheque with apparently impeccable backing, is still a cheque and not cash and, in the absence of solid support, it is an unwarranted inference, that a person particularly a banking or financial institution, who or which accepts the cheque of another bank, accepts it as cash and not with the rights and other considerations which arise out of the circumstance that it is a cheque and not cash.[8]

In the case of *Lyritzis v Westpac* [9] there was an issue of whether a bank manager's advice to an opal dealer that a bank cheque was "as good as cash" was misleading and deceptive within the meaning of s 52 of the *Trade Practices Act* 1974 (Cth) and whether such advice was negligent. The bank cheques were in fact forgeries on a stolen bank cheque forms and given in exchange for opals. It was held that the manager's failure to mention the exceptions to the Australian Paper Clearance System assurances that bank cheques will be paid was negligent and also in breach of s 52. These exceptions, the most important one in the circumstances of the case, forgery, will be discussed further below.

The Australian Paper Clearance System assurance is that the worth of such instruments is the financial backing of such financial institutions. There is, however, something of an anomaly here as noted before. If, say, the CBA drew a cheque on the NAB, it would have the same financial backing, yet this is not a financial institution cheque since it is not drawn by CBA on itself. Moreover,

[8] *Sidney Raper Pty Limited v Commonwealth Trading Bank of Australia* (1975) 2 NSWLR 227, 233-234.

[9] [1994] FCA 1458.

it would not attract the benefit of the Australian Paper Clearance System assurances to be discussed further below.

*Salability of autonomous payments*

Another major reason for the popularity of the autonomous payment instrument is to facilitate the 'sale' or disposal by the seller of his payment. The payee on a bank cheque can, all things being equal, transfer the cheque by negotiation to another party.

Yet another reason for the use of autonomous or independent payment instruments is the general credit enhancement effect of these. Absent an autonomous or independent payment instruments, the normal unwritten 'bargain' is for the vendor to take into consideration when formulating his side of the bargain, the possibility that the buyer may not pay: the vendor therefore charges more for the goods or services because of the possibility of a bad debt. If there are many similar sales the cost of bad debts can be spread across the whole operation. Bad debts mar the balance sheet of the vendor; so their elimination or reduction is a boon. This in turn improves the vendor's credit profile and improves the ability to borrow.

In addition the provision of an independent payment instrument also spares the vendor the need to check out the buyer's creditworthiness. The latter can be difficult, time consuming and therefore costly. If the buyer does not provide a valid autonomous or independent payment instrument, costly and time consuming debt recovery proceedings may need to be undertaken.

Possession of valid autonomous or independent payment instruments and consequent certainty of payment also enhances the ability of a large public company vendor to borrow money directly from the public, by having such obligations to be held on trust to 'back' an issue of promissory notes. However, this is not commonly encountered in Australia.

*The unwritten economic bargain*

Since financial institution cheques including bank cheques are widely regarded as cash substitutes it is useful in assessing the efficiency of loss allocation rules to ponder the bargain implicit in their use. Use of a personal cheque raises two unpalatable possibilities for the payee. The first is the possibility of the drawer's insolvency – the payee on a personal cheque merely becomes an unsecured creditor. The second is that the drawer may stop payment – the payee will be deprived of funds whilst awaiting an outcome to litigation as well as losing the use of money tied up in pursuing litigation. (The Financial Ombudsman Services will not normally be available as the complaint by the payee will not be about his or her bank but about the bank of the purchaser of the bank cheque.) Acceptance of a bank cheque instead of a personal cheque is therefore perceived as eliminating these possibilities. Use of cash, of course, also eliminates them but the risk of loss or theft makes this a dubious payment possibility for large scale purchases like real estate and cars. Payment by credit card is also limited by the dollar amount one can purchase with a credit card and by the fact that normally vendors of real estate and private sellers of cars do not have credit card acceptance facilities. Moreover, the availability of chargeback with credit cards means that the possibility of litigation and dispute is not eliminated.[10] In such circumstances financial institution cheques including bank cheques seem a favorable means of payment to a vendor. Stopped personal cheques and chargeback with credit cards mean that business payees will charge more for goods and services to cover this possibility.

From the payer's point of view there may be advantages in using a financial institution cheque. Because of the perception of financial institution cheques,

[10] See Ch~~apter~~ 12.

especially bank cheques, as being a cash equivalent the payer may be able to argue for a reduction in price.

It is important therefore that there be certainty in regard to financial institution cheques in order that transactional risks can be avoided or allocated by agreement between the parties. If a bargained allocation of risks is upset by the uncertainty of the law it will promote inefficiency.

*Conclusions*

There are compelling commercial reasons for the use of bank cheques, the most important one being certainty of a payment. Rightly or wrongly bank cheques are currently regarded as a safe cash substitutes under present law. These reasons impact on the bargains parties make and efficiency demands that such bargains be sustained.

### 7.5 Parties likely to impugn validity of autonomous payment instruments

Where there has been fraud involved in the issue of a bank cheque the person 'impugning' the instrument will be the drawer bank; and, in this case, the most effective way to do this will be by stopping payment on it. This usually happens when the bank realizes it has been duped. It may also occur when, for example, the bank pays a supplier of goods or services with a bank cheque and then stops payment because it is dissatisfied with the goods or services provided to it.

### 7.6 Failure of consideration for the issue of bank cheques.

Basically this involves the issue of whether the bank can refuse to pay the payee on the bank cheque because of a dispute it has with the purchaser of the cheque.

Of all the reported cases on fraud in Australia and New Zealand involving bank cheques, the most common cause is where a rogue obtains a bank cheque without paying for it and passes it onto a person in exchange for something. Surprisingly enough the law on this point is far from clear, the outcome often depending on how the bank cheque is drawn up, either to ‘or bearer’ or to’ or order’ and the effect of the ‘not negotiable’ crossing.

*The Sidney Raper case – doubts begin*

In[11] an American couple bought a bank cheque from the Commonwealth Trading Bank with the US equivalent of a bank cheque, a cashier’s cheque. This latter cheque was stopped by US authorities. The Australian bank then stopped payment of the Australian bank cheque when it was in the hands of a real estate agent with whom the American couple were conducting some real estate negotiations. Glass J A indicated that the failure of consideration provided by the Jacobsens, the American couple, did constitute a defect in title:

> The crossing of the cheque (the ‘not negotiable’ crossing) means that negotiability in its full sense does not exist. A prior defect in title is transmissible.[12]

Moffit P does not appear to have considered the question. However, Hurley J A took quite a different view on the issues of value for the bank cheque from

---

[11] (1975) 25 FLR 217.

[12] Ibid~~,~~ 246.

**Formatted:** Font: 10 pt

**Formatted:** Normal, Space Before: 6 pt, After: 6 pt the Jacobsens. His view was that there was consideration provided at the time when the bank cheque was handed over since the failure of the US cashier's cheque only rendered the contract between the Jacobsens and the bank rescindable *ab initio*.

However, Hurley J took the view that since the bank had the right to set aside the transaction and to repudiate liability on the cheque and since the cheque was crossed 'not negotiable' this right enured against the plaintiff. Therefore the payee was not paid on the bank cheque. It is also important to realize that it was decided that the payee had not provided any consideration to the American couple.

What if the payee in the *Sidney Raper* case had provided consideration to the Jacobsons? If this had occurred there may have been room for s 37 of the *Cheques Act* to apply. It provides that:

> Where value has at any time been given for a cheque, the holder shall, as regards the drawer and indorsers who become indorsers before that time, be conclusively presumed to have taken the cheque for value.

There was no room, however, for the application of s 37 since no consideration had been provided by Sidney Raper Pty Ltd to the Jacobsons. It is important to note, that the Court was of the view that Sidney Raper Pty Ltd, although nominated as the payee, was in fact a remote party. Glass J said

> It was payable to Sidney Raper Pty Ltd or bearer and was handed to P J Jacobson who was the first holder and the immediate party to the bill and the plaintiff payee was a remote party taking title by delivery.[13]

[13] Ibid~~,~~ 245.

If the cheque had not been crossed 'not negotiable' and if Sidney Raper Pty Ltd had provided consideration to the Jacobsons it could be argued that Sidney Raper Pty Ltd would have qualified as a holder in due course and could have enforced the cheque against the bank. The bank cheque was, however, crossed and marked 'not negotiable' (the usual practice in Australia) and this would have therefore meant that the payee to whom was negotiated would have taken subjects to defects in title. This in turn raises the question whether the failure of consideration for the issue of the bank cheque is a defect of title which the payee, as a remote party, takes subject to or whether it is a mere personal defence.

*Personal defences and defects of title – what is failure of consideration and does this mean the bank drawer can refuse to pay?*

The *Cheques Act* makes a distinction between “personal defences” and “defects of title”: see, for example, s 49(2). Section 55 also provides that

> Where a cheque that bears a crossing of a kind referred to in paragraph 53(1)(b) ['not negotiable' crossing] is transferred by negotiation to a person, the person does not receive, and is not capable of giving, a better title to the cheque than the title that the person from whom the first mentioned person took the cheque had.

Crawford & Falconbridge are of the view that failure of consideration is not a defect in title. They maintain that:

> failure of consideration is not one of the items listed as defects of title in sub s56(2) [Australian *Cheques Act* s51(2)], although illegal consideration is, and one would have thought that had the subject of consideration thus come to the attention of Parliament it would have

> disposed of all material aspects of it at the one time. Secondly the possibility of failure of consideration between a maker and a payee being a defence against a remote holder seems to fly in the fact of the careful distinction in the Act and the case law between consideration and value and to undermine the whole concepts of accommodation parties and holders for value who themselves give no consideration.[14]

Professor Ellinger maintains:

> ..... some defences cannot be raised against a holder for value because he has furnished consideration for the bill. Thus the absence of consideration between prior parties does not constitute a valid defence against him.[15]

Section 37 supports this. Ellinger also puts it another way when he says

> One authority suggests that total failure of consideration does not constitute a defence to an action brought by a holder for value who is a remote party (*Watson v Russell* (1864) 5 B&S 968). This view deserves support. As a remote party who is a holder for value has furnished consideration for the bill, it seems irrelevant that a consideration furnished by prior parties has failed.[16]

The Australian case of *Roberts v Malouf* [17] supports the view that failure of consideration for the issue of the cheques may not constitute a defence in title. Here, M gave D a cheque made out to D or order for payment of a gambling

[14] Bradlley Crawford *Crawford and Falconbridge, Banking and bills of exchange : a treatise on the law of banks, banking, bills of exchange and the payment system in Canadae* (-1986) Vol 2, 1527.

[15] Peter~~eter~~ Ellinger, *Modern Banking Law* (1987)~~,~~ 509.

[16] Ibid 510.

[17] *Roberts v Malouf* (1929) 29 SR (NSW) 179.

debt. D transferred it by negotiation to R (i.e. by delivery and indorsement) who gave value. The cheque was dishonoured upon presentation. It was held that the cheque was given for a consideration which by dint of the *Gaming & Betting Act* 1912 was not illegal but void. D had acquired a good title to it and therefore R was entitled to enforce it against the drawer, M. Although the cheque was crossed and marked 'Not negotiable' R was a holder for value. The Court relied upon the following passage in *Halsbury's Laws of England*, the authority for which was the old case of *Lilley v Rankin*:

> .. there may in fact be a failure of consideration between the immediate parties owing to the transaction in respect of which the instrument is given being null and void. In such cases the transaction not being prohibited but only null and void, an instrument given in respect of it cannot be enforced as between the immediate parties, but is valid in the hands of a holder for value. [18]

This would seem to suggest that failure of consideration for the issue of the bank cheque would not in itself constitute a defect in title affecting the title of the 'remote' payee to whom the bearer bank cheque marked 'not negotiable' cheque is negotiated by the acquirer.

*Fraud and failure of consideration*

However, quite often the failure of consideration will be inextricably tangled with fraud. Section 3 (3) *Cheques Act* mentions fraud as a defect in title: this is again echoed in s 51(2). This is a defect in title which attaches to the instrument and can affect the title of a person who takes not as a holder in due course. Glass J A in *Sidney Raper* appears to be of the view that the failure of consideration for the issue of a bank cheque and the surrounding circumstances gave rise to a defect in title:

[18] (1886)56 LJQB 248.

> The crossing of the cheque (the 'not negotiable' crossing) means that negotiability in its full sense does not exist. A prior defect in title is transmissible.[19]

Hutley J maintained that the failure of the US bank cheque used for the purchase of the Australian bank cheque made the contract between the Jacobson and the drawer bank rescindable *ab initio.*

> [U]ntil that rescission takes place as between the parties it cannot be said that there is no consideration and in a case such as this where the instrument got into the hands of a holder before there was an effective rescission, this taking place when the account in Australian pounds in the name of the second third party was opened. As this occurred after the bank cheque was in the hands of the holder, it is not correct to say there was no consideration given for the bank cheque. It seems to me that when the bank cheque reached the plaintiff it was a cheque for which value had been given.[20]

Nevertheless the judge was of the view that the bank's right of rescission enured against the plaintiff by reason of the 'not negotiable' crossing. It can therefore be conclude that where there is a failure of consideration for the issue of the bank cheque coupled with a fraud this may constitute a defect in title and the payee on a bank cheque written "payee's name or bearer" and marked 'not negotiable' would take subject to this defect of title.

It is submitted, therefore, that the most desirable form of a bank cheque from the point of view of the payee or subsequent holder who wishes to enforce it

[19] *Sidney Raper Pty Limited v Commonwealth Trading Bank of Australia* (1975) 2 NSWLR 227, 246.

[20] Ibid ,240.

where there has been a failure of consideration in regard to its issue is a crossed bearer cheque without the words ‘not negotiable’ written on it.[21] A bank cheque written this way has several advantages from the payee’s point of view. Such a payee or subsequent holder would qualify as a holder in due course if he gave value to his or her transmitter. A holder in due course takes free from defects in title and personal defences between prior parties.[22] Even if failure of consideration for the issue of the cheque constitutes a defect in title or, at the very least, a personal defence between prior parties, that is, between the issuing bank and the rogue, those conclusions do not matter if the payee can be viewed as a holder in due course.

But would not the payee on such an instrument be in a vulnerable position if the words ‘not negotiable’ do not appear on the cheque? If the payee lost the cheque and it finished up in the hands of another holder in due course then this latter holder in due course would prevail over the prior payee/holder in due course. The answer would be for the payee to add the words ‘not negotiable’ once it is in his or her hands, thus protecting his title.

*The* Ricky Yan case – *what happens when the bank cheque is made out to the name of the payee or order and there is a failure of consideration for its issue-can the drawer bank refuse to pay?*

The next important case in regard to a fraudster obtaining a bank cheque and passing it onto an innocent third party is the New Zealand case of *Ricky Yan v Post Office Bank* [23] It is important to remember that the payee in *Sidney Raper* case had provided no consideration. In the New Zealand case the plaintiff did provide consideration. This is perhaps the essential difference between the two

[21] Quaere whether this would be in breach of *Reserve Banking Act* 1959 s 44 that provides ‘A person shall not issue a bill or note for the payment of money payable to bearer on demand and intended for circulation’.

[22] *Cheques Act 1986* (Cth) s 49(2).

Formatted: Font: Italic

[23] *Ricky Yan v Post Office Bank* [1994] INZLR 155, 162.

cases. What the two cases have in common is that in both cases the consideration for the issue of the cheques failed.

The facts in *Ricky Yan*, taken from the head note, were as follows 'RickyYan had received a bank cheque for $50,000which cheque had been issued and subsequently stopped by the Post Office Bank Ltd. The transaction involved a Mr Lam (also known as Mr Wong) (Lam/Wong) who claimed to represent a group of Hong Kong businessmen who were keen to invest in the Wellington Chinese restaurant business. Lam/Wong paid $2m to a Mr Wah by personal cheque and persuaded him to pay a Mr Deng $250,000 by personal cheque which cheque Deng was to invest as Lam/Wong directed. Deng deposited the cheque with Post Bank and arranged to get a bank cheque for $50,000 payable to "Far East International or order". Far East International was the trading name of Yan's business. Deng then gave Lam/Wong the bank cheque. Lam/Wong delivered the bank cheque to Yan in exchange for $32,000 in cash with the balance being a deposit for Yan's restaurant business as an earnest of good faith. The cheque for $2m was dishonoured with subsequent dishonours, whereupon Post Bank stopped payment on their bank cheque before presentment.' Diagrammatically, the complex fact situation looks thus:

| | | | | |
|---|---|---|---|---|
| Lam/<br>Wong | Wah | Deng | | Yan |
| A ➔ | B ➔ | C buys bank cheque | ➔ via A ➔ | D |
| Cheque | Cheque | | ↖ Stopped because of failure of prior cheques | |

The Court of Appeal dealt initially with the issue of whether there had been a proper delivery under s 21 of the *Bills of Exchange Act* 1908 (NZ) (BEA). This is broadly similar to s 26 of the *Cheques Act* 1986 (Cth) and basically says that to make a drawer liable on a cheque delivery must be made by the drawer in order to give effect to the drawing. The Court held that there was a proper delivery. The Court said: 'There is nothing in the evidence to suggest that Post Bank parted with the note involuntarily or subject to any express condition or restriction'.[24] Further on McKay J delivering the judgment of the Court said:

> It seems clear that by handing to its customer Deng a cheque made out (effectively) to Mr Yan the bank authorised Deng to pass the cheque on to the named payee, Mr Yan, which he did through Lam/Wong .[25]

Since the New Zealand bank cheque was made out to the name of the payee or order there could be no argument about the payee being viewed as a holder in due course as there was in the *Sidney Raper* case. The Court said:

> It [the cheque) was not 'negotiated' to Mr Yan, however, as neither Deng nor Lam/Wong were ever the holder of the note and neither was in a position to negotiate it. The note was incomplete until it was delivered to the original payee Mr Yan: Section 85. Section 38 which sets out the rights and powers of a holder in due course, also refers in paragraph (b) to holding the bill free from any defect in the title of prior parties) Here there were no prior parties."[26]

Having decided that there was a proper delivery of the bank cheque, the Court moved onto the intricate area of consideration. Here again there was a fundamental difference from the *Sidney Raper* case, where the payee on the bank cheque had not provided consideration to anyone. In *Ricky Yan*, Ricky

---

[24] Ibid.

[25] Ibid~~,~~ 160.

[26] Ibid 162.

Yan had given $32,000 to Mr Lam/Wong (A) in exchange for the bank cheque. Nevertheless, the Court pointed out that there was still some uncertainty and commented:

> What is less clear is whether the bank can rely on failure of consideration from the customer to whom it gives the cheque when that customer is not a party to it, and the named payee has no knowledge of the failure of the consideration but himself gives consideration for it in good faith.[27]

*How a remote party may provide consideration to make drawer who has received no consideration liable*

The Court explored the meaning of s 27 of the *Bills of Exchange Act* (NZ) which is virtually the same as ss 35, 36 and 37 combined of the Australian *Cheques Act*. Section 27 of the New Zealand Act reads as follows:

> (1) Valuable consideration for a bill may be constituted by —
> (a) Any consideration sufficient to support a simple contract;
> (b) An antecedent debt or liability. Such a debt or liability is deemed valuable consideration whether the bill is payable on demand or at future time.
> (2) *Where value has at any time been given for a bill, the holder is deemed to be a holder for value as regards the acceptor and all parties to the bill who became parties prior to that time.* (italics added)

The Court decided that Mr Yan came within the terms of s 27(l)(a) and commented:

> Mr Yan does appear to be within the preceding paragraph 27(1)(a), unless those words are to be read as requiring that the consideration must

[27] Ibid.

> pass from the payee to the drawer of the bill (or the maker of the note) and not to a third party. As to this, Section 27(2)'says that the holder is deemed to be a holder for value where value has been given at any time for a bill.'[28]

The latter sentence of the above quotation is most important since it provides the legal basis for allowing a payee to enforce the cheque against the bank where the payee has given value to the person who gave the payee the cheque but where value for the issue of the bank cheque has failed. Section 37 of of the Australian *Cheques Act* reads: "Where value has at any time been given for a cheque, the holder shall, unless the contrary is proved, be presumed to have taken the cheque for value." The only difference between this and s 27(2) of the New Zealand Act is that the New Zealand section refers to a bill of exchange. Nothing turns on this distinction. With refreshing vigour the Court said:

> Section 27(2) provides that the holder [which term includes the payee] is deemed to be a holder for value 'where value has been given at any time for a bill'. Here value was given by Mr Yan in exchange for the delivery of the note to him by which it became complete. [29]

The law seems to struggle with how s 37 of the *Cheques Act* is to be interpreted. On the face of it s 37 appears to make a statutory exception to the normal rule that consideration must move from the person who wishes to enforce the promise of the drawer and/or indorsers.[30]

[28] Ibid~~,~~ 162.

[29] Ibid~~,~~ 163.

[30] The issue of the meaning of s 37 is not only important in regard to the position of a payee or subsequent holder of a bank cheque who wishes to make the issuing bank liable as drawer when this may be in doubt because of failure of consideration for the issue of the bank cheque but also when the person who has a cheque negotiated to him as a gift and his ability

One of the possible reasons that there seems to be little Australian authority on the meaning of s 37 of the *Cheques Act* and its antecedent, s 32(2) of the *Bills of Exchange Act* 1909 (Cth), is that the Australian and New Zealand courts seem to have a more flexible attitude to the issue of consideration in regard to negotiable instruments. For instance, in *Wragge v Sims, Cooper & Co (Aust) Pty Ltd* [31] the purchaser owed money to the vendor but gave promissory notes to the vendor's agent.[32] Here the High Court had no difficulty in departing from strict contractual rules regarding consideration. Since the promissory notes were given to the agent at the direction of the vendor the agents were considered to be holders for value and able to sue on the notes.

Similarly, in *Walsh and Ors v Hoag & Bosch Pty Ltd* [33] , an Australian case, the vendor's solicitors drew a trust cheque in favour of the vendor's estate agent in respect of the estate agent's commission and then stopped payment at the request of the vendor; when sued by the estate agent, the solicitors argued lack of consideration but the Supreme Court found in favour of the payee.Two judges (Young CJ and Jenkinson *3)* were of the view that the antecedent debt

---

to enforce payment against prior parties on the cheque; and it is also important when a person who has an order cheque negotiated to him, the indorser signs without recourse and the indorsee is seeking to make prior parties liable because of his inability to proceed against his immediate indorser.

[31] (1933) 50 CLR 483.

[32] A more flexible attitude towards privity of contract and the issue of consideration can be seen in such decisions as *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 76and *Official Trustee in Bankruptcy v Arcadiou* (1985) 8 FCR 4. In the latter case a mother gave a mortgage over land in Mildura to her son and daughter-in-law if they would in turn give a mortgage over their property in Werribee to Guardian Investments Pty Ltd which was to advance money to the father. All of this took place. Subsequently the mother became bankrupt and the issue was whether the mortgage by her to the son and daughter-in-law was valid; the mother's trustee in bankruptcy argued that the mother received no consideration for the mortgage. The Court held that there was valuable consideration even though the mother received no financial benefit from the agreement. The Court said that what was important was that consideration moved from the son and daughter- in-law even though it did not move directly to the promisor: see also, *Trident General Insurance* Co *Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107.

[33] [1977] VR 178.

**Formatted:** Font: 10 pt

**Formatted:** Space Before: 6 pt, After: 6 pt

**Formatted:** Normal (Web), Space Before: 6 pt, After: 6 pt or liability of a third party was capable of constituting consideration. Lush and Jenkinson decided that the solicitors were agents for the vendors and that the cheque was accepted by the firm of real estate agents as a conditional discharge of the vendor's indebtedness.

Again, in *Bonior v A Siery Ltd* [34] , a New Zealand case, the issue of where the consideration came arose. A controlling director caused the company he controlled to pay one of his personal creditors. The drawer company failed to pay on the cheque and when sued argued lack of consideration, but the Court found that the payee was a holder for value. In none of these cases was there direct reliance upon, s 37 or its equivalent; the courts being able to find a way around the principles of privity of contract and consideration that is consistent with the special nature of negotiable instruments.

What we are essentially concerned with here is whether the payee who provides consideration to the transmitter of the bank cheque can use this to argue that the drawer of the bank cheque who has received no consideration for the issue of the bank cheque is still on his signature. Certainly *Ricky Yan* seems to support this proposition.  It is also supported by Professor Tyree's example of how s 37 works:

> A draws a cheque in favour of B and gives it to B as a gift. If B indorses the cheque to C as a gift and C indorses the cheque to D for value then D and every later holder is deemed to have given value for the cheque as against A, B and C.[35]

Diagrammatically, this could be illustrated thus:

A drawer → gift B→indorses as gift C →indorses for value D.

[34] [1968] NZLR 254.

[35] Alan L Tyree, *Banking Law in Australia* (2002) 412.

Applying this to a bank cheque scenario: A drawer of bank cheque receives no value→ B transfers it for value  to C - C is a holder for value not only vis-à-vis B but also vis-à-vis A even though A received no value.

The recent case of *Vella v Permanent Mortgages Pty Ltd*~~[32a]~~[36], an Australian case, also discusses the issue of consideration. Here C gave A his personal cheque to repay a debt. This was rejected by A. C then drew a cheque on a joint account with ANZ he held with another party and bought a bank cheque from ANZ with it. He then gave this bank cheque to A who in turn used it to pay off his overdraft with the Bank of Queensland. ANZ sought to recover the money from A on the basis of money had and received since the monies in the joint account had been fraudulently obtained. The crux of the problem was whether whether the fact that the cheque drawn from the joint account was paid to the Bank for it to issue a bank cheque stopped the ANZ following the monies into the hands of A. Young CJ decided the situation was different from that in the *Raper* case where the payee had provided no consideration to the remitter who in turn had provided no consideration for the issue of the bank cheque. In the *Vella* case the payee had indeed provided consideration to the remitter. Young CJ pointed out that:

> In the instant case, Mr Annous [A] was owed money by Mr Caradonna [C]. The inference that must be drawn from the facts is that Mr Annous [A] had "invested" money with Mr Caradonna [C], had demanded it back and Mr Caradonna [C] was ostensibly paying it back. Especially in view of s 35 of the *Cheques Act* this must be classed as consideration. Mr Annous [A] took the money in good

---

[32a] [2008] NSWSC 50.~~5~~

**Formatted:** Normal (Web), Space Before: 6 pt, After: 6 pt

[36] [2008] NSWSC 505.

> faith and it would seem to me that he has a good defence to the ANZ Bank's claim.[37]

The judge was of the opinion that the case was similar to where goods have finished up in the hands of an innocent third party under a voidable contract where equity will not allow rescission. A, the payee, took the bank cheque in good faith before there was any rescission and these equitable principles still applied even though the claim was a common law claim for money had and received.[38] Suffice it to say, at this stage, that the case implicitly favors the view that provision of consideration by the payee to the remitter suffices to make the drawer liable on the instrument.[39]

*The drawer bank may be liable on the basis of estoppel*

Estoppel may also provide a means of enforcing a bank cheque where there has been no consideration given for its issue. The Court in *Ricky Yan* also decided that it would have come to the same conclusion on the basis of estoppel. The Court said:

> Post Bank must be taken to be aware of the fact that bank cheques are commonly relied upon in commercial transactions as being almost equivalent to cash, and that the purpose of obtaining a bank cheque, rather than the customer proffering his own cheque, is to enable the payee to have added assurance of payment. This would be futile if the bank's cheques were to be no better than the customer's cheque against which it was issued. By handing to Deng a bank cheque made out to Mr Yan and thereby authorising its delivery to Mr Yan, Post Bank was clearly representing to Mr Yan that its cheque was valid and effectual and was not subject to any rights of cancellation arising out of the

[37] Ibid, 676.

[38] Ibid, 665-675.

[39] See further discussion around fn 30.

contract between Post Bank and Deng Mr Yan having relied on the validity of the cheque by paying out $32,000 to Lam/Wong, Post Bank is estopped from setting up the failure of consideration from Deng as a ground for cancelling the obligation to pay Mr Yan.[40]

*Criticism of Ricky Yan*

The fairness of the *Ricky Yan* seems to be without dispute but what is questionable about it is the idea that there was an issue of the bank cheque to Yan. 'Issue' refers to the first delivery of the cheque to a person who takes the cheque as a holder – without an issue of a cheque it belongs to the drawer.[41] Since the bank cheque was made out to the name of the payee or order there could not be a transfer by negotiation to him. The Court therefore had to resort to the somewhat farfetched notion that the bank authorized Deng to deliver its bank cheque to Yan. It is bit difficult to conceive that the bank authorized a person to deliver the bank cheque on its behalf to the payee when the cheque for the bank cheque given to it by Deng ultimately failed.

Professor Geva has criticised the decision on the basis that the Court 'failed to explain to explain how the payee, who takes the instrument from its original owner, the remitter, holds it free from defences available to the issuing bank against that predecessor in title.'[42] Professor Geva argues that the payee on a bank draft should be considered to have a derivative title and that as such should be able to enforce free from any of the issuing bank's defences against the remitter. This argument is not, however, sustainable in Australia where it is common place for financial institution cheques to be crossed and marked 'not negotiable'.

[40] *Ricky Yan v Post Office Bank* [1994] 1 NZLR 154, 164.

[41] *Cheques Act 1986* (Cth) s 3.

**Formatted:** Font: Italic

[42] Benjamin~~.~~ Geva,~~-~~ 'The ~~issuing~~ Issuing Bank Defences ~~against~~ Against the Payee of a Bank Draft – ~~addendum~~ Addendum to 'The ~~autonomy~~ Autonomy of the Banker's Obligations on Bank Drafts and Certified Cheques' (1994) 73 *The Canadian Bar Revue* 280,281.

*Conclusions*

Banks have argued that they are not liable on bank cheques when the consideration given to them fails but these arguments are, in the main, dubious. Nevertheless, the law is uncertain on many of the points raised in these cases and results can depend on how the bank cheque is written out. The *Sydney Raper* case raises the distinct possibility that if a bank cheque is bought with consideration that fails and is accompanied with fraud then this may constitute a defect in title and that therefore the payee on a 'bearer' bank cheque crossed and marked 'not negotiable' takes subject to this defect in title. In the *Ricky Yan* where the bank cheque was made out to the name of the payee or order, the court may have reached the right conclusion in terms of certainty of payment, namely, that the bank should pay but the legal reasoning that the rogue was somehow authorized by the bank to deliver it to the payee seems questionable. The uncertainties involved and having legal outcomes depend on form is surely undesirable from an efficiency point of view.

**7.7 The American position**

The American position on this issue is worth comparing. Under the pre -1990 version of the *Uniform Commercial Code* (some states still retain this version) it was possible to argue that the payee on bank draft [43]or cashier's cheque[44] was a holder in due course since § 3-302 (2) expressly provided that 'a payee may be a holder in due course.' Despite this a holder in due course was, somewhat surprisingly, still subject to any defence to the obligation of the bank to pay if he or she had dealings with the issuing bank since there was an express provision to this effect[45] In any case if the instrument was made out to the purchaser's name and remained with the purchaser, having been paid for

[43] ~~a~~ A cheque drawn by one bank on another.

[44] Where the drawee and drawer bank are one and the same – the equivalent of our financial institution cheques.

[45] *UCC* § 3-305(2).

with a fraudulent cheque, such a holder could not argue that value had been given and that it was taken in good faith, the basic two requirements of a holder in due course. Defences relating to the bank’s obligation to pay could also be raised against holders not in due course. Thus where a rogue tricked a bank into issuing a cashier’s cheque to him the bank was able to resist payment on the basis of fraud.[46]

Article 3 in the Code was redrafted in 1990 since there was concern that there had been some erosion of the cashier’s cheque as a cash substitute.[47] Nevertheless, even under the ‘new’ 1990 version a bank could still assert its own defences, for example, failure of consideration for the issue of the cheque against someone not a holder in due course.[48]

American law therefore does not offer anything in terms of certainty of payment.

**7.8 The Australian Paper Clearing System assurances**

Disquiet following the *Sidney Raper* case about the worthiness of bank cheques prompted the Australian Bankers' Association to issue guidelines, indicating in what circumstances its members might dishonour their own bank cheques.[49] These guidelines have now been incorporated into the procedures of the Australian Paper Clearing System that provides as follows. The one that is of particular relevance is the following:

---

[46] *TPO, Inc v FDIC* 487 F2d 131 (3d Cir ~~,~~1973).

[47] Bryan ~~.~~D ~~,~~Hull, ‘Cashier’s Cheques: Not as Good as Gold’ (1992) *Journal of Banking Law and Practice*, 136-~~-13~~8.

[48] Revised UCC, ss 3-303 (b) and 3-305(a)(2)(1990 Official Text).

[49] Neville Mainwaring, ~~Neville~~ (1985) 23 *Law Society Journal* 430,431. However such assurances may provide cold comfort if the banks were to argue that value means value to them. Typically the payee on a bank cheque does not provide consideration to the drawer, the bank. Thus the bank as a drawer would not be liable and could refuse payment (see *Justin Seward Pty Ltd v Commissioners of Ruraland Industries Bank* 60 FLR 51).

**Formatted:** Font: 10 pt

**Formatted:** Normal, Justified, Indent: Left: 0 cm, Hanging: 0.32 cm, Space Before: 6 pt, After: 6 pt

> The limited grounds on which any financial institution cheque, including a bank cheque, may be dishonoured are where:
>
> the consideration for the issue of the cheque has failed (ie, the financial institution did not receive payment for issuing the cheque) and, either:
>
> (i) the holder of the financial institution cheque has not given value for it; or
>
> (ii) if the holder has given value for the cheque, the holder knew at the time of giving value that the consideration for the issue of the cheque has or would fail.[50]

*Weaknesses of the Australian Paper Clearing System assurances*

As to the first part of the statement one could not criticise it in terms of the legal position of a payee on a bank cheque. It may even go further than the law provides since, as we have seen, the payee of a typical bank cheque - a crossed bearer cheque marked ‘not negotiable’ - may not be able to enforce the bank cheque against the bank where there has been lack of, or a failure of, consideration relating to the issue of the bank cheque due to the ‘not negotiable’ crossing. But this poses the question of whether it is desirable that the holder of a bank cheque, who is roughly in the same position as a bona fide holder for value without notice should have to rely on such a letter of comfort.

There are a number of reasons for doubt. Not all financial institutions belong to the Australian Paper Clearing System, although the majority do. Obviously

---

50 <http://www.apca.com.au/Public/apca01_live.nsf/WebPageDisplay/Payment_Cheques_Info> at 28 September 2009.

these assurances are arguably not contractually binding on members vis-à-vis payees on financial institution cheques including bank cheques, although the assurances do speak of members having 'agreed among each other, for the benefit of the general public, the limited circumstances in which financial institution cheques may be dishonoured.' If they were not adhered to, would the payee be able to bring a case Australian Paper Clearing System or member under s 52 of the *Trade Practices Act* 1974 (Cth) or *Australian Securities And Investments Commission Act* 2001 (Cth) or any equivalent for misleading and deceptive conduct? To succeed on this basis the plaintiff would have to show he or she was aware of the assurances- most plaintiffs would only become aware of these after the event. It would surely be more reassuring if the legal position of the payee or holder in such circumstances was that he could, if necessary, enforce the bank cheque in a court of law against the bank as drawer rather than rely upon the largesse of the banks and other financial institutions.

The *Vella*[51] case where the drawer bank sought to recover monies from the innocent payee on a bank cheque also raises doubts about the worth of the assurances. It will be recalled that ANZ sought to recover on the basis of monies had and received. This seems contrary to the spirit of the assurances: yes, the bank will honor the bank cheque and pay it if the payee has provided consideration; but thereafter, will seek to recover the money from the payee on a quasi-contractual basis from the payee! The fact that the bank was not successful in this case – probably due to some confusion of how title passes with a negotiable instrument and how this fits in with a quasi contractual claim – should not in itself inspire a great deal of faith in the assurances.

Assuming the bank cheque in the *Vella* case was crossed and marked 'Not Negotiable', the payee, even though he had provided consideration to the

[51] [2008] NSWSC 505.

remitter, would only be a holder for value and, as such, would take subject to defects in title.[52] Although discussion on holders was mainly eschewed, this would seem to mean that the payee's title to the money was defective and that therefore he was not therefore the equivalent of a bona fide purchaser for value without notice prior to rescission of a voidable contract. Although the outcome of the case seems fair, it may, if the above assumption is correct, be viewed as somewhat dubious. If this is the case, the assurance is virtually worthless. The bank honors the bank cheque but is able to claw back the money.

Although purporting to bind banks and other financial institutions it would not be too difficult for a bank to extricate itself from the assurance. For example, it refers to the holder having not given value; the bank could always argue that this means value to the bank. As we have seen there is some authority to support such an argument  The second part of the statement above is a qualification to liability that on the face of it, appears fair and aimed at stopping someone who is in cahoots with the rogue from being able to enforce it against the bank. In practice it could, however, work out unfairly since the burden would be on the payee or holder, if the bank stopped payment, to prove that he or she had no knowledge of the failure of consideration.

*Summary*

There appears to be a number of possible causes of action against the drawer of a bank cheque where there has been a failure of consideration for its issue (invariably accompanied by fraud) but where the payee has provided consideration to the transmitter:

- If the bank cheque is made out to the name of the payee 'or bearer' and it is not crossed and marked ''not negotiable' then the payee can argue that the cheque has been negotiated to him or her and that holder in due course status has been acquired, thus conferring an

[52] *Cheques Act 1986* (Cth)~~,~~ s 49(2).

**Formatted:** Font: Italic

unassailable title and the unimpeachable right to have the cheque paid: ss 49 and 50 *Cheques Act*. This would require a major departure from current banking practice since it is usual for financial institution cheques to be crossed and marked ‘not negotiable’.

- If the bank cheque is made out to the name of the payee ‘or order’ then the payee can use s 37 of the *Cheques Act* if he or she has provided consideration, even though not a holder in due course: *Ricky Yan* case.

- Estoppel: *Ricky Yan* case. This finding of the Court may be somewhat dubious since the Court seems to have recognized a commercial practice without hearing any evidence as to its existence.

- The Australian Paper Clearing System assurances.

**7.9 Cost efficiency of allocation of liability**.

The following Cooter and Rubin ‘rules’ to assess efficiency of allocation of liability for loss will now be used:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

The public perception is that financial institution cheques, especially bank cheques, will be paid. They are viewed as a safe cash equivalent. Hence they are often required by vendors when payment in cash is not feasible or potentially dangerous because of the possibility of theft or loss. People make bargains on this basis and the provision of a bank cheque is an important element of this, affecting the price and other conditions of the contract. Efficiency demands that bargains be upheld by the law, so certainty of payment in regard to financial institution cheques is of paramount importance. Against this background we can now make an assessment of the efficiency of the current rules for allocation of liability.

*Loss bearing*

The first Cooter and Rubin rule relates, it will be recalled, to which party can best bear the loss. In terms of which party can most easily bear the loss, it is fairly clear that this should be the financial institution that has issued the cheque. They are in a position to pass on the costs and can also take out insurance to guard against the possibility. The current state of the common law in Australia is though unclear on whether they bear liability for the loss. If the cheque is crossed and marked 'Not Negotiable' and made out to the name of the payee 'or bearer'- the usual practice in Australia- it might well be that, even if the payee has taken the cheque in good faith and for value, he or she cannot force the drawer financial institution to pay since failure of consideration may well be considered a defect in title and the payee as a non-holder in due course takes subject to this.

A way around this is not to have the cheque marked 'Not Negotiable' but this poses a threat to the payee if it is lost. The Australian Paper Clearing System assurances address the problem by the financial institutions undertaking to honor their cheques if the holder, invariably the payee, has taken the cheque in good faith and for value. The gist of the Australian Paper Clearing System assurances needs to be enshrined in legislation and if this were done the Cooter and Rubin 'rule' about which can most easily bear the loss would be satisfied: financial institutions would be liable if they did not pay. As long as the holder has provided consideration and acted in a bona fide manner the financial institutions will bear the loss stemming from the issue of a financial institution cheque where there has been no consideration for its issue. As long as the holder complies with the conditions laid down by the assurances and comes within their limits the financial  institution cheque will be paid. In short, financial institutions have voluntarily shouldered liability subject to the caveats in the assurances.

*Which party can most easily avoid the loss?*

The second Cooter and Rubin test relates to the issue of which party can most easily avoid the loss. The person that can usually most easily avoid the loss is the person that acquires the financial institution cheque in the first place, usually this will be the rogue. However, to allocate liabilty to rogues would be somewhat self defeating: they will rarely be found and will usually be persons of straw. Moreover, where the payment for the issue of a bank cheque fails, it will not always involve fraud. There was, for example, no evidence in the *Sidney Raper* case to suggest that the Rapers definitely knew that the US cashier's cheque against which the Australian bank cheque was issued would not be paid. The person, even when fraud is involved, that can most easily avoid the loss is the financial institution that issues the financial institution cheque. It has the staff, resources, and contacts to verify that it is being properly paid for the issue of the financial institution cheque.

*Which rule is the cheapest to enforce?*

Taking the third Cooter and Rubin test, which rule is the cheapest to enforce, when applied to the issue of allocation of liability where there is a failure of consideration for the issue of a financial institution cheque, one is struck by the both the complexity of the law and its uncertainty. The results seem to depend on how the financial institution cheque is drawn up: if it is made out to the name of the payee 'or bearer' crossed and marked 'not negotiable' then the payee, overlooking the Australian Paper Clearing System assurances, may not be able to enforce it (*Sidney Raper*). The Australian Paper Clearing System assurances are good and promote efficiency but are of dubious legal standing. On the other hand, if the cheque is made out to the name of the payee or order it can be enforced (*Ricky Yan*). The uncertainty and complexity here make for expensive adjudication. Moreover, the services of the Banking and Financial services Ombudsman- since 2008 called the Financial Services Ombudsman- will not be available since the payee will inevitably not be complaining about his or her bank or financial institution but about the drawer bank or financial institution that has failed to pay.

Overall, if the gist of the Australian Paper Clearing System assurances could be put into a statute then this would be efficient since it would satisfy the three Cooter and Rubin 'rules'. A possible amendment along these lines might be as follows:

If

(a) the drawer and the drawee on a cheque are the same person; and

(b) the payee has provided consideration to the remitter of the cheque in exchange for the cheque; [53]and

(c) the payee received the cheque from the remitter [54] in good faith and without notice of any defect in the title of the remitter then the payee shall have all the rights of a holder in due course despite any crossings on the cheque.

" Remitter" means

(a) the drawer institution where the drawer and the drawee on a cheque are the same person[55]; or

[53] That is the payee has given the remitter valuable consideration in return for the physical delivery of the cheque ( not for its issue).

[54] Ibid.

[55] Since it is quite common for the drawer bank to come to settlements and hand over bank cheques thought it might be a good idea to include the drawer bank in the definition of remitter.

**Formatted:** Font: 10 pt

**Formatted:** Font: 10 pt

**Formatted:** Font: 10 pt

**Formatted:** Font: 10 pt

**Formatted:** Font: 10 pt

(b) the person who has obtained the cheque from the drawer[56]; or

(c) any person to whom the cheque has been negotiated in good faith and without notice of any defect in title. [57]

The other amendment that this thesis seeks would be an amendment to make it crystal clear that s37 can apply to a payee as well so that the payee who has provided consideration to the remitter can use this vis-à-vis the drawer of the bank cheque.

### 7.10 Summary and recommended changes

Failure of consideration, typically involves fraud and may lead to non payment. This erodes the certainty of payment so essential to bank cheques as a reliable cash substitutes. The law relating to the issue of enforceability when there is a failure of consideration for its issue are complex and uncertain, thereby failing one of the Cooter and Rubin 'rules' for efficient allocation of loss rules, namely clarity and simplicity of rules. Therefore to ameliorate the current situation the following is advocated:

---

[56] It might be thought that the wording should refer to the cheque being "issued". But if the bank cheque was made out to the name of the payee or order then one could not correctly say "issue" since issue is defined in s 3 CA to mean "*the first delivery of the cheque to a person who takes the cheque as holder*". In turn "*holder*" in relation to a cheque payable to order is defined as "*the payee or an indorsee who is in possession of the cheque as payee or indorsee*". Thus it means that if you buy a cheque from the bank made out to my name or order then there is strictly speaking not an "issue". I have used the word "obtained" which is delightfully vague but remember we are trying to cover here situations where the person may be tricking the drawer bank eg by giving over counterfeit notes in exchange for the bank cheque. There is probably a better word than "obtained" but none springs immediately to mind.

[57] If the cheque is made out to the name of the payee or bearer it might go through several hands (negotiations) before it was handed over to the payee; so this why I have included this sort of person in the definition of remitter. It should be noted that it does not cover someone who steals from the original remitter – what we are talking about here is a genuine transferee not a thief or a finder of the instrument.

**Formatted:** Font: Not Italic

**Formatted:** Font: Not Italic

**Formatted:** Font: Not Italic

**Formatted:** Font: Not Italic

**Formatted:** Font: 10 pt

- The definition of a financial institution cheque (which covers bank cheques) should be extended to also cover cheques drawn by one financial institution on another one.
- Where consideration has been provided at any stage for the bank cheque then it should be able to be enforced.
- The gist of the Australian Paper Clearing System assurances need to be enshrined in legislation (an example of the sort of legislative change that would hopefully ensure certainty of payment has been suggested).

## Chapter 8

# OTHER INSTANCES OF FRAUD IN REGARD TO BANK CHEQUES

### 8.1 Overview

Since bank cheques (also known as financial cheques) are, rightly or wrongly, regarded as safe substitutes for cash it is not surprising that rogues have devised ways to exploit various ways to profit from such a reputation. Such ploys are often crude and range from stealing the forms and forging banks officer's signatures to altering the payee or the amount on a validly signed bank cheque. Another even simpler scam is for the rogue to purloin a cheque made out to an institution and then use such a bank cheque to pay off a debt owed by the rogue to that payee institution. In such circumstances the law must work out who should bear the loss. Since bank cheques are perceived differently it is at least arguable that special rules should apply to them.

### 8.2 Outline of this chapter

This chapter will therefore examine whether the allocation of fraud loss with bank cheques in such circumstances is efficient by addressing the following questions:

- Should there be a duty of care on banks to safeguard bank cheques?
- Is the allocation of loss in regard to bank cheques which are stolen or lost efficient?
- How is the loss allocated in regard to fraudulently altered bank cheques and is it efficient?
- What efficiency weaknesses can be detected in a hypothetical but common case of fraud with bank cheques?
- What changes should be made to the law?

## 8.3 Duty of care to safeguard bank cheque forms

Where bank cheque forms are lost or stolen and the rogue completes them and forges the signature of authorised bank officers or just makes up signatures of fictitious bank officers, then the bank will not be liable as drawer on these instruments.[1] The Australian Paper Clearance System assurances also make it clear that forgery will mean financial institution cheques (including bank cheques) will not be paid. This merely accords with the statute.[2]

*Cases alleging duty of care*

However, it has been suggested in some cases that banks owe a duty to take reasonable care to secure blank bank cheques so they are not stolen by rogues. In *Capri Jewellers Pty Ltd v Commonwealth Trading Bank of Australia*[3] a cleaner stole blank bank cheque forms and forged the signature of the authorised signing officers and bought some opals at Capri Jewellers. He then disappeared. The bank dishonored the cheque and Capri Jewellers sought to recover the money from the bank on the basis that it had been negligent in allowing an unauthorised person to obtain possession of it. On the facts the court held that, although such a duty might have existed, reasonable care had been taken and therefore no breach of the alleged duty had taken place.

---

[1] *Cheques Act 1986* (Cth) s 32.

[2] *Cheques Act 1986* (Cth) s 32.

[3] [1973] ACLD 152.

In *John's Period Furniture' Pty Ltd v Commonwealth Savings Bank of Australia,*[4] several blank bank cheque forms were stolen from a post office. The police were notified of the theft however but the bank did not place any advertisements about the stolen bank cheques. Some of the cheques were filled in and fraudulently signed by the rogue to buy goods. The bank dishonored the cheques on the basis that the signatures were forgeries. But the seller argued that the bank had failed in its duty to take reasonable care when it discovered the theft, as it should have publicized the theft so that it could minimize the potential loss to the innocent transferees of these instruments. The Full Court held that the defendant did not owe the plaintiff any duty of care to warn the public of the theft of the bank cheque forms.

In *Johnson Matthey Ltd v Australia and New Zealand Banking Group Limited* [5] the main issue was whether there was a relationship of proximity between the plaintiff, a bullion dealer, and the defendant, the issuer of the bank cheque used by the rogue to obtain the gold. The plaintiff's claim was that there was a relationship of proximity between the defendant (and other banks) and bullion dealers generally. But the court queried why bullion dealers were so special and found the case did not fall into a category where the law imputes a duty of care.

*Ascertainable class?*

The main legal problem in the argument for a duty of care to be imposed on financial institutions including banks for the loss of financial institution cheques seems to be that the plaintiffs are not members of any ascertainable class or group as required by the *Caltex* case.[6] The *Caltex* case and subsequent

---

[4] (1981) 24 SASR 224.

[5] (1989) Aust Torts Reports 80-256.

[6] *Caltex Oil (Australia) Pty Ltd v The Dredge* '*Willemstad*' (1976) 136 CLR 529.

cases[7] make it clear that no liability for economic loss will apply where the plaintiff belongs to an indeterminate class. Cases, for example, relating to auditors show a marked aversion by the courts to impose liability for any loss suffered by anyone who might buy shares on the strength of the audit.[8] The problem would appear to be how to fairly limit liability so that the defendant is not liable to an indeterminate number of people for an indeterminate amount.

These bank cheque decisions place traders in an invidious position for they inevitably regard bank cheques as equivalent to cash and therefore place reliance upon them. A wise practical precaution might be to contact the branch of the bank on which the bank cheque is drawn and confirm that such a cheque has been validly signed and issued. Admittedly this might involve some embarrassment and loss of time. In some instances there might be practical difficulties; for example, in *Johnson Matthey* the bank cheque was presented for payment at 9.00 am Sydney time but drawn by a Queensland bank where the time was 8.00 am Queensland time.

### 8.4 Cost efficiency of allocation of liability for loss of bank cheque forms.

The Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss are as follows:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

The rules for allocation of loss are found mainly in statutes like the *Cheques Act*, the *Bills of Exchange* Act and codes of conduct like the Electronic Funds

[7] *Hill (t/a RF Hill and Associates) v Van Erp* (1997) 188 CLR 159: *Perre v Apand Pty Ltd* (1999) 198 CLR 180.

[8] *R Lowe Lippman Figdor & Franck v AGC (Advances) Ltd* (1992) 2 VR 671*; Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 71 ALJR 448; *Caparo Industries Pty Ltd v Dickman* [1990] 1 All ER 568.

Transfer Code (EFT). They are therefore specially tailored having regard to the nature of the payment instrument. But the Cooter and Rubin ‘rules’ provide a useful prism to examine more general problem of tortious liability for economic loss which is the issue at hand here.

Certainly because the general commercial community regards financial institution cheques, especially bank cheques, as tantamount to cash and because financial institutions promote this view – witness the Australian Paper Clearance System assurances – it is not surprising that plaintiffs have attempted to make banks responsible for their loss using ordinary tort principles. But where is the line to be drawn? Fairly narrowly it would seem. Gibbs J in *Caltex* said:

> The fact that the loss was foreseeable is not enough to make it recoverable. However, there are exceptional cases in which the defendant has knowledge or means of knowledge that the plaintiff individually and not merely as a member of an unascertained class, will be likely to suffer economic loss as a consequence of his negligence, and owes the plaintiff a duty to take care not to cause him such loss by his negligent act.[9]

Although Cooter and Rubin’s three fold test for efficiency was not devised with some general tortious liability in mind it is interesting to apply to it this problem.

First, in terms of loss bearing (which party can most easily bear the loss) it makes sense in terms of efficiency to impose a duty on banks for the loss of instruments that are regarded as tantamount to cash; second, in terms of loss avoidance (which party can most easily and cheaply avoid the loss), it is obviously easier for a bank to safeguard bank cheques than for payees to verify

[9] *Caltex Oil (Australia) Pty Ltd v The Dredge* ‘*Willemstad*’ (1976) 136 CLR 529, 555.

the authenticity of each bank cheque they receive. However, in terms of the third test, namely, which rule is the cheapest to enforce it would have to be conceded that the metes and bounds of general tortious liability are somewhat uncertain and are being constantly  being worked out and revised by the courts. From a rule simplicity point of view this could mean expensive adjudication.

In terms of fairness one could surely question the wisdom of the courts' reluctance to make banks liable for the loss of bank cheques. First, blank banks cheques are somewhat like the printing plates for currency notes – in the hands of a rogue they can cause considerable damage in commerce. Loss of currency plates or blank bank cheque forms is almost inevitably going to lead to skullduggery. This is an argument in favor of imposing a duty. Second, a 'counterfeit' bank cheque can involve an innocent payee becoming personally liable on the instrument – not only will the payee not be paid but it could mean the payee has to pay others if the payee transfers the instrument to someone else and the bank cheque is not ultimately paid. If the bank cheque is made out to the payee's name 'or bearer' – this is the usual practice in Australia – then, if the payee negotiates the cheque by transfer to another person, the payee warrants to the transferee that the cheque is what it purports to be and that as the transferor by delivery he or she is not aware of any fact that renders the cheque valueless.[10] If the bank cheque is made out to the payee's name or order the situation is even worse: if the payee indorses it to someone else by his indorsement the indorser is estopped from denying not only to the immediate indorsee but also to any subsequent ones that the drawer's signature is valid and that the cheque itself is valid.[11] All this loss and liability stems from the banks' carelessness in safeguarding the blank banks cheques! Yet the common law imposes no duty here. Surely this is an argument here for

[10] *Cheques Act 1986* (Cth) s 77.

[11] *Cheques Act 1986* (Cth) s 74.

statutory intervention to protect payees on bank cheques in such circumstances.

*Conclusion*

The law's failure to impose a duty of care in regard to the safekeeping of bank cheques is arguably inefficient since it leads to doubts about their certainty. Efficiency considerations strongly suggest that such a duty should be imposed on banks.

### 8.5 Alterations to bank cheques.

What happens when a bank cheque that has been issued and properly signed and issued but a rogue alters the name or the amount?

Where there is a fraudulent and material alteration to the cheque by the holder it is discharged.[12] Discharge of the cheque means basically that all the rights on the cheque come to an end. But the *Cheques Act* allows a person who takes a cheque which is fraudulently and materially altered to enforce payment of the cheque as altered against the person who made the alterations, or against a person who authorised or agreed to the alteration, or against a person who indorsed the cheque after it was altered.[13] In addition the cheque may be enforced according to its original tenor if the alteration is not apparent.[14]

Case law establishes that the drawer owes a duty to the drawee bank to write out the cheque in such a way so as not to facilitate alterations.[15] If there is a

---

[12] *Cheques Act 1986* (Cth) s 78(2).

[13] *Cheques Act 1986* (Cth ) s 82(3).

[14] *Cheques Act 1986* (Cth ) s 82(3)(b).

[15] *Commonwealth Trading Bank of Australia v Sydney Wide Stores Pty Ltd* (1981) 55 ALJR 574 which reaffirms an English line of decisions to the effect that the drawer owes a duty of

breach of this duty by the drawer the drawee bank is entitled to debit the account for the fraudulently altered amount.

If the alteration is obvious and the collecting bank collects it for the account of a person other than the true owner it runs the risk of being considered negligent and making itself liable for conversion.[16]

How do these complicated rules work out in regard to bank cheques, given that these are regarded as safe cash substitutes?

*The Harvey Jones case*

In the English Court of Appeal decision of *Harvey Jones Ltd v Woolwich plc*[17] a young couple bought a draft issued by the defendant bank, Woolwich plc. (In England a banker's draft is the equivalent of an Australian bank cheque, that is, a cheque drawn on the bank itself.) This was given by the couple to Harvey Jones Ltd, the payee, to pay for some kitchen units. Whilst the instrument was in the premises of Harvey Jones Ltd an unknown party stole it, cleverly altered the name so that the alteration was not apparent, took it to another bank and deposited it. The drawee (and drawer bank) Woolwich plc, paid it in due course to the deposit/collecting bank and the rogue withdrew the money and disappeared. The payee, Harvey Jones Ltd, brought an action in conversion as the true owner of the bank draft against the paying bank which, of course, was also the drawer of the draft.

There are a number of curious points about the case. First, the payee must have regarded the debt as having being discharged by the mere provision by the

---

care when drawing up the cheque not to facilitate alterations, for example, by leaving spaces or writing in pencil.

[16] *Cheques Act* 1986 (Cth) s 95.

[17] Heard with another case involving an altered ordinary cheque, thus: *Smith and another v Lloyds TSB Bank plc; Harvey Jones Ltd v Woolwich plc* [2001] 1 All ER 424.

couple of the bank draft. This is a testimony to the high commercial regard for bank cheques or drafts. With an ordinary cheque discharge of the debt is conditional on the cheque being honored – the debt is not discharged until actual payment and if the cheque is not paid then the debt revives.[18] Second, the action in conversion was against the paying bank not against the collecting bank.[19] Presumably the collecting bank could have successfully invoked the statutory defence available to collecting banks in actions against them for conversion (s 95 in Australia), namely, that it had not been negligent – the alteration was very cleverly done and not at all discernable.[20] This defence is not available to the drawee/paying bank. It should be remembered that conversion is s tort of strict liability and negligence is not normally relevant. (The defence in s 95 is a considerable concession to banks in their collecting capacity.)

*Action against the drawee bank*

Can a true owner of a cheque bring an action against the drawee bank in conversion? The English Court of Appeal did not say this was not possible but decided that in any event no action lay against the paying bank/drawer here because the fraudulent alteration of the bank draft meant that it was a worthless piece of paper and that no action could be brought on it.[21] It was a dead letter. The payee argued that since the bank, prior to it being purloined and paid, would have been willing to replace the lost bank draft, then this meant that the altered cheque was not worthless. The payee also argued that

---

[18] *Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GMbH* [1977] 1 Lloyd's Rep 463.

[19] In the companion case *Smith and another v Lloyds TSB* [2001] 1 All ER 424 it was decided that no action in conversion could be brought against a collecting bank where the cheque was materially altered. Here it was an ordinary cheque but the same reasoning would also apply to a bank cheque.

[20] See *Cheques Act 1986* (Cth) s 95.

[21] See 78 (2) *Cheques Act 1986* (Cth) which provides that 'A cheque is also discharged if the cheque is fraudulently and materially altered by the holder'. This is the Australian equivalent of s 64 of the UK *Bills of Exchange Act* 1882.

since the drawee bank actually paid the draft to the deposit/collecting bank this raised an estoppel against it in terms of the draft being worthless after alteration. Both of these arguments were rejected by the Court of Appeal. The moral of the case seems to be: lock up the bank cheques when received as a payee because if they are stolen and materially and fraudulently altered the loss will fall on the payee. The same result would seem to apply if a person purchased a bank cheque and lost it before handing it over to the payee. This is presumably what prompted Pill LJ to blithely say:

> In the case of a banker's draft, the customer's account was debited when the draft was issued to him. He had the benefit of a bill drawn by the bank itself, which he might require to satisfy business requirements, but once he had it, he assumed the relevant risk as he would assume the risk if he drew bank notes which were stolen.[22]

In other words it is like cash. If it is stolen and cleverly altered by the thief and paid by the bank the payee has no remedy against either the paying bank or collecting bank.[23] This hardly inspires confidence in bank cheques, which are meant to overcome the concerns about carrying large amounts of cash.

Moreover it seems somewhat at odds to some of the other provisions in the *Cheques Act*. Discharge of the cheque means basically that all the rights on the cheque come to an end. But discharge does not mean there are no rights on the instrument at all. The Act itself provides that where a drawee institution in good faith and without negligence pays such a cheque to the holder the drawee institution may rightfully debit the drawer's account according to the tenor of the cheque as drawn.[24]

[22] [2001] 1 All ER 424, 434.

[23] *Smith and another v Lloyds TSB* [2001] 1 All ER 424.

[24] *Cheques Act 1986* (Cth) s 91.

In addition the Act allows a person who takes a cheque which is fraudulently and materially altered to enforce payment of the cheque as altered against the person who made the alterations, or against a person who authorised or agreed to the alteration, or against a person who indorsed the cheque after it was altered.[25] In addition the cheque may be enforced according to its original tenor if the alteration is not apparent.[26]

*Discharge of debt with a bank cheque*

One of the interesting aspects of the *Harvey Jones* case is that apparently the payee regarded the debt as being discharged by the provision of the bank cheque, presumably because the payee stipulated this as the mode of payment. In some jurisdictions legislation expressly provides that mere provision of a bank cheque discharges a debt. Under the pre-1990 version of article 3 of the *Uniform Commercial Code* – still retained in several US states- the mere provision of a cashier's cheque means that the underlying obligation is discharged.[27] The result then is that if the cashier's cheque cannot be enforced this means the seller cannot sue the buyer for breach of contact because when the seller accepted the cashier's cheque, the buyer was discharged on the contract. This would seem to be the same anomalous position of the seller in the *Harvey Jones* case.

## 8.6 Cost efficiency of allocation of liability for alterations to bank cheques.

The following Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss will be used in regard alteration of bank cheques:

- Which party can most easily bear the loss?

[25] *Cheques Act 1986* (Cth) s 82(3).

[26] *Cheques Act 1986* (Cth) s 82(3)(b).

[27] *UCC* s 3-802.

- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Bearing the loss*

Taking Cooter and Rubin's first test for assessing the efficiency of the rules for allocation of loss in regard to payment instruments, namely, which party can most easily bear the loss, then clearly the *Harvey Jones Ltd* decision puts the loss on the payee who only has the cold comfort of an action against the rogue. The parties in the scenario who can most easily bear the loss and pass it on, the paying and collecting banks, are completely exonerated. From this point of view it is at odds with the first of Cooter and Rubin's tests.

*Avoiding the loss*

The second test - which party can most easily and cheaply avoid the loss – is more problematic. In terms of safe custody of the bank cheque once it is in the hands of the payee, it could be argued that the payee can most easily avoid the loss by taking precautions. However, not all precautions will be effective, especially if the rogue is an 'insider' like an employee. The application of *Harvey Jones Ltd* would be the same if the person who purchased the bank cheque lost it – no action against the paying bank for paying out on an altered cheque; the loss falls upon the purchaser, the person who arguably can most easily avoid the loss. However, this seems to go against one of the commonly perceived reasons for obtaining a bank cheque in the first place, namely, the perception than it is safer than carrying around large sums of cash. The *Harvey Jones Ltd* decision on it facts show than it is not any safer than having cash.

Professor Lawrence in a seminal article arguing for revision of article 3 (dealing with negotiable instruments) of the pre-1990 version of the *Uniform Commercial Code* in order to make cashier's cheques, the equivalent to our bank cheques, cost-effective maintains that the alteration rules, basically very similar to ours, should still apply unchanged to cashier's cheques on the basis that this defence is necessary if these instruments are to have any advantage over cash since these rules protect against loss and theft.[28] But Lawrence admits that he has not explored these loss allocation rules for alteration to see whether they are consistent with cash equivalency position he espouses. He also sees that it is fair that some of the risks associated with alteration should be borne by holders of cashiers' cheques. Yet, this is difficult to understand if acceptance of such an instrument discharges the underlying obligation – the payee is left stranded without any remedy. Here in Australia the law casts a positive obligation on the drawer to draw the cheque in such a way so as not to facilitate alterations. This is often used as a 'defence' by banks when the customer complains about a debit to his account caused by a fraudulently altered cheque of the customer. However, in the case of a bank cheque it is the bank itself that is the drawer. It is therefore more efficient to demand that bank cheque drawers themselves draw the cheques in such a way as to make alteration well nigh impossible and also to guard against paying a altered cheque, than it is to ask the payee to take precautions against fraud that will often be the work of 'insiders'.

The third Cooter and Rubin rule - which rule is the cheapest to enforce – when applied to *Harvey Jones Ltd* must lead to the conclusion that it is indeed a simple rule  and therefore cheap to adjudicate on.

However, in weighing up the mix it must be remembered that the three Cooter and Rubin tests do not necessarily have to be given the same weight. In the context of assessing the efficiency of the rule for allocation of liability for fraudulent and material alteration to bank cheques it must be borne in mind that financial institution cheques (and especially bank cheques) are supposed

[28] Larry Lawrence, 'Making Cashier's Checks and Other Bank Checks Cost-Effective: A Plea for Revision of Articles 3 and 4 of the Uniform Commercial Code' (1980) 64 *Minnesota Law Review* 275, 282.

to inspire confidence. They are regarded as essential to the efficient operation of the market place. It therefore makes good sense to give more weight to the ability of banks to bear the costs of fraudulent and material alterations to bank cheques once they have been issued rather than have the loss fall on the payee of the bank cheque or the purchaser of it even though they might be in a good position to avoid the loss.

If it is desirable from an efficiency point of view to have an instrument that is safer than carrying large quantities of cash then the *Harvey Jones Ltd* decision is neither efficient nor fair.

**8.7 The NAB warning – a hypothetical**

In 2006 the National Australia Bank (NAB) came out with a timely warning about the danger of having bank cheques and, by extension, other financial institution cheques use for property settlements made out to the name of financial institutions without anything more:, for example, Pay National Bank. Instead NAB recommended that bank cheques should have more of an indication after the name of the payee eg ‘Pay National Bank for the account of Jim Smith’. This is wise counsel. However, the problem is that not many consumers will do this. An example of how this would work out and what the legal outcome would be as follows.

Andrew approaches West Bank and buys a bank cheque that takes the following form. He is well known to the bank and pays with traveler’s cheques.

**West Bank**

Not Negotiable

date

Pay Poles Emporium or bearer

The sum of ten thousand dollars $10,000.00

*Jane Gross*

Manager

Andrew intends to use this money to buy some furniture but on the way to Poles Emporium he loses the cheque. He immediately tells a policeman, Constable Plod. But Barry, a rogue, finds the cheque and takes it to Poles and purchases a sophisticated computer for $11,500 (making up the difference with cash). The salesman at Poles suspects nothing and the bank cheque goes into Poles' bank account. Once Andrew realised he had lost the cheque he goes to the West Bank and tells them to stop payment on the bank cheque and staff tell him they are not prepared to do this unless he gives them an indemnity. This he does and West Bank stops payment on the bank cheque.

*What are the rights and liabilities of the parties?*

Poles is an innocent party who has provided value for the bank cheque but as it is crossed and marked 'not negotiable' it takes subject to defects in title (see s 55 *Cheques Act*) as it has the bank cheque negotiated to it. This is the unusual feature of bank cheques. Most ordinary cheques are issued to the payee. A bank cheque, however, is issued to the purchaser of it – he or she is the "or bearer" of it - then it is transferred by negotiation to the payee.[29] As Barry found the bank cheque he does not have a good title to it. The title or legal ownership still rests with Andrew. This means that Barry cannot give a good title to Poles even though it was named as the payee. Even if Poles could force West Bank to pay it would have no right to retain the money as it does not

[29] *Sidney Raper Pty Limited v Commonwealth Trading Bank of Australia* (1975) 2 NSWLR 227, 245 where it was said of the bank cheque 'it was payable to Sidney Raper Pty Ltd or bearer and was handed to P J Jacobson who was the first holder and the immediate party to the bill and the plaintiff payee was a remote party taking title by delivery'.

have a good title to the bank cheque. Poles, of course, would still have remedies against Barry the rogue but this would be cold comfort.

Andrew is still the rightful owner of the bank cheque. The ‘not negotiable’ crossing protects his legal title or ownership of the bank cheque. If the ‘not negotiable’ crossing was not on the bank cheque then Poles would qualify as a holder in due course with an unassailable title to the bank cheque.[30]

It should be noted that the Australian Paper Clearing System assurances would not help out much in the above situation: there is no forgery here; no fraudulent alteration; and no failure of consideration for the issue of the bank cheque.

*NAB example*

Here is the example given by NAB

> Jones enters into a contract for the purchase of property for $1.5m from Smith, who in turn has a mortgage of $900 k to XYZ Credit Union. In arranging settlement a solicitor (or land agent/conveyancer) purchases a number of bank cheques, payable to the usual utilities, to Smith’s mortgagee ($900 K to XYZ Credit Union) and residual monies to Smith. The cheque to satisfy Smith’s mortgage with XYZ Credit Union is payable to that institution solely. Shortly after having purchased the cheque it is misplaced or stolen before settlement has taken place. A thief obtains the bank cheque and deposits it into his own account with XYZ Credit Union, explaining to the teller that because he maintained an account with that financial institution he purchased the cheque payable to the financial institution. The teller accepts this as a reasonable explanation. He immediately transfers all the funds overseas and

[30] See *Cheques Act 1986* (Cth) s 49(2).

> absconds. Settlement falls through and the purchaser of the bank cheque reports the item as lost/stolen to the issuing bank. The issuer will not replace the item until it confirms the cheque remains unpresented. Investigations reveal however the item has been negotiated for value. A dispute between all the parties results and the collecting credit union is placed in a difficult position where it must explain why it accepted a deposit to its customer's account that was not payable to its customer.

NAB comments on the above as follows.

> In the above example, had the cheque been payable to XYZ Credit Union on behalf of Smith the collecting Credit Union would have rejected the deposit and the thief's attempt to defraud all legitimate parties to the transaction would have been thwarted.

This is sound practical advice but an analysis of the true legal position is appropriate.

*Is the XYZ Credit Union, as a collecting institution, in the wrong here?*

When collecting cheques for customers collecting institutions run the risk that they are collecting the proceeds of the cheque deposited for a person who is not the true owner. To put it simply the collecting institution may help the rogue 'get away' with the money. Under the law of tort this is called conversion: dealing with the true owner's property in a manner inconsistent with the true owner's right to possession. It should be noted that the true owner in bringing an action against the wrong doer or any other accomplice does not have to prove any wrongful intent. In other words the wrong doer or accomplice might have acted completely innocently.[31]

[31] Alan Tyree, *Banking Law in Australia* (2002), paras 8.1-8.23.

Due to the high risks involved with the tort of conversion collecting institutions are given a concession: they will only be liable for conversion if they have been negligent: *Cheques Act*, s 95. But s 95 does not define negligence. For this one must turn to case law.[32] The Act defines good faith in s 3(2) as something done honestly even though it may have been done negligently

The only example s 95 gives of negligence (and even this is done in a round about way) is if the collecting institution collects a third party order cheque (that is, an order cheque where the name of the payee is different from that of the customer of the collecting institution) without looking for absence of or irregularity of indorsements

Even though a collecting institution may be, for some reason, unable to rely upon the statutory defences to an action for conversion by the true owner of a cheque, it may nevertheless have the holder in due course defence available to it. This is an absolute defence to an action in conversion since the holder in due course is viewed as having the legal title. The collecting institution will qualify as a holder in due course if it takes from a holder a cheque which is complete and regular, value having been given (for example, it cashes the cheque before receiving the money from the drawee institution), the collecting institution takes it in good faith without notice of any defects in title and the cheque is not crossed and marked 'not negotiable'.[33]

---

[32] Examples of negligence: failure to open an account properly: *Lumsden & Co v London Trustee Savings Bank* [1971] 1 Lloyds' Rep 114; where a special relationship between the true owner and the customer of the collecting bank facilitates the conversion: *Hannan's Lake View (Central) Ltd v Armstrong & Co* (1900) 16 TLR 236; where there are suspicious circumstances: *Motor Traders Guarantee Corp Ltd v Midland Bank Ltd* [1937] 4 All ER 90; collecting cheques marked 'account payee only': *Akrokerri (Atlantic) Mines Ltd v Economic Bank* [1904] 2 KB 465.

[33] *Cheques Act 1986* (Cth) s 50.

Taking this last defence first, it is clear that in the circumstances XYZ cannot be a holder in due course as the cheque, even if were considered that the bank cheque was negotiated to it, since the ‘not negotiable’ crossing prevents this.[34] At the most it might be considered a holder for value – if, for example, it owed the rogue customer value by dint of a lien or previous value provided to the customer.[35] This is even improbable on the facts provided in the NAB example.

Would XYZ be able to argue under s 95 that it had not been negligent? There would be little chance of this either. The name of the payee, XYZ Credit Union, was completely different from that of its customer. True, the bank cheque was highly likely to have been also been made out to ‘or bearer’. Could it argue that its customer came within the words ‘or bearer’?

This argument is somewhat dubious. In *Day v Bank of New South Wales* [36] there were two cheques: one made out to ‘F L Day or bearer’ and the other to ‘Frank L Day’ and the words ‘or bearer’ crossed out (this made it an order cheque). These cheques were also crossed and marked ‘Not Negotiable’.[37] They were purloined by a dishonest real estate agent and collected by the defendant bank. The Supreme Court of South Australia found that the bank had not been negligent in regard to the ‘or bearer’ cheque but that it should have queried the indorsement of the order cheque and asked for proof of identity.

[34] *Cheques Act 1986* (Cth) s 50 (1)(iii).

[35] *Cheques Act 1986* (Cth) ss 37, 38.

[36] (1978) 19 ALR 32.

[37] *Cheques Act 1986* (Cth) s 21.

But in *Moser v Commercial Banking Co of Sydney Ltd* [38] a cheque was made out to 'Pay A & B or bearer' and was collected for the account of A. The Court said since it is made out to joint names it should have been queried if collected for the account of one of the payees. The collecting bank found little comfort in the words 'or bearer' in the circumstances. Frank J said where a cheque was collected for the account of one of the joint payees.

> ... it seems clear that one payee was entitled to no more than a joint interest in the cheque ... it seems clear that the mere condition of the words 'or bearer' is not sufficient to justify the bank regarding the details concerning the payee or payees as of little or no consequence.[39]

Although these cases are not on all fours with the NAB example it casts doubt on the 'or bearer' argument. Obviously all the circumstances are relevant to whether the collecting bank has not been negligent. Although it is possible to transfer a bank cheque by negotiation it is not very common and this, in itself, should have prompted some further enquiry. The explanation that he was the customer of XYZ Credit Union and that was why he had the bank cheque made out that way seems not very convincing when the bank cheque was going into his account The words 'not negotiable' do not mean that the bank cheque was not transferable and do not in themselves act as any sort of warning to the collecting institution: *Commissioners of State Savings Bank of Victoria v Permewan Wright & Co.*[40]

---

[38] (1973) 22 FLR 123.

[39] Ibid, 126.

[40] (1914) 19 CLR 467.

It would therefore be unlikely that the collecting institution, XYZ Credit Union, would be able to show that it had not been negligent, thus making it laible for conversion.

In summary, these examples show how fraud can take place without any forgery or alteration of bank cheques and how it behoves a purchaser of such a cheque to add more details when the payee's name is the name of a financial institution. It should be noted that the law even allows a description of the transaction giving rise to the order on a cheque.[41]

**8.8 The cost efficiency of allocation of loss in the two NAB examples.**

The Cooter and Rubin 'rules' to assess efficiency of allocation of liability for loss will now be applied:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Loss bearing*

In the first example the allocation of loss rules for cheques applied to bank mean that the loss falls on Poles Emporium due to the 'Not Negotiable' crossing. As it happens the payee is a large retailer and one can presume that it can spread the loss. In a choice between Andrew and Poles Emporium the loss legally falls on Poles. This therefore broadly accords with Cooter and Rubin's first principle for assessing efficiency.
With this sort of fraud where a rogue misappropriates a bank cheque made out to a large organization, typically a bank or a large retailer, from an 'insurance'

[41] *Cheques Act 1986* (Cth) s12 (2)(b).

angle (the gist of the first Cooter and Rubin 'rule') it is more efficient that the loss falls on the organization.

*Loss avoiding*

The issue as to which party can most easily avoid the loss is a little trickier. In the first example, Andrew has lost the cheque. This suggests some carelessness on his part. However, it could just as easily have been stolen with the same end result and without any carelessness on Andrew's part. How could Poles have avoided the loss? In the example, the rogue did not go into the store, assess the price of an item and return with a bank cheque made out for the exact price: he brought the bank cheque into the store, selected an item and then made up the balance with traveler's cheques. The fact that the bank cheque was not made out for the exact price of the computer should have alerted the Poles employee that there was something untoward about the purchase. Arguably Poles could have most easily avoided the loss, namely its conversion of the cheque. (It is noteworthy that conversion is a tort of absolute liability and neither negligence nor intention are relevant unless provided by statute.)

*Cost of the rule*

Coming to the third Cooter and Rubin principle and applying it to the Poles example, which rule is the cheapest to apply? The reason why Poles does not obtain a good title to the bank cheque even though it was made out to its name is because of the effect of the 'Not Negotiable' crossing which restores the *Nemo Dat* rule. This is a relatively straight forward rule that no court would have difficulty applying; nor would any competent lawyer have any difficulty in giving advice on this. It could therefore be said that the rule is efficient from this point of view.

The second NAB example is a little more difficult to assess in terms of efficiency since the payee is also acting in a collecting capacity for the rogue.

*Loss bearing*

As to the first Cooter and Rubin rule (which party can most easily bear the loss?), clearly it is the collecting institution, the credit union. And the legal rule for allocation of loss does put the loss on it. It is therefore efficient.

*Loss avoiding*

The second, Cooter and Rubin rule asks: which party can most easily avoid the loss? Once again, as with the first example, the acquirer of the bank cheque has lost it or had it stolen. This does suggest a degree of carelessness in the case of loss. But if it were stolen this does not necessarily imply carelessness or fault. However, against this the XYZ Credit Union collected the bank cheque after having received an unsatisfactory explanation as to why a bank cheque made out to the XYZ Credit Union should go into a private account. Of the two parties therefore XYZ Credit Union could be seen as being in a position to most easily avoid the loss. Once again the legal rule for allocation of loss does put the loss on the collecting institution: it would not be able to discharge the burden of proof of showing it had not been negligent, thus making it liable for conversion.[42] It is therefore efficient in the light of the second Cooter and Rubin rule.

*Cost of the rule*

As to the third Cooter and Rubin rule, which rule is the cheapest to apply, bank are given a great concession: they are only liable for conversion if they cannot

[42] *Cheques Act 1986* (Cth) s 95.

show they have not been negligent.[43] This statutory defence prompted Professor Tyree to write:

> A more rational approach would be for the risks to be borne equally by all users of the cheque system or, alternatively, by those who are demonstrably careless. [44]

The statutory defence does undoubtedly complicate the issue of conversion, a relatively straightforward rule. But s 95 of the *Cheques Act* does not define negligence. For this one must turn to case law. The Act defines good faith in s 3(2) as something done honestly even though it may have been done negligently. The only example s 95 gives of negligence is if the collecting institution collects a third party order cheque (that is, an order cheque where the name of the payee is different from that of the customer of the collecting institution) without looking for absence of or irregularity of indorsements.[45] However, case law provides us with many examples of negligence.[46]

It is a complicated rule and therefore costly in terms of adjudication. However, this is somewhat tempered by the burden of proof in its application. All the plaintiff has to prove is conversion of the chattel, the piece of paper. If the collecting institution can demonstrate that it has not been negligent then it is not liable in conversion to the true owner. (The liability of the collecting institution is based upon conversion: it is not based upon negligence.) This

---

[43] *Cheques Act 1986* (Cth) s 95.

[44] Tyree, above n 31 para 8.52.

[45] *Cheques Act 1986* (Cth) s 95 (2).

[46] Failure to open an account properly: *Lumsden & Co v London Trustee Savings Bank* [1971] 1 Lloyds' Rep 114; where a special relationship between the true owner and the customer of the collecting bank facilitates the conversion: *Hannan's Lake View (Central) Ltd v Armstrong & Co* (1900) 16 TLR 236; where there are suspicious circumstances - *Motor Traders Guarantee Corp Ltd v Midland Bank Ltd* [1937] 4 All ER 90; collecting cheques marked 'account payee only': *Akrokerri (Atlantic) Mines Ltd v Economic Bank* [1904] 2 KB 465

might act *in terrorem* and act to dissuade banks from defending actions in conversion.

In summary, overall the rules for allocation of loss in regard to these hypotheticals are efficient in terms of Cooter and Rubin's principles, the one exception being how s 95 of the *Cheques Act* operates: it is unduly complex and therefore costly to adjudicate on.

## 8.9 Conclusions

First, the law's failure to impose a duty of care in regard to the safekeeping of bank cheques is arguably inefficient since it leads to doubts about their certainty. Efficiency considerations strongly suggest that such a duty should be imposed on banks since it is more efficient for banks to guard against theft than for payees to verify the authenticity of each bank cheque they receive**.** Moreover, it is not always possible for payees to do this. The banks can pass on the cost of safeguards to customers and claim it as a tax deduction.

Second, the rules for allocation of loss in regard to alteration of cheques when applied to bank cheques throw the loss on the payee and, if the bank cheque is taken in discharge of the debt, the payee effectively has no remedy: *Harvey Jones*:. The payee is basically in the same position as if cash were taken. This undermines the role of bank cheques as reliable cash substitutes.

Third, the NAB suggestion of adding more details when having the name of an institution is put on bank cheques cheques is a practical solution to safeguard against conversion. However, the concessions afforded to bank by s 95 of the *Cheques Act* go too far and are arguably inefficient since they offend against the first of the Cooter and Rubin rules, namely, loss spreading and the principle of rule simplicity.

**Summary**

To ameliorate the position from an efficiency perspective, the following is advocated:

- A duty of care in regard to the safekeeping of bank cheques should be introduced.
- Responsibility for alterations should be placed on the issuing banks as a spur to devise alteration proof bank cheques.
- When consumers buy bank cheques they should be asked for what purpose it is being purchased and this should be written by the banks on the front of the bank cheque.

## Chapter 9

# A UNIFORM RULE FOR FRAUD LOSS ALLOCATION

### 9.1 Overview

In the previous chapters the rules for allocation of fraud loss have been examined. One is immediately struck by the differences, even within the one system. For instance, with forgery of signature, subject to the estoppel and ratification exceptions, the loss is thrown on the banks whereas with fraudulent authorization, the duty cast upon drawers by law to draw their cheques in such way so as not to facilitate alterations - this is arguably more likely to lead to consumers being made liable.[1] With credit cards it depends on how they are used – if used with a PIN then the EFT Code applies and the loss is much more likely to fall on the banks unless ( and this is unlikely to happen much) the banks can prove fraud or gross negligence on the part of the cardholder.[2] If the credit card is used with a pen then the contact basically governs the situation not the EFT Code.[3] Do these different rules regarding allocation of loss correspond to any logic or are they just the result of the different rules being developed as each system has developed? More importantly is this diversity inefficient? Or would a uniform rule for fraud loss allocation be more efficient?

### 9.2 Outline of this Chapter

This chapter will examine whether uniform rules for fraud loss allocation is desirable and more efficient by addressing the following questions.

---

[1] See Chapter 5 & 6.

[2] See Chapter 4.

[3] See Chapter 5.

- What are the arguments in favor of uniform rules for fraud loss allocation?
- What are the arguments against uniform rules for fraud loss allocation?
- What did the failed US *Uniform Payments Code* provide for?
- Was the US *Uniform Payments Code* efficient?

### 9.3 Arguments in favor of uniform rules for fraud loss allocation

*Learning costs*

In theory different rules for fraud loss allocation involve greater learning costs for consumers and institutions involved with the payment instrument or method .than a uniform rule.[4] This assumes that consumers learn such rules for fraud loss allocation which is somewhat dubious.[5] Banks are much more likely to learn rules and a uniform one, assuming it is not unduly complex, will be cheaper than learning multiple ones. This, in turn, will be cheaper for users including consumers as users benefit from savings that are passed on, assuming that there is competition between banks.

*Confusion Costs*

It would seem that diverse rules about fraud loss allocation may also lead to confusion. A consumer might think that the rule for allocation of loss of fraud with a PIN credit card would be the same as with a signature credit card. The problem has been described in these terms.

[4] Clayton Gillette and Stephen Walt, 'Uniformity and Diversity in Payment Systems' (2008) 83 *Chicago- Kent Law Review* 499, 512.

[5] Amos Tversky and Daniel Kahnemann, 'Judgment Under Uncertainty: Heuristics and Biases' 185 (1974) *Science* 1124, 1127-28.

> Diversity [of fraud loss allocation rules] increases learning costs among users and leads to unanticipated consequences when uninformed users make incorrect assumptions about uniformity. The greater the uniformity across payment systems, the lower the search costs incurred by a party in selecting the appropriate device for her transaction.[6]

Gillette and Walt, on the other hand, maintain that confusion costs in regard to unauthorized losses in the US are quite low; and maintain that even if there were some confusion costs it does not mean that they are unjustified or that they could be easily eliminated by a uniform legal rule.[7] They contend, for example, that if it were possible to reduce confusion costs regarding credit and debit cards by having the same rule for both it might cause confusion in regard to other forms of payment like cheques since consumers might think that cheques are subject to the same loss allocation rule.[8] This seems a somewhat doubtful argument, at least in regard to Australia. But one presumes that the confusion costs as regards fraud loss allocation rules in regard to credit card must be high in Australia since if a consumer uses a PIN credit card the EFT loss allocation rules will apply whereas a signature credit card transaction is not subject to these but only to contractual rules for fraud loss allocation. If the two were governed by the same rule it is difficult to see why consumers would think that rule applied to cheques which would seem to a consumer an entirely different way of paying; and, conceivably, subject to different rules.

*The distortion argument*

---

[6] Clayton Gillette and Stephen Walt, above n 4,, 499.

[7] Ibid, 521.

[8] Ibid, 522.

Does the existence of different fraud loss allocation rules distort consumer's choice of payment instrument or method? It is doubtful whether most consumers are even aware of the different fraud loss allocation rules. Moreover, fraud is perceived as an unlikely event even if consumers knew about such differing rules. Behavioral economics suggest that an individual is likely to underestimate a negative future event unless someone in his or her immediate ken has recently experienced this.[9] Moreover, with individuals optimism prevails the further the event seems in the future [10] Selection of a payment method is often dictated by the vendor who usually concentrates on the likelihood of being paid. One assumes that the consumer's choice will usually be dictated by convenience and other perceived advantages rather than being influenced by fraud loss allocation rules. For example, it is more convenient to carry a plastic card in one's wallet or purse than to carry a cheque book because of size and the use of the credit card will attract loyalty points whereas the use of a cheque will not. Happily, the consumer's choice and the vendor's choice usually coincide.

However, just because consumers probably do not take into account different fraud loss allocation rules in choosing a payment instrument does not mean that such rules are irrelevant. The matter has been explained as follows:

> Users would presumably still prefer that the rules reflect the hypothetical risk allocation that relatively informed parties would have struck, since that bargain is likely to have price or other *ex ante* effects.[11]

---

[9] Amos Tversky and Daniel Kahnemann, above n 5, 1127-28.

[10] Stefano Dellavigna and Ulrike Malmendier, 'Contract Design and Self Control: Theory and Evidence' (2004) 119 *Quarterly Journal of Economics* 353; George Lowenstein and Richard H Thaler, 'Anomalies: Intertemporal Choice' (1989) *Journal of Economic Perspectives* 181.

[11] Clayton Gillette and Stephen Walt, above n 4 , 503.

In other words the law should try and reflect what bargain regarding fraud risk allocation the parties, if informed, would have arrived at.

*Economies of scale*

A uniform right would also lead to economies of scale. The argument is put thus.

> If all customers of financial institutions were subject to or protected from the same risks, the industry could structure its processes and services whether to absorb or to guard against losses occasioned by the risk.[12]

On the other hand, assuming different payment methods involve different costs, having the same fraud loss allocation rule might introduce distortions.

*Same risk avoiders – same rule?*

Since Cooter and Rubin make loss avoidance a chief plank in their principles for fraud loss allocation rules - often the consumer is the best loss avoider - this perhaps suggests that a uniform rule might be appropriate since it involves the same person However, what is expected of the consumer varies widely even in the same system; for example, the drawer of a cheque is not expected to guard against forgery but is expected to draw cheques in such way that they are not easily altered.[13] With a PIN it turns on authorization – the consumer is not supposed to divulge it to others or keep a record of it that can be accessed by others. These are all very different concepts that would seem to make a uniform rule difficult to devise.

---

[12] Peter Alces, 'A Jurisprudential Perspective for the True Codification Of Payments Law' (1984) 53 *Fordham Law Review* 83, 101.

[13] See Chapter 5 & 6.

*Fraud loss allocation rules as part of the transaction*

Fraud loss allocation rules only form part of the transaction. If there are uniform rules governing this it perhaps suggests that a uniform rule for fraud loss allocation might also be appropriate. There are, for example, standard rules governing such things as merchantable quality and fitness for purpose.[14] These probably reflect the law's recognition that the merchant seller is a repeat player probably with better knowledge than the consumer. It therefore perhaps follows that uniform rules for fraud allocation might also be appropriate.

## 9.4 Arguments against uniform rules for fraud loss allocation

*Unforeseen effects of uniform rule*

It is virtually impossible to foresee the direction payment instruments might take. And sometimes there are resurrections. Who would have thought 40 years ago that the ancient bill of exchange in Australia would have such a dramatic revival as a way of raising finance? The fraud loss allocation rules relating to these form part of the well established principles that underlie accommodation bills.[15] Arguably a uniform rule for fraud loss allocation rule might unforeseeably interfere with future developments with payment instruments and methods.

*Deprivation of rights*

It could be argued that the choice of payment instrument (and the accompanying fraud loss allocation rules) should be left to the parties. A repeat player like a merchant might well be aware of the different rules of

[14] *Trade Practices Act 1974* (Cth) ss 71, 74.

[15] Robert Peters, *The Commercial Bill Market in Australia* (1987), 3-5.

fraud loss allocation and make decisions about payment based or partly based on such considerations. The merchant might know, for example, in a distance sale (credit card not present) that there is a high risk of fraud but calculate that immediate payment and increased sales make the game still worth the candle. It is less likely, all other things being equal, that there would a fraud with a bank cheque but requesting such a bank cheque, especially if the goods were not expensive, could meet with consumer resistance because of the bother and cost.

*Different risks and different players*

It could also be contended that if any such uniform law was contemplated that it might not cover the fact that with different payment systems different risks and players bear different risks at different times. For example, it could be argued that banks should bear a greater risk depending on the configuration of EFT systems used. If a bank had ATMs that had vertical keypads that could be easily seen rather than horizontal ones shielded by the body of the user, this might suggest they should carry a greater risk. On the other hand, if a consumer uses a pencil to write out cheques this is inviting fraudulent alterations. A contrary argument would be that the system provider should provide a more 'idiot proof' system – cheques, for instance, that can only be written out with a special pen provided by the bank with the numerals being written in boxes on the cheques. Because of the infinite possibilities of risk bearing this would suggest that, assuming that such a uniform rule for loss allocation has an element of assigning loss according to risk, it would be difficult to craft such a rule.

## 9.5 The US attempt at a uniform rule for allocation of fraud loss

But there have been attempts in America to craft a general rule for allocation of loss resulting from fraud.

*The still born US Uniform New Payments Code*

Following the consumer friendly *Truth In Lending Act* which, amongst other things, conferred chargeback rights on credit card holders and the *Electronic Fund Transfer Act* with its simple 'failure to report' test for allocation of loss, the American Law Institute appointed Professor Hal Scott in the late 70s to revise Articles 3, 4, and 8 of the *Uniform Commercial Code* dealing with payment instruments. Inspired undoubtedly by article 9 of the *Uniform Commercial Code* which revised the law of personal property security instruments by doing away with the bewildering variety of personal property securities - chattel mortgage, pledges, trust receipts and the like - and replacing it with single framework and consistent terminology, Professor Scott sought to do the same sort of thing in the payments area with the *Uniform New Payments Code* (UNPC).

The UNPC was to apply to an 'order' that was defined in a vary broad way[16] This was the basic concept that was to cover cheques, credit cards, debit transactions, ATM withdrawals, wire transfers, and all forms of EFT. In short, virtually all payment instruments whether paper based or electronic. It was to apply to all orders for the transfer of funds payable by, at, or through, or transmitted by or to, an 'account institution', this being defined as 'any person (an individual or organization) who in the ordinary course of business maintains an account of a customer.'[17]

---

[16] *Uniform New Payments Code* § 10:

> An order is a complete and unconditional direction initiated to effect a funds transfer by a person to itself or to another person (a) of a sum certain in money; (b) from an account; (c) to take place immediately or at a definite time; (d) to or for the benefit of an identified payee, other than the payor account institution in the case of orders drawn on an account, which can only be accessed by orders payable to the payor account institution or to bearer;(e) with no other direction by the drawer except as authorized by this Code; and (f) identifying the drawer or, if it is a written draw order, signed by a person in the capacity of the drawer.

[17] *Uniform NewPayments Code* § 53 (1).

Even when the UNPC was drafted distinctions between paper and electronics were becoming blurred. This is especially true now. The cheque system of today would not be able to function without computers and signature credit cards depend on electronics to function  Professor Alces maintains that the UNPC is to be admired, if for no other reason, in that it 'minimized the legal effect of noncrucial distinctions between payment systems.'[18]

*Uniform risk allocation for fraud*

The third and fourth parts of the proposed American *Uniform New Payments Code* (UNPC) dealt with authorized and unauthorized orders including the duties and liabilities of the various parties.

Under the proposed UNPC a consumer may avoid liability for an 'unauthorized' order by issuing a notice of loss or theft to the payer account institution.[19] A consumer drawer's liability in regard to unauthorized orders (this includes cheques) was to be limited to $50 for unauthorized orders up to $500 even if the consumer did not notify the payer account institution irrespective of negligence.[20] (These figures here would have to be multiplied many times over to put them into today's figures.)

In all other cases a drawer whose negligence 'substantially contributed to the order becoming unauthorized' is precluded from claiming that the order was unauthorized.[21] Although negligence was not defined the UNPC drafters opined that 'it should generally consist of actions which could be taken by the

[18] Peter Alces, above n 12, 104.

[19] *Uniform New Payments Code* § 200(1).

[20] *Uniform New Payments Code* § 200(3).

[21] *Uniform NewPayments Code* § 200(2).

drawer to prevent the loss at a lower cost than the discounted expectation of loss.'[22]

These loss allocation rules seem to be drawn from a number of sources. In some ways the proposed loss allocation rule's $50 ceiling is very similar to the US federal credit card rule.[23] Clearly it is in the interests of a consumer to notify any unauthorized orders if they are aware of them and thus avoid liability altogether.

*Criticism*

Such proposed loss allocation rules, of course, did not meet with universal approval in America. The following gives a flavor of some of the initial vicious criticism:

> The fusion into a new UPC of a gelded, maimed UCC Article 3, a stripped-out, macerated version of UCC Article 4 and excessively protective(consumer oriented but bank apathetic) provisions from the EFTA, FCBA and TILA, together with sibling credit card charges and check guarantee services, into a single comprehensive statute creates a legal griffin.[24]

Anne Geary, Counsel for the Philadelphia Bank, in response to the proposed *Uniform Payments Code* acidly asked:

[22] *Uniform NewPayments Code* § 200 comment 3 on purposes.

[23] *Truth- in- Lending Act* (TILA) §133(a)(1)(B).

[24] James Vergari, 'A Critical Look at the New Uniform Payments Code' (1983) 9 *Rutgers Computer & Technology Law Journal* 317, 331.

> ..having mastered these legal languages [the different laws applying to payment systems], should we all now be forced to forget them and learn Esperanto?[25]

Banking interests finished up killing off the UNCP. The following description of the stance of the New York Clearing House Association (NYCHA) when it appreciated the thrust of the UNCP was typical of the banking industry:

> the effort to meld check, credit card, and electronic fund transfer law would impose some of the consumer protection features of the federal legislation on the checking system, and it reacted with its accustomed fury.[26]

The NYCHA in a somewhat preposterous analogy maintained that boats, cars, and trains are all forms of transportation but no one would argue in favor of a comprehensive code covering all forms of transportation.[27] Obviously they all travel at different speeds but it would not be ridiculous, for example, to have a comprehensive passenger safety code.

### 9.6 Were the failed UNPC rules efficient?

In this section the following key Cooter and Rubin 'rules' will be used to assess the UNPC efficiency of allocation of liability for loss:

- Which party can most easily bear the loss?

[25] Anne Geary, 'One Size Doesn't Fit All – Is a Uniform Payments Code a Good Idea' (1983) 9 *Rutgers Computer and Technology Law Journal* 337, 341.

[26] Edward L Rubin, 'Efficiency, Equity and the Proposed Revisions of Articles 3 and 4' (1991) 42 *Alabama Law Review* 551, 557.

[27] The New York Clearing House Association, Statement on the Proposed Uniform New Payments Code (29th September 1983).

- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Which party can most easily bear the loss?*

It is submitted that the UNPC rules for fraud loss are fairly simple and robust. They are largely consistent with Cooter and Rubin's rules for efficient loss allocation rules. They clearly put the losses in the main on the parties able to carry and spread these losses, namely, the financial institutions.

*Which party can most easily avoid the cause of loss?*

Consumers are given an incentive to mitigate the losses by reporting any loss or theft, thus reducing liability to zero. Apart from the $50 liability ceiling for orders under $500, they also allocate loss to the party which can most easily avoid the loss by providing that where negligence has substantially contributed to the order becoming unauthorised then the order is deemed authorized.

*Which rule is the cheapest to apply?*

Most cases would probably come within the $50 penalty. Adjudication of these would therefore be simple, thus complying with Cooter and Rubin's rule that rules should be simple. Cases of $500 or more would be few and far between. Here perhaps the simplicity breaks down with liability depending on the notoriously difficult concept of negligence.

Professor Rubin, however, thinks that, subject to some redrafting, the UNCP was a major intellectual achievement and that:

> Scott had succeeded in achieving what Gilmore and Dunham had

> achieved for security interests in the original UCC; he had penetrated through a welter of specific and contradictory statutes to perceive the regularities of the underlying transactions, and the legal rules that were necessary to facilitate them.[28]

## Conclusions

- A uniform rule for fraud loss allocation across different payment systems is possible.
- A uniform rule for fraud loss allocation would seem to be efficient.
- Whether it is more efficient than ameliorating current fraud loss allocation rules will be explored in the final chapter.

[28] Edward L Rubin, 'Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising UCC Articles 3 and 4' (1993) 26 *Loyola of Los Angeles Law Review* 743, 745.

## Chapter 10

# THE RIGHT TO STOP PAYMENT OF CHEQUES & EFFICIENCY

"God helps those who help themselves."  English Proverb

### 10.1 Overview

Often a perception that there is fraud on the part of a seller of goods or services will prompt the consumer to contemplate whether the particular payment system provides a stop payment mechanism since there is no help like self help. Of course, there may be other reasons for stopping cheques, such as loss, destruction or theft by a third party. Thus the right to stop payment is a natural corollary of any system of loss allocation.

However, some systems of payment do not provide a right to stop payment, for example, EFTPOS and cash. English cheque law that has been inherited in Australia does provide such a right but not all cheque law systems do. There is, for example, no general right of stop payment in regard to cheques in France.[1] The right to stop payment is a self help remedy and the issue that is raised here is whether it is efficient or fair.

Usually a contract can be assumed to profit both parties since both the vendor and the purchaser's individual preferences will be satisfied and there will be an improved resource allocation. But this assumes some conditions. The most crucial condition has been described in the following terms.

---

[1] Benjamin Geva, *Bank Collections and Payment Transactions: Comparative Study of Legal Aspects* (2001) 133.

> … these outcomes [ preference satisfaction and improved resource allocation] depend on both parties being fully informed, at the time of the contract negotiations, about all material aspects.[2]

This suggests an economic justification for a stop payment right. Usually the vendor will have more knowledge of the product or service than the consumer not only about intrinsic qualities including defects but also about market conditions and prices. Thus the seller is in a better position to know the real situation than the consumer; this is particularly true if it is a complex product or a product or service that is bought only occasionally. To use the jargon of economics the seller is 'the lowest cost information gatherer.'[3] But this superior knowledge will not generally give rise to a legal obligation to disclose. The good faith doctrine has shallow roots in Anglo-Australian law whereas the 19th century caveat emptor rule is still fairly deeply rooted. Of course, the vendor's superior knowledge has in a sense surrogates in the form of implied terms as to merchantability of goods and fitness for a particular purpose.[4] This helps out the consumer if a dispute arises, especially if it develops into litigation. However, prevention of 'mistakes', that is, where the consumer enters into a contract and is put at a gross disadvantage resulting from an imbalance in knowledge that produces an actionable wrong, is obviously preferable and more efficient than correcting these 'mistakes' by litigation.

It would therefore seem that a stop payment right might therefore be economically justified if it fulfils this purpose.

### 10.2 Outline of this chapter

---

[2] Anthony Duggan, Michael Bryan, Francis Hanks, *Contractual Non- Disclosure* (1994) 149.

[3] Ibid, 161.

[4] *Trade Practices Act 1974* (Cth) s 71(1) and (2).

This chapter will therefore examine whether the right to stop payment when fraud is apprehended is efficient by addressing the following questions:

- What are the consumer rights in regard to cash compared with cheques?
- What is the theoretical basis for allowing stop payment on a cheque?
- What are the reasons for stopping payment?
- What is the nature of payment by cheques when there is a dispute?
- Is the right to stop payment over disputes efficient?
- What are the stop payment rights in regard to lost or stolen cheques?
- Is the right to stop payment in regard to lost or stolen cheques efficient?
- What changes should be made to the law?

### 10.3 Payment by cash compared with cheques

Before exploring the right to stop payment with ordinary cheques a brief description of payment by cash and its characteristics is appropriate by way of contrast and to understand the right in regard to cheques.

Payment has been described as follows:

> Usually it denotes the transfer of money or a money fund, or performance of some act tendered and accepted in discharge of a money obligation.[5]

Cash can be interpreted to mean more than coins and notes and usually is when large sums are involved.[6] However, since the concern here is with consumer

[5] Roy Goode, *Payment Obligations in Commercial and Financial Transactions* (1990) 11.

[6] Typically charterparties stipulate payment in cash but this has always been interpreted to mean the equivalent of cash: see *A/S Awilico of Oslo v Fulvia SpA di Navegazione of Cagliari* [1981] 1 WLR 314, 320.

payments, the description will be confined to coins and notes. Not all payments with coins and notes will satisfy a contract that requires payment by cash. The coins and notes must constitute legal tender.[7] But what is meant by legal tender? It has been defined as follows:

> Legal tender denotes those notes and coins which are sufficient tender to discharge an obligation to pay in money.[8]

There must be not only a legal tender of cash but there must be an acceptance. Here the terms of the contract may be important. The contract might provide that the acceptance of the tender of payment is subject to a condition precedent, in which case there is no real acceptance until that condition is fulfilled. Or the acceptance may be subject to a condition subsequent, in which case the fulfilment of that condition would undo the payment. However, in either case, the payee would actually have possession of the money.

Generally speaking therefore once cash has been physically paid over to the payee, it is not possible to stop payment. There is no need to present the notes

---

[7] *The Reserve Bank Act 1959* (Cth) provides in s 36 that 'Australian notes are a legal tender throughout Australia.' *Currency Act 1965* (Cth) sets out in ss 16 (1) and 17 what coins are legal tender.

(a) in the case of coins of the denomination of Five cents, Ten cents, Twenty cents or Fifty cents or coins of 2 or more of those denominations--for payment of an amount not exceeding $5 but for no greater amount;

(b) in the case of coins of the denomination of One cent or Two cents or coins of both of those denominations--for payment of an amount not exceeding 20 cents but for no greater amount;

(c) in the case of coins of a denomination greater than Fifty cents but less than Ten dollars --for payment of an amount not exceeding 10 times the face value of a coin of the denomination concerned but for no greater amount;

(d) in the case of coins of the denomination of Ten dollars--for payment of an amount not exceeding $100 but for no greater amount; and

(e) in the case of coins of another denomination--for payment of any amount.

The references to coins in subsection (1) of section 16 do not include references to coins that have been called in in pursuance of this Act.

[8] *Halsbury's Laws of Australia*, Vol X, Alan L Tyree, Jon D Stanford and Fadi Khoury, *Banking and Finance* [45-670].

or coins to a third party obtain payment. Once handed over payment is complete: there is no time lag between the physical transfer and payment since they are inextricably entwined. Moreover, there is no one to whom a direct an effective stop payment request may be made. Cash is therefore the ultimate bearer payment. By its very nature it does not allow for stop payments. Damaged or contaminated notes may, however, be exchanged for value.[9]

### 10.4 Theoretical legal basis of the right to stop payment of cheques

The right to stop payment in regard to ordinary cheques is well known. But what is the theoretical basis for this right? Some theories about negotiable instruments are in fact inimicable to stop payment rights. If one regards a negotiable instrument as a type of assignment of a debt then such a theory would not support the notion of a right to stop payment. With an assignment of funds the holder of the funds, for example, a bank, once notified of the assignment must hold the money in trust for the assignee.[10] In equity the money belongs to the assignee. This means there cannot be a stop payment by the drawer, unless expressly conferred by statute. In Scotland cheques are regarded as assignments of funds. But the English *Bills of Exchange Act* 1882 explicitly states that a bill (this also covers cheques) is not an assignment of funds, except for Scotland.[11] This stance is also echoed in the Australian *Cheques Act* 1986 (Cth) in s 88 which provides that:

> The drawing of a cheque does not, of itself, operate as an assignment of funds that are available, in the hands of the drawee institution, for the payment of the cheque.

---

[9] <http://www.rba.gov.au/CurrencyNotes/DamagedNotes/index.html> at 25/8/08.

[10] *Norman v Federal Commissioner of Taxation* (1963) 109 CLR 9.

[11] *Bills of Exchange Act 1882* UK s 53.

In Scotland this also has another curious effect in banking practice, since the money in equity belongs to the assignee upon the holder of the funds being notified, if there is not enough money to cover the cheque on the first presentation, the bank must reserve sufficient funds to meet the cheque when it is presented again. Why? Because in equity there is a link between the payee and the bank because the payee has an equitable right to the money. There is no such right between the payee and the bank on a cheque under Australian law. If the cheque bounces it is a matter, all other things being equal, between the payee and the drawer who are contractually linked by dint of the drawer's undertaking.[12] The payee has no rights against the bank in regard to an ordinary cheque that is not paid.

The Anglo-Australian position, of course, reflects the notion that payment with a cheque is a conditional payment and thus, before payment is made by the drawee to the payee, it can be stopped.[13] The hiatus between the drawing of the cheque and payment by the bank thus facilitates a countermand of payment This approach was also adopted in America[14] after some flirtation with the assignment of funds theory.[15]

### 10.5 Reasons for stop payment

There are three main reasons for stopping payment. First, because a cheque is lost; second, because a cheque is stolen; and third where there is a dispute between the parties. All three are often associated with fraud- the person who has lost a cheque typically wants to stop payment to prevent a rogue obtaining possession; the person who has a cheque stolen wants to stop payment to prevent the thief from achieving his nefarious purposes; the person who has

[12] *Cheques Act 1986* (Cth) s 71.

[13] *Cheques Act 1986* (Cth) s 90.

[14] *Uniform Negotiable Instruments Act 1943* § 127; *Uniform Commercial Code* (1978 version) § 3-409(1).

[15] *Loan & Savings Bank v Farmers and Merchants Bank* 74 SC 210, 54 SE 364 (1906).

paid by cheque but is in dispute with the seller often think thinks he or she is a victim of a scam. Of course, the drawer may be mistaken as to the reason. She might, for instance, think that when the goods do not arrive that she is a victim of a scam when this might not be the case. Of course, drawers might also abuse the right for fraudulent purposes or to gain more time for payment.

### 10.6 Nature of payment by cheque and right to stop payment for disputes.

Payment by cheque, from a practical point of view, is usually not regarded as complete until the cheque is honoured. This is neatly illustrated by the case of *Re Hone*.[16] Here the drawer gave a cheque to a rating authority and a receiving order was made against the drawer after the issue of the cheque but before it was paid to the rating authority's bank. It was held that payment had not been made on the issue of the cheque but when it was paid, which was after the date of the receiving order. Therefore the amount was recoverable by the trustee in bankruptcy.

However, there are many cases that hold that payment is complete when the cheque is handed over since it is argued that non-payment is a condition subsequent. Lord Denning in *Thompson (Inspector of Taxes) v Moyes* said:

> If a cheque is met it ranks as an actual payment from the time it was given and not a conditional one. If the cheque is not met, the tradesman can have recourse to the debtor, because then there has been no payment. But subject to it being defeated by that condition subsequent, the payment is complete at the time when and at the place where the creditor accepts the cheque.[17]

[16] [1951] Ch 89.

[17] [1961] AC 867, 1004

The High Court in *National Australia Bank v KDS Construction Services Pty Ltd (in liq)* made the same point:

> Generally speaking, when a cheque is given in payment of a debt, it operates as a conditional payment. The payment is subject to a condition that the cheque be paid on presentation. If it is dishonoured the debt revives. Although it is sometimes said that the remedy for the primary debt is suspended, the suspension is no more than a consequence of the conditional nature of the payment: *Tilley v Official Receiver in Bankruptcy* (1960) 103 CLR 529 at 532–3, 535–6, 537 The condition is a condition subsequent so that, if the cheque is met, it ranks as an actual payment from the time it was given. Subject to non-fulfilment of the condition subsequent, the payment is complete at the time when the cheque is accepted by the creditor: *Thomson v Moyse* [1961] AC 967 at 1004.[18]

*Right to countermand*

In Australia the drawer's right to countermand a cheque will not prevent the drawer from being sued on the cheque. [19] This is especially so if the cheque has been passed onto a holder in due course who will be able to enforce it against the drawer free from any disputes between the drawer and the payee.[20] Even in a legal action by the payee against the drawer a defence by the drawer to the action is not easy to establish. The fact that the drawer has a right of set-off or a counterclaim against the payee stemming from the contract of sale will not necessarily provide a defence to a claim on the cheque. Judgement will be entered for the payee but the drawer can pursue his claims against the payee in another legal action. Leave to defend the claim will only be granted if the

[18] (1987-1988) 12 ACLR 663, 667.

[19] *Cheques Act 1986* (Cth) s 90.

[20] *Cheques Act 1986* (Cth) ss 49, 50.

cheque is affected with fraud, illegality or failure of consideration: *Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GMbH*.[21] However, when the payee has not provided the drawer with any goods or services or defective goods and services, stopping payment is an effective practical step if the cheque remains in the hands of the payee (the usual case).

It should also be noted that delivery of the cheque (essential for the holder to be able to sue on the instrument) can be made conditional: if the condition is not fulfilled, then there is no delivery of the cheque and the drawer cannot be sued on the cheque: *St George Wholesale Finance Pty Ltd v Spalla.*[22]

Where a consumer is not supplied with the goods or services at all – more likely to happen with mail order goods and internet sale- this means the payee has not provided the drawer with any consideration. (Usually the consumer will regard this as fraudulent.) This will be a defence to an action on the stopped cheque since total failure of consideration is one of the few defences to an action on the cheque by the payee.[23] A wise cheque provider might also

---

[21] [1977] 1 WLR 713; [1977] Lloyd's Rep 463.

[22] (2000) 181 ALR 682.

[23] One can gather what defects in title and equities a person who is not a holder in due course (eg a payee) can be subject to by looking at the privileged position a holder in due course has by dint of s 49(2) of the *Cheques Act* 1986 (Cth) which provides as follows:

(2) A holder of a cheque who is a holder in due course:

(a) holds the cheque free from any defect in the title of prior parties as well as from mere personal defences available to the drawer and prior indorsers against one another; and

(b) may enforce payment of the cheque against any person liable on the cheque.

Section 3(3) of the *Cheques Act* 1986 (Cth) also gives a non-exhaustive list of what things can amount to a defective title.

Where a person obtains a cheque --

(a) by fraud, duress or other unlawful means; or

(b) for an illegal consideration, the person's title to the cheque is defective.

The reason why, even between immediate parties to a cheque, that is, the drawer and the payee, rights of set-off or a counterclaim cannot be set up as a defence to an action on the cheque is because payment by cheque is to be treated as cash. The payee will therefore normally be entitled to summary judgement: *Montecchi v Shimco (UK) Ltd* [1979] 1 WLR make the delivery of the cheque conditional on obtaining the goods or services requested.

*The American Position with regard to stopped cheques*

The position of the drawer in America is somewhat superior to that of the drawer in Australia. In America not only can the drawer stop payment but he or she can resist any action on the stopped instrument by the holder, typically, the payee, on the basis of a breach of warranty, the usual nature of a claim for defective goods and services.[24] This will not work if the payee is, however, a holder in due course (under American law it explicitly provides that a payee may be a holder in due course).[25] On the other hand, in Australia, the right to stop payment is purely a stop gap measure because of the 'cash' principle since in most cases there will not be a total failure of consideration, fraud or illegality but usually a breach of warranty or condition. Thus the drawer is relegated to a claim on the contract in a separate action whereas in America the drawer's claim which prompted the stop payment is heard at the same time, either as a defence or as a separate claim heard at the same time.

In both America and Australia, however, the apparent policy is to place the buyer, the drawer, in an advantageous position vis-à-vis the seller, the payee, at least in the negotiating period prior to litigation.

*The position with traveller's cheques*

These are neither covered by the Australian *Cheques Act* nor by the *Bills of Exchange Act* and the right to countermand purely a matter of contract between

---

1181. Of course, the drawer is entitled to bring a separate action against the payee for damages arising out of the same transaction.

[24] *Uniform Commercial Code* § 3-306 (b) (1978 version).

[25] *Uniform Commercial Code* § 3-302 (2) (1978 version).

the issuer and the user. The user signs the traveller's cheques and countersigns them when paying for goods and services or cashing them at a bank, usually overseas. The contract does not give an express right in regard to lost or stolen cheques but the purchaser of traveller cheques is given a right to replacement ones provided the lost or stolen ones are not countersigned but the right can also be made subject to other conditions.[26] In effect this is a sort of right to stop payment. However, a right to stop payment is not given when there is a dispute between the counter signer and a seller. There are several reasons for this. First, traveller's cheques are somewhat like bank cheques in the sense that there is a widely held perception that they will be paid, if countersigned; they have a 'cash' reputation. Second, probably issuers do not want to be caught up in disputes, for example, between a tourist and a Moroccan market stall holder as to whether the bags sold are genuine camel saddle bags as claimed by the vendor.

### 10.7 Efficiency of stopping payment in regard to disputes

The following Cooter and Rubin rules will be referred to in the following discussion about the efficiency of stopping payment:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

The clear effect of stopping payment is to allow the drawer to keep the funds, although, it may be only temporarily. The drawer may, depending on the reasons for the stop, also have the consideration, for example, the goods or services of the underlying contract. Especially, in regard to disputes, the drawer (the buyer), is placed in a better position vis-à-vis the seller. Indeed, it may

[26] Alan L Tyree, *Banking Law in Australia* (5th ed, 2005) 226.

even be that without these funds the buyer/drawer could not even contemplate taking up the dispute with the seller, let alone initiating legal proceedings. Such a right has been described as follows:

> The effect of the concept is to both discourage abuse and to equalize the bargaining/ dispute settlement posture of the parties by extending special advantages to the buyer.[27]

Rubin also echoes this correction in the imbalance between consumer and vendor when he writes:

> A stop order is a device that enables consumers to counteract the social inequity of loss imposition vis-à-vis vendors of goods or services. Suppose a consumer pays for merchandise, brings it home, and discovers or believes that it is defective. If she has paid by cash, she must initiate the lawsuit against the merchant, a law suit attended by many of the difficulties just described. If she has paid by check, however, she can simply contact the bank and stop the check.[28]

As noted already, the stop payment right is a natural consequence of the fact that a cheque is not an assignment of funds and was not devised as a consumer remedy; but as Rubin points out 'it has turned out to be one of the truly effective mechanisms for consumer redress'.[29]

Of course, it may be that consumers may abuse this right. However, one has to assess this in the light of the ability of the parties, the consumer and the retailer,

[27] Thomas O Mittelsteadt, 'The Stop Payment Right in an Electronic Payment Environment: An Analysis of the Transition Problems Involved when Integrating a Traditional Right into New Value Transfer Systems' (1981-1982) 17 *New England Law Review* 355, 365.

[28] Edward Rubin, 'Efficiency, Equity and the Proposed Revision of Articles 3 and 4' (1991) 42 *Alabama Law Review* 551, 577.

[29] Ibid.

to react to the allegation of shoddy goods and services or an allegation of fraud. Often, it is not easy to initially determine who is at fault. This therefore suggests that 'the initial burden must be placed on the merchant-because he is almost always economically more capable of pursuing the dispute.'[30] This accords with Cooter and Rubin's first rule for loss allocation, namely, which party can most easily bear the loss.

*Costs arguments*

Undoubtedly, stopping a cheque involves costs. The bank must respond in a timely fashion to the countermand. The cheque processing may have to be interrupted. Changes must be made to figures. All of this involves labour costs if nothing else. The solution to this problem by some banks has been to charge the payee a fee in regard to the stopped cheque, a rather galling prospect from the payee's point of view since the payee might well have also parted with the consideration as well as having had the cheque bounce. Some banks, like ANZ, have stopped this practice, so unpopular has it been with customers. Most banks charge a fee to the drawer for stopping payment: ANZ, for example, charges $20.[31].There are no publicly available details of how such fees are calculated. It might well be excessive with the bank making the drawer or the payee bear the cost. On the other hand, if it is less than the real cost or if no fee charged at all this means that the cost of it is spread over the whole customer base. As between the payee, the retailer, and the bank, it would seem more efficient for the bank to bear the cost and pass it on to all users

Since the right to stop payment would seem to be a valuable consumer right worth retaining to right the imbalance between consumer and retailer, it is submitted that the cost of it should be spread across the system as far as possible on the basis of Cooter and Rubin's loss spreading principle.

---

[30] Above n 26, 374.

[31] <http://www.anz.co.nz/ratefee/charges/acctserv.asp> at 2/9/09.

*Is the right to stop the cheque worth it?*

If the right to stop cheques was so infrequently used in regard to disputes, for example, an argument could be made that consumers would be better off in the long run without it since they and other customers of the banks bear the cost of it. This ignores the fact that to the individual consumer who has received goods or services not in compliance with the underlying contract the right to countermand is often in reality the only practical solution to remedy the situation. Even if the right is not frequently used its mere presence might also have a salutary effect on retailers' compliance with the underlying contract. Moreover, a stop payment right needs to be provided in regard to lost or stolen cheques.

*Bank not following countermand when there is a dispute*

If the bank has not followed the valid countermand of its customer it has paid away its own money and may not debit the customer's account. There are a number of options open to the paying bank here. It can try and maintain the debit on the basis of the *Liggett* action.[32] In other words it may try and be subrogated to the rights of the payee if the customer tries to sue the bank and this would therefore diminish the amount recoverable since it would be reduced by the amount for the defective goods and services or fraud.

Unlike American law, the Australian *Cheques Act* does not explicitly say who has the burden of proving the bank error if the bank disobeys a valid countermand.[33] In practice if the error is denied by the bank the customer will have the burden of proving it. This seems particularly unfair – not only has the bank maintained the debit but the customer has to go to the expense and time

[32] *Ligget (B) Liverpool Ltd v Barclays Bank Ltd* [1928] 1 KB 48.

[33] Rubin, above n 28, 577.

involved in proving the bank's fault. It also seems contradictory: the law gives the buyer a self help remedy against a vendor who has not complied with the underlying contract but not against the bank when there is a problem.

**10.8 Stop payments in regard to lost or stolen cheques**

If a consumer drawer is aware that a cheque has been lost or destroyed the drawer can countermand payment of it.[34] Often lost cheques and stolen cheques are the genesis of subsequent fraud. Whether stopping payment protects the drawer from liability on the cheque depends on how the cheque is drawn: if it is a bearer cheque and not crossed and marked 'not negotiable' it may be possible for it to finish up in the hands of a holder in due course who will have the right to enforce the cheque despite the stop put on it.[35] On the other hand, if it is crossed and marked 'not negotiable' there can be no holder in due course and the drawer is protected. If it is an order cheque and it is lost or stolen the finder or thief would have to forge the payee's name and therefore, the person who takes it, even though in good faith and for value, cannot be a holder of it[36] and *ipso facto* cannot be a holder in due course. Thus, the drawer of such a stopped cheque would be protected from liability if it were stopped

The other problem faced by the drawer is the possibility of being doubly liable, first on the lost one and then on the replacement one. The *Cheques Act* has a solution to the problem. The person who has lost a cheque has a right to have a replacement cheque from the drawer and the drawer can insist upon an indemnity and security in regard to liability on the lost instrument and any costs involved in issuing a new one.[37] The Australian *Cheques Act* goes further than

[34] *Cheques Act 1986* (Cth) s 90.

[35] *Cheques Act 1986* (Cth) s 50.

[36] *Cheques Act 1986* (Cth) ss 3, 32(2).

[37] *Cheques Act 1986* (Cth) s 115.

the British *Bills of Exchange Act* since it provides that if the lost cheque had been indorsed, the holder may require the indorser of the lost cheque to indorse the replacement one but, yet again, the indorser may seek protection from double liability by compelling the loser to provide an indemnity and security.

**10. 9 Efficiency of stop payment in regard to lost or stolen cheques**

Cooter and Rubin's second principle for loss allocation looks to which party can most easily avoid the loss. In the case of lost cheques this is obviously the person who lost it. Since the person who loses it must provide an indemnity and security before obtaining a replacement one, the cost is attributable to the person who could most easily have avoided the loss.

American legislation not only covers lost cheques but also stolen ones.[38] It is doubtful whether the word 'lost' in the Australian legislation would cover theft. In terms of loss avoidance it could be argued that the loss, the theft, is not avoidable and that therefore sheeting home responsibility to the victim of the theft is not efficient since it is not something that can be avoided. This may be true in some cases, for example, armed robbery. But it could be argued that precautions might diminish the possibility of theft in many cases; for example, leaving the front door open with the cheque on the hallway table might increase the likelihood of theft. Most household insurance policies do not pay out for theft if the household is not locked; so it might be concluded that whether the theft is avoidable depends on the circumstances. Overall in the case of theft it might be said that the American approach is perhaps equivocal in terms of efficiency when the theft is unavoidable.

Nevertheless, the Australian approach covering as it does loss and destruction of cheque is efficient since the party who often has no control or responsibility for the loss, the drawer, is protected from double liability and the victim of the

[38] *Uniform Commercial Code* § 3-804 (1978 version).

loss may still be able to be paid by dint of the replacement cheque. Of course, it could be argued that the drawer could reduce the possibility of the lost cheque that is stopped being enforced by a holder in due course by the simple expedient of adding a ‘not negotiable’ crossing.[39] Therefore the drawer does have some control over the ultimate enforceability of the lost cheque. But the payee or subsequent holder also can protect themselves along the same lines by adding a ‘not negotiable’ crossing if the cheque is uncrossed or if it is a general crossing by adding the words ‘not negotiable’ between the lines and this would stop any one from becoming a holder in due course on the stopped lost cheque. But since the loss is initially borne by the payee, it is submitted that the payee has more of an incentive to do this than the drawer.

### 10.10 Conclusions and recommendations

It is submitted that the stop payment right for disputes is efficient since it improves the efficiency of the contract between consumer and seller in the sense that the burden of the dispute is placed upon the vendor until the dispute is resolved. This is efficient since generally the vendor is financially stronger than the consumer and is consonant with Cooter and Rubin’s loss bearing principle. Moreover, the mere possibility of stopping payment might act as a spur for greater contract compliance by the vendor.

It is submitted that the ‘cash’ principle which denies drawers’ claims and defences against the payee in an action by the payee to enforce payment on the cheque is not efficient since it necessitates another separate legal action by the drawer against the payee for breach of contract. The unfairness of this must be galling to the drawer who has a valid claim against the payee but is then forced to initiate separate legal proceedings if she or he can afford them. Quite often the game will not be worth the candle for the consumer. If the ‘cash’ principle allows exceptions like total failure of consideration, fraud and illegality to be

[39] *Cheques Act 1986* (Cth) s 57.

set up it is difficult to understand why breaches of contract could not be set up too. The changes would only involve some changes to procedural rules relating to cross claims and counterclaims.

The stop payment in regard to lost/destroyed cheques is efficient but, unlike the American position, it is not clear whether it also covers stolen cheques. It should be extended to cover stolen cheques too.

Where a bank has disobeyed a valid countermand the burden of proving disregard of stop payment should not be on drawer. Rubin has pointed out the manifest unfairness of this:

> The real social equity problem involving loss allocation lies in the process of resolving disputes and imposing losses. When a loss occurs and the bank disagrees with its customer about who should be responsible, the bank can resort to self help, by simply deducting the disputed amount from the customer's account. The result is that most consumers are powerless when the bank resorts to self help, even if they feel they are right. This is the paradigmatic case of unfairness: to feel that one is right but know that one has no address.[40]

Moreover, in Australia the relevant law, the *Cheques Act* does not provide any penalty for banks that maintain a debit when a valid countermand is given, so the only way for the consumer to tackle the problem is a threat of litigation or that the matter will be taken to the Financial Ombudsman Service. In short the system does not treat both parties' sides of the dispute on an equal footing. Not only has the value of the stop order been emasculated but the customer has to fight the bank's own self help remedy, the debiting of the customer's account.

[40] Rubin, above n 28, 577.

It would be fairer and more efficient – given that the bank's resources are infinitely greater than most consumer's (the loss spreading principle) – for the bank to reaccredit the account in accordance with the stop payment order and for the bank to have the burden of proving that no loss stemmed from its error.

**Summary of recommended changes**

- Allow the drawer a right to set up any dispute against the vendor in the same action where the vendor/payee brings an action on the stopped cheque.
- The right to stop cheques should be explicitly extended to stolen cheques.
- Banks to reaccredit the account in accordance with the stop payment order and for the bank to have the burden of proving that no loss stemmed from its error.

## Chapter 11

## STOPPING PAYMENT ON BANK CHEQUES

### 11.1 Overview

Most of the cases and articles in Australia have been about the right of the payee to enforce payment against the bank where there has been a failure of consideration. This is often accompanied by fraud.[1] Another issue is whether the buyer of a bank cheque can stop payment on it?

The buyer's attempts to stop payment may be motivated by apprehension or a discovery that the vendor has not complied with his obligations under the contract. This is often, in the buyer's view, considered to be fraud. If, for example, the buyer has bought a motor car and paid for it with a bank cheque and discovers that the engine is completely defective or that the seller does not have a good legal title to the car, then he may endeavor to stop payment on the bank cheque. Whether the buyer can successfully do this depends on whether a bank cheque is a truly independent payment instrument or not. If the bank cheque has already been cleared he will have to resort to legal proceedings to recover his money or seek damages. Stopping payment is therefore easier.

Conversely, it will be the seller who will be trying to enforce payment on the payment instrument, arguing that the enforceability of the payment instrument is independent of the underlying bargain.

---

[1] See, eg, John Wilkin, 'Dishonour of Bank Cheques' (1994) 22 *Australian Business Law Review* 296;;; Robin Edwards, 'Bank Cheques & Solicitors' (1990 *Law Institute Journal* 592-3; Wikrema S Weerasooria, 'The Australian Bank Cheque – Some Legal Aspects' (1976) 2 *Monash University Law Review* 180; Stan Robertson, 'Bank Cheques – Nearly as Good as Cash' (1976) *Rydge's* Business Journal 120; Robert Makin, 'The Australian Bank Cheque – Some Further Legal Aspects' (1976) 3 *Monash University Law Review* 66.

## 11.2 Outline of this Chapter

This chapter will examine whether there is a right for the purchaser of a bank cheque to stop payment on it and whether such a right, if it exists, is efficient by addressing the following questions.

- What are *jus tertii*?
- Do the rights of the purchaser of the bank cheque in regard to the underlying contract give rise to a right to compel the issuing bank not to pay*?*
- What are the arguments in favor of the purchaser being able to stop payment?
- What is the position of the bank as drawer?
- Are personal defences or equities different?
- Is uncertainty engendered by the right to stop payment?
- What if the bank cheque is made out to the payees' name or order?
- What is the American position?
- Is allowing claims of the bank cheque buyer/remitter vis-à-vis the payee being used to stop the drawer bank from paying efficient?
- What changes should be made to the law?

## 11. 3 *Jus Tertii*

Can the claims of the remitter, the buyer of the bank cheque, vis-à-vis the payee, the seller, for example, that the goods are not of merchantable quality be used by the remitter against the drawer of the bank cheque to stop payment? Not infrequently this may, at the very least, involve allegations of fraud or sharp practices. The basic issue involves looking at *jus tertii*,[2] a defence based

[2] An expression used in this context in Anthony Gordon Guest *Chalmers and Guest on Bills of Exchange* (1964), 102.

on rights of third parties, namely, the purchaser of the bank cheque. The drawer of an ordinary cheque has a right to countermand payment of a cheque.[3] However, the person that buys the bank cheque to remit to the payee is not the drawer – the bank is the drawer.

In *Justin Seward Pty Ltd v Commissioners of Rural & Industrial Bank*[4] the drawer bank mistakenly wrote out a bank cheque to a firm of estate agents when its customer instructions had been countermanded. The drawer bank stopped payment on the cheque and indorsed on the bank of the cheque "18/5/79 - consideration failed". The payee on the bank cheque obtained summary judgement against the bank and the bank appealed maintaining that the payee plaintiff had provided no consideration. Leave to defend was granted and the acting Judge said *obiter dicta*:

> Good's (the customer) withdrawal of instructions suggests that he had some reasons for no longer wishing to pay. Good may have been able to give evidence of, say, fraud in which case if proved there could be little question of the bank's (sic) not being able to avoid liability on its cheque. [5]

In *Walsh & Others v Hoag & Bosch Pty Ltd* [6] there was a situation that is somewhat similar to bank cheque scenario. The vendor's solicitor drew a trust cheque in favour of the estate agent. There was never any doubt that the estate agent was owed the commission. The vendor asked the solicitor to stop payment on the trust cheque. The estate agent, the payee, sued the solicitor on the cheque and the case was fought out on the issue of whether there was consideration provided to the solicitor/drawer by the estate agent /payee. The

---

[3] *Cheques Act 1986* (Cth) s 90.

[4] *Justin Seward Pty Ltd v Commissioners of Rural & Industrial Bank* [1980] 60 FLR 51.

[5] Ibid 54.

[6] *Walsh & Others v Hoag & Bosch Pty Ltd* [1977] VR 178.

Court was split on the issue. Two of the judges (Young CJ and Jenkins J) took the view that the antecedent debt or liability of a third party (the vendor) was capable of being viewed as sufficient consideration vis-à-vis the solicitor/drawer. Lush and Jenkins JJ were of the view that the solicitors were agents for the vendor and that the cheque was accepted by the firm of real estate agents as a conditional discharge of the vendor's indebtedness. It was this agency relationship which presumably gave the solicitor's client the right to countermand payment on the trust account cheque. The Court commented:

> ... the appellants (the solicitor/drawer of the cheque), at the time the cheque was given had at least ostensible and probably actual implied authority to make the payment on behalf of the Logans (the vendors) and were in effect making the payment out of moneys of the Logans in their hands, for which they were accountable to the Logans. [7]

In Canada there appears to be one case that says that a remittance instrument may not be countermanded[8]. In Canada it is, however, customary for the payee to have the remittance instrument cashed at the counter (the crossing on an Australian bank cheque makes this impossible). Hence in Canada there is a practical problem to stopping payment on a bank cheque.

Thus, it can be seen that in Australia there is not a great deal of authority on the issue of whether a purchaser of a bank cheque can compel the bank to stop payment on it.

---

[7] Ibid, 421.

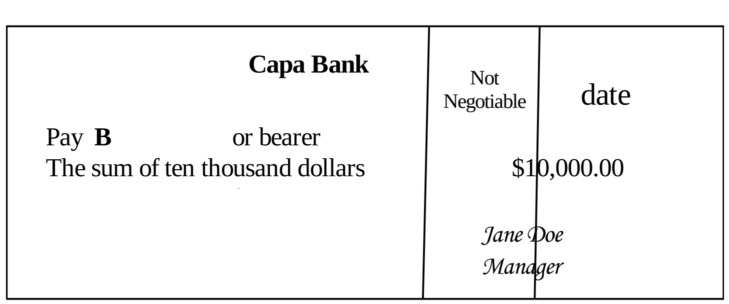
[8] *Brossard v Sterling Bank* (1912) 8 DLR 889 (Quebec SC).

## 11.4 Do the rights of the purchaser of the bank cheque in regard to the underlying contract give rise to a right to compel the issuing bank not to pay?

The right to stop payment on a bank cheque is a complex question since it involves looking at the underlying contract as well as the rights of the payee on the bank cheque and also the rights of the debtor (the person who bought the bank cheque) in regard to the bank cheque. To facilitate discussion, a look at a typical situation where the issue may arise will be used. A buys a car from B and pays him with a bank cheque drawn by the bank C.

A ← sale of car B

→ provision of bank cheque bought by A




Typically, in Australia the bank cheque is made to B as payee or bearer, crossed and marked "Not negotiable". It should be noted, and this is crucial, that the bank cheque is negotiated or transferred to the payee B by A. This is unusual. Normally, an ordinary cheque is not negotiated to a payee - it is issued to him i.e. he or she does not have the cheque transferred to him by negotiation. A typical Australian bank cheque made out to the name of the payee or bearer is different.[9] In the situation above A is the first holder (he is the "or bearer") - he then transfers it by negotiation by simply handing it over

[9] Some banks now have bank cheques made out to the name of the payee or order. There is no reason why the purchaser of a bank cheque cannot insist that it be made out to the name of the payee or order.

to B (the payee) since it is a bearer instrument.[10] Since the cheque is crossed and marked "Not negotiable" the payee cannot be a holder in due course, and will take subject to defects in title and personal defences available to the drawer.[11]

Imagine in the above sale of a car by B to A that there has been a fraudulent misrepresentation by B, the seller. A's immediate and understandable reaction is to contact the bank C and request it to stop payment. This places the bank in an invidious position. The bank does not want to be drawn into a dispute between A and B. Moreover, for all the bank knows, the bank cheque may have been transferred onto another party by B.[12] The usual and understandable reaction of the bank in such a situation is to refuse to stop payment.

## 11.5 Arguments in favor of the purchaser being able to stop payment

Nevertheless, there is a strong argument that A can compel the bank to stop payment of the bank cheque.

As noted above, the payee on a bank cheque negotiated to him takes subject to defect in title and equities of prior parties, that is to say, A who transferred it to B.

---

[10] Glass J in *Commonwealth Bank v Sidney Raper Pty Ltd* (1975) 25 FLR 217, 245 referring to a bank cheque said:

> It was made payable to Sidney Raper Pty Ltd or bearer, and was handed to P Jacobson who then delivered it to the payee. It followed that P Jacobson was the first holder and the immediate party to the bill and the plaintiff payee was a remote party taking title by delivery.

[11] Hutley JA in *Commonwealth Bank v Sidney Raper Pty Ltd* said at 247 when referring to a bank cheque crossed and marked “not negotiable”:

> whatever was done by the plaintiff or others prior to the bank cheque reaching the plaintiff does not deprive the bank of its right to set aside the translation and to repudiate liability on the cheque.

[12] If the cheque is passed by the payee to another person then that person also cannot be a holder in due course since such a person takes subject to defects in title due to the not negotiable crossing.

Section 49(2)(b) of the *Cheques Act* 1986 (Cth) talks of a holder in due course taking 'free from any defects in the title.... as well as mere personal defences'.[13] The converse of this is that a person who is not a holder in due course takes subject to defects in title and personal defences. B on a bank cheque made out to B or bearer crossed and marked 'not negotiable' is precisely in that position.

A mere holder like B is therefore, subject to the ownership rights of A to the bank cheque as well as defensive rights that A may have vis-à-vis B on the contract for the purchase of the car. A may be able to argue that because of the fraudulent misrepresentation he has rescinded the contract and that ownership of the bank cheque rests with him.[14] B the payee, takes subject to that ownership. Putting it simply A says to B "you don't own that bank cheque because I have rescinded the contract because of your misrepresentation". The right of ownership/possession of the bank cheque would lie with A.

How does this argument affect the bank as drawer? Can it go ahead and pay out on the bank cheque when it has been advised by A that the payee B has a defective title or no title at all?

**11.6 The bank as drawer**

The starting point is perhaps s79 of the *Cheques Act* which provides that:

---

[13] *Cheques Act 1986* (Cth) s 49(2)(a) used to refer to a holder in due course holding the cheque free from any defects in the title of prior indorsers ..." "whereas s43(1)(b) of the *Bills of Exchange Act 1909* (Cth) says a holder in due course "holds the bill free from any defect of title of prior parties ..." The reference of prior indorsers in the *Cheques Act* was clearly wrong and was amended in 1998 to read as 'prior parties'.

[14] If there is a unilateral mistake as to identity it is possible that there may be no contract in which case the title in the bank cheque rests with the person who bought the bank cheques ("A"). If the contract is voidable for, say, fraud and is rescinded by the person who bought the bank cheque ("A") then the title will revert back to "A" even though the bank cheque is in the hands of "B".

> A cheque is paid in due course if the cheque is paid to the holder in good faith and *without notice of any defect in the holder's title or that the holder had no title to the cheque"*. (italics added by author)

The concept of payment in due course is fairly simple: it means payment to a holder that has the result that the obligations on the cheque come to an end and any rights of action on the cheque are extinguished. If, however, the bank has notice of the holder's defect in title or that he or she has no title at all and goes ahead and pays it, then the bank cheque is not discharged[15]. The bank could in affect be compelled to pay it again to the true owner. Who is the true owner in this scenario? A. The bank could then seek to recover from B.

Section 79 must also be read with s 92 of the *Cheques Act* which provides:

> Subject to subsection 32(1) [which deals with unauthorised signatures] where a bank, in good faith and *without negligence*, pays a crossed cheque drawn upon it to a bank, the bank shall be deemed to have paid the cheque in due course. (italics added by author)

This would not give much comfort to the bank in the circumstances being considered. If the purchaser of the bank cheque advises the bank that the payee has no title or a defective title then, clearly, if the bank goes ahead and

---

[15] *Cheques Act 1986* (Cth) s 79 is primarily concerned with the drawee bank. It allows the drawee bank to say "I'm discharged" if it pays the holder even though that person may not be the true owner. It is to be noted that the section does not refer to the holder in due course. The fact that the section refers to the holder is a considerable concession to the drawee bank to protect it against conversion since payment by the drawee bank to someone who is not the true owner would be conversion. However, the concession that payment to the holder suffices is qualified if the drawee bank knows that the holder has no title or that his title is defective then payment to the holder will not result in the drawee bank being discharged. Normally the drawee bank will not know whether the holder has a good or bad title to the cheque. But on a bank cheque the bank is both drawer and drawee. Thus when the bank is told by the person who bought the bank cheque that the holder has not title or a defective title the bank may not obtain a good discharge if it pays the bank cheque.

pays it to a bank, it will not be deemed to have paid the cheque in due course, since it has been negligent.

If knowledge by the bank as drawer and drawee that the holder's title is defective or that the holder has not any title at all prevents the bank from obtaining a good discharge, then it follows that the bank can set up A's ownership rights as a defence if the payee B sues the bank as drawer, if the bank stopped payment.

Moreover, it follows that if A has rights of ownership despite the fact that the bank cheque is in the hands of B, he can restrain the drawer bank from paying B, since the bank cheque belongs to him or her.[16]

All of the above is a natural consequence of the fact that the payee as a remote party on a bank cheque crossed and marked 'not negotiable' does not have an unassailable legal title to the cheque.

### 11.7 Are personal defences or equities different?

When it comes to equities or personal defences that the payee takes subject to, the situation is a little less clear.[17] The usual way of explaining the difference between defects in title and personal defences is to say that the latter are defences that exist between the immediate parties, for example, I write you out a cheque for $100 that I owe you and you are indebted to me for the sum of $30, then when you sue me on the cheque I can set up the $30 as a counterclaim or set-off. (This, of course, for convenience overlooks the so-

---

[16] In a sense when "A" asserts his rights of ownership vis-a-vis the bank he is saying that "B" has no right of possession of the bank cheques since the right of possession belongs to the legal owner, viz "A". If "B" has no rights of possession "B" cannot sue the bank.

[17] On a normal cheque equities or personal defences are, in effect, allowed to be argued about between the payee and the drawer, even if it is in separate actions. The payee on a bearer bank cheque is a remote party who is also subject to those equities or personal defences since the cheque is crossed and marked "not negotiable".

called ‘cash’ principle whereby the drawer is forced to pay on the cheque and bring a separate action against the payee.)

Professor Geva refers to ‘equities of ownership’ as opposed to ‘equities of defence’.[18] The latter might, for example, include a right to plead breach of a warranty as a defence to an action on the contract for the price.

But some personal actions go to the root of the obligation and can amount to a defect in the title. If A, in the example above, has been induced to enter the contract by a fraudulent misrepresentation as to identity by B, he can rescind the contract *ab initio* and this will then mean that, although the bank cheque is in the hands of B, he will not have a good title to it. This is an example of a contractual right pertaining to the underlying contract for the purchase of the car that results in B not having a good title to the bank cheque. Not all contractual actions will result in a defect in title; for example, a counterclaim will not.

*Conclusion*

In short, it appears that the purchaser of a bank cheque may be able to use his proprietary right to the bank cheque to stop the bank paying out on the bank cheque; and, conversely, the bank, if sued by the payee, may plead the purchaser's proprietary rights as a defence to an action on the cheque by the payee. In the latter case, the payee of a bank cheque crossed and marked "not negotiable" has the cheque negotiated to him subject to defects or lack of title vis-à-vis the transferor by delivery (the person who bought the bank cheque) and the bank, as drawer on the bank cheque, can set this up as a defence.

[18] Benjamin Geva, ‘The Autonomy of the Banker’s Obligation on Bank Drafts and Certified Cheques’ (1994) 73 *The Canadian Bar Review* 21, 42.

## 11.8 Uncertainty engendered by the right to stop payment

It is suggested that the ability of the purchaser to compel the drawer bank on a bank cheque to stop payment on it can lead to great uncertainty.

First, it would seem that the burden of proof lies upon the bank under ss79 and 92 of the *Cheques Act*.[19] If it has any knowledge of a defect in title or lack of title, it will not obtain a good discharge. How is the bank to react to the claim of the purchaser of the bank cheque that the payee has no title to it or a defective title? If the bank ignores the purchaser's claim and pays out on the bank cheque, it runs the risk of double payment - it would be liable to the purchaser since he is the owner of the bank cheque and it has paid out to the payee.[20] The bank can then, of course, sue the payee in restitution. This might provide cold comfort if the payee has few assets or cannot be found. If the bank does stop payment on the bank cheque because of the purchaser's allegations about the payee's lack of title or defective title, this casts doubts on the reliability of bank cheques as an alternative to cash payment.

## 11.9 Would the position be different if the bank cheque was made out to the payees' name or order?

In such a case, the bank cheque which is handed over to the payee by the purchaser of the bank cheque is <u>not</u> negotiated to the payee as is the case with

[19] The true owner would sue the drawee bank in conversion in which case the drawee bank would seek to rely on s 79 (payment in due course) or s 92 (protection of a bank paying a crossed cheque in accordance with the crossing) of the *Cheques Act 1986* (Cth). The latter defence would involve the drawee bank establishing that it had acted without negligence.

[20] If the bank acquiesced to the claim of the purchaser of the bank cheque that the payee had not title or a defective title and stopped payment on the bank cheque it would most likely ask such a purchaser for an indemnity. Whether such an indemnity would be worth anything would depend upon the financial standing of the purchaser. It is interesting to note that where a cheque is lost or stolen the drawer, before handing over a replacement cheque, is entitled not only to an indemnity but also adequate security: *Cheques Act 1986* (Cth) s 115.

one made out to payee or bearer. The case of *Ricky Yan v PO Bank Ltd* [21] is authority for the proposition that when a bank hands it over to the 'purchaser' of the bank cheque, the latter has the authority of the bank to deliver it to the payee where the bank cheque is made out to the payees' name or order . It is not negotiated to the payee. This is further evidenced by the fact that such an order bank cheque would not bear any indorsement by the purchaser of the bank cheque in favour of the payee. Such an order bank cheque should according to *Ricky Yan* be viewed as being issued to the payee as opposed to being negotiated to him or her.

Thus, between the purchaser of the bank cheque and the payee there is no negotiation and thus, the payee (even overlooking the fact that the bank cheque is inevitably crossed and marked "not negotiable") cannot qualify as a holder in due course since transfer by negotiation is a crucial requirement. Thus the payee on a bank cheque made out to his or her name or order will not take free from defects or lack of title.

Now the issue is whether the purchaser of such an order bank cheque can compel the drawer bank to stop payment on it. Here the payee is not a remote party who obtains a derivative title. The title to the order bank cheque passes from the drawer bank to the payee. It does not pass via the "purchaser" of the bank cheque, who merely remits it on behalf of the drawer bank.[22] What right has the purchaser/remitter of such an order bank cheque have to compel the drawer bank to stop payment to the payee? In the case of a bearer bank cheque the title to the bearer bank cheque passes to the purchaser and then, by negotiation, to the payee who take subject to defects in title because of the "not negotiable" crossing. The purchaser's equity of ownership is what gives the purchaser the right to intrude and stop payment.

---

[21] *Ricky Yan v Post Office Bank* [1994] NZLR 155.

[22] This argument which was accepted in the *Ricky Yan* case is a little doubtful, however, when the purchaser from the bank is a rogue who pays with a 'dud' cheque : see Ch X, 12.

Does the purchaser of an order bank cheque, that is, made out to the name of the payee or order have any ownership rights in regard to the cheque?

*The Ricky Yan case*

In the *Ricky Yan* case, the failure of consideration related to the purchase of the bank cheque due to fraud. On the other hand the payee gave value for it to the customer/remitter and the payee took it in good faith. The bank cheque was made out to the name of the payee or order. As noted already it was not negotiated to the payee - the bank entrusted the cheque to its customer so that he could deliver it to the payee. The payee was thus allowed to plead the New Zealand equivalent of s37 of the *Cheques Act* and enforce the cheque against the drawer bank.

What is the situation if the customer of the bank gives good consideration for the issue of the bank cheque made out to the name of the payee or order but the payee does not, however, give the customer/remitter what he bargained for? Between the payee and the customer/remitter, the requirements as to value may not be satisfied as the payee has broken the contract between himself and the remitter of the contract. The payee may not be able to use s 37of the *Cheques Act* to enforce the bank cheque against the drawer.

But does this necessarily mean that the purchaser of such an order bank cheque can take advantage of this to stop the bank paying out on the cheque?

If the bank cheque is made out to the name of the payee or order and crossed and marked `Not Negotiable', the instrument is <u>not</u> a negotiable instrument. Here it is helpful if view the instrument is viewed as a chattel, which indeed it is. It would, therefore, seem that the situation is somewhat analogous to a situation where, for example, A who has bought a car from B and asks C to give some goods (a table) to B in payment. Assuming that A rescinds the contract, what is the position in regard to the ownership of the table? C has given B the table on the assumption that the underlying contract was valid. If this is not the case, then the title to the table should revert to C. There would appear to be no reason why the same logic would not apply to a bank cheque made out to the name of the payee or order. The title to such a bank cheque would revert to the bank as drawer.

This still does not mean that the customer who ordered the bank cheque made out to the payee's name or order has title to it. But the bank cannot keep the bank cheque and also keep the customer's money. When the title reverts to the bank the customer is entitled to the return of his or her money. The customer may be able to use this as a basis for stopping the bank paying out on the bank cheque.

*Conclusion*

It can be can be said in Australia that where the bank cheque is made out to the name of the payee or bearer (the usual practice in Australia) but the payee has no right to the bank cheque then the remitter's title to the bank cheque may be used by him to stop the drawer bank paying out on the instrument. If the bank cheque is made out to the name of the payee or order and is in the hands of the payee the remitter's right to stop payment if the payee has no legal right to the bank cheque is a little less clear if *Ricky Yan* is good law since it purports to establish that the payee has no derivative title from the remitter.

### 11.10 The American position

The case of *Dzuriak v Chase Manhattan Bank*[23] is good illustration of the dilemma that courts face in regard to a stop right payment, that is, bank cheque

[23] 58 App Div 2d 103, 396 NYS.2d 414 (1977), aff'd 44 NY 2d 776, 406 NYS 2d 30, 377 NE 2d 474 (1978).

reputation versus remitter's rights. Dzuriak bought a certified cheque for US $17,000, for all intents and purposes, the equivalent of an Australian bank cheque.[24] He was going into a restaurant business with another person and was persuaded to put the certified cheque into a company that was supposed to be used for the restaurant business. Prior to the certified cheque being paid he discovered that his money was being converted by the other shareholder and he tried to stop the bank paying. The bank refused to stop payment. At first instance he succeeded but it was reversed on appeal, the court citing the principle that certified cheques and cashier's cheques (a cheque drawn by the bank) had a cash reputation that had to be protected. The rogue in question was a man of straw, so it is not difficult to imagine Dzuriak's sense of injustice at not being able to restrain the bank as the rogue spent his money for his own purposes. Had Dzuriak paid with his own cheque he could have easily stopped payment, undoubtedly a rather galling thought for him in retrospect. On the other hand, in the case of *Drinkall v Movius State Bank* the court held that a bank on notice of an illegal transaction was obliged to obey a stop payment request by a customer on a cashier's cheque.[25]

In both these cases, the certified cheque and the cashier's cheque were just vessels for the customer's money as the bank had been paid for the instruments. This is, of course, the usual situation in Australia too.

The general gist of the American cases then is that a stop payment right in regard to certified cheques and cashier's cheques should not prevail.

The 1990 'new' version of Article 3 of the American *Uniform Commercial Code* provides that banks cannot use the defences of the remitter vis-à-vis the payee to stop payment on a cashier's cheque unless they make the remitter a

---

[24] The bank that certifies a cheque undertakes a separate liability: *Uniform Commercial Code* § 4-403 (1978 version) and the customer's funds are 'frozen' or subject to charge in favour of the bank.

[25] 11 ND 10 88 NW 724 (1901).

party to the law suit. Thus if, for example, if the remitter bought a car with a bank cheque and discovered it was not working properly and prevailed upon the bank to stop payment on the cashier's cheque and the bank is then sued by the payee on the instrument, the bank cannot use the remitter's complaints about the car as a defence unless it makes the remitter a party to the law suit. The bank would plead the money into court and remitter and payee would then fight it out as to whether the payee was entitled to the money.

## 11.11 The cost efficiency of allowing complaints of the bank cheque buyer/remitter vis-à-vis the payee being used to stop the drawer bank from paying.

The following Cooter and Rubin efficiency rules will be used to inform this issue:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Public perception*

Again the public perception of financial institution cheques, especially bank cheques, intrudes here. Vendors demand them since they calculate that they will not be dishonored. Most vendors would be horrified if they knew there was a possibility that the purchaser could lean on the drawer bank to stop payment if the purchaser is dissatisfied with the goods. Most banks will not in fact succumb to such pressure. Moreover, it does not come within the Australian Paper Clearing System assurances. In terms of fraud that justify bank cheques being stopped these only mention the most egregious ones, where, for example, the cheque has been reported lost or stolen and is subsequently presented for payment by or on behalf of someone who has no title to it and where bank cheques are issued for consideration that fails (covered in Chapter 7).[26] However, there is very plausible argument, as has been shown, that some equities of ownership may entitle the purchaser of the bank cheque to compel the bank not to pay. This would seem to do great damage to the reputation of bank cheques as a safe cash equivalent instrument.

To assess the efficiency of the allocation of loss rules in regard to equities of ownership that entitle the purchaser of the bank cheque to compel the bank not to pay, it is apposite to briefly remind ourselves of the two perceived benefits of bank cheques, namely, the solvency of the drawer and certainty of payment. If the purchaser's equities of ownership can be used to stop the bank drawer from paying this does not relate to its solvency only to certainty.

*Rule certainty*

As has been noted already, apart from definitional aspects, there are no special provisions in the *Cheques Act* that relate to financial institution cheques including bank cheques. The *Cheques Act* provides a set of rules for the *ex post* resolution of disputes and for giving advice. Kaplow argues that advice on

---

[26] http://www.apca.com.au/Public/apca01_live.nsf/WebPageDisplay/Payment_Cheques_Info> at 8/12/09. The limited grounds on which any financial institution cheque, including a bank cheque, may be dishonoured are where:

- the cheque is counterfeit or has been forged;
- the cheque has been materially altered;
- the cheque has been reported lost or stolen and is subsequently presented for payment by or on behalf of someone who has no title to it;
- the cheque is the subject of a court order restraining payment, or
- the consideration for the issue of the cheque has failed (ie, the financial institution did not receive payment for issuing the cheque) and, either:

  (i) the holder of the financial institution cheque has not given value for it; or

  (ii) if the holder has given value for the cheque, the holder knew at the time of giving value that the consideration for the issue of the cheque has or would fail.

the application of a rule will generally be cheaper than with a standard since the rule in itself largely will in most cases provide the answers sought.[27] However, this is only true if the rules are clear. The law relating to whether the purchaser's defences vis-à-vis the vendor relating to the underlying contract can be utilized by the purchaser to stop payment on the bank cheque is somewhat unclear. Commerce is ill served by this uncertainty. Efficiency demands that there be certainty, especially at the time when the parties agree to use a bank cheque. By allowing *jus tertii* (the rights of third parties, here the purchaser) to stop payment of bank cheques it stops them being effective cash substitutes. As mentioned already parties strike bargains on the basis that bank cheques are effective cash substitutes. Allowing *jus tertii* to prevail means that the parties are prevented from using a useful bargaining tool.

*Consumer rights*

What then of consumer rights? If the law is changed to prevent *jus tertii* from being used will not purchasers who use bank cheques be deprived of a useful consumer remedy? As a general rule stop payment rights can be seen as counterbalancing the imbalance in bargaining rights that are typical of the consumer contract. But here we have to balance the rights of purchasers against society's right to have an effective cash substitute. Professor Lawrence maintains that in America, at least, "few cashier's check transactions involve unethical sellers taking advantage of unwary consumers".[28] (Admittedly he offers no evidence of this.) But it is also likely to be the position in Australia too. Bank cheques are generally used in bargained-for- exchanges where, for example, the vendor may agree to accept a lower price for the car in exchange for the perceived certainty of a bank cheques. The sale of a car between two

[27] Louis Kaplow, 'Rules versus Standards and Economic Analysis' (1992-93) 42 *Duke Law Journal* 557, 564.

[28] Larry Lawrence, 'Making Cashier's Checks and other Bank Checks Cost-Effective: A Plea for Revision of Articles 3 and 4 of the Uniform Commercial Code' (1980) 64 *Minnesota Law Review* 275, 319.

consumers is a good example of this. In addition bank cheques are used widely in real estate transactions where purchasers typically seek legal advice .Again here they are not typically the uninformed consumer whose rights on the underlying contract need to be protected by conferring a legal right on the purchaser to use these to stop payment. In short bank cheques are used by consumers where the financial soundness of the payment instrument is taken into consideration by the parties and is reflected in the bargain or their use is accompanied by legal advice.

Turning now to look at Cooter and Rubin's rules, the first one relates to which party can best bear the loss. Obviously this will be the bank. However, in terms of an effective cash substitute the question is not appropriate when certainty is the goal sought with bank cheques. If the law does not allow *jus tertii* the loss falls on the purchaser who must pursue the vendor. This might seem a harsh result. However, as with letters of credit certainty of payment is paramount and this echoes the autonomous nature of the letter of credit where the words of Jenkins LJ in *Hamzeh Malas & Sons v British Imex Industries Ltd* have a strong resonance:

> ..... it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the good are up to contract or not.[29]

This should also be the position with bank cheques.

The second Cooter and Rubin rule asks: which party can most easily avoid the loss? Allowing *jus tertii* means the loss falls on the vendor and a purchaser would perhaps argue that this is appropriate since the stopping of payment of

[29] [1958] 1 All ER 262, 263.

the bank cheque stems from the vendor's breach of contract or even fraud, something which the vendor can avoid. However, again certainty of payment which should be the hallmark of a bank cheque demands that the bank cheque be paid and the parties left to seek out their differences on the contract.

The third Cooter and Rubin rule asks: which rule is the simplest to apply? Certainly the current law relating to *jus tertii* is exceedingly complex and uncertain. A better and more cost effective rule would be to eliminate *jus tertii* as a way of stopping payment on bank cheques. This would be more compatible with bank cheques being reliable cash substitutes and thus promote efficiency.

It might be tempting to contemplate a fraud exception, as there is with letters - the only exception to the autonomy principle. However, successfully invoking this exception with letters of credit is notoriously difficult. If it can be established that the seller has been fraudulent then it may be possible to stop payment. Shientag J. In *Sztejn v J Henry Schroder Banking Corp.*) explained it this way: '…where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.'[30]

Thus, buyers may be successful in such circumstances restraining the issuing bank from accepting documents which, although regular on the face of it, cover a shipment of defective goods. There are, however, several limitations on the ability of the buyer to invoke fraud to prevent the bank from paying under a letter of credit. First, the forgery or fraud must be discovered before realisation of the letter of credit, an unlikely state of affairs in most cases.

[30] 31 NYS (2d) 631 (1941), 634.

Secondly, the forgery or fraud must be proved to have been committed by the seller.[31]

It is therefore dubious whether a fraud exception to allow the purchaser of a bank cheque to stop payment is worth the trouble given that such an exception has been so problematic in the context of letters of credit. It certainly would be contrary to rule simplicity

The issue of whether the complaints of the remitter vis-à-vis the payee can be used being used to stop the drawer financial institution from paying depends on fine distinctions between defects in title (*jus tertii*) and personal defences. It would seem that a remitter can use defects in title to prevent the bank from paying out on the instrument In terms of regarding bank cheques as being reliable cash substitutes this is not desirable. It is not efficient if payment is central to the working of the market. It is therefore advocated that *jus tertii* as a basis for stopping payment be abolished in the interests of certainty of payment given the usual informed use of bank cheques.

**Summary**

- If bank cheques are to be effective cash substitutes efficiency demands that purchasers not be allowed to use their disputes with the vendor, even if they may seem to involve fraud, to stop the banks paying out on the bank cheques unless there is a court order (this latter point accords with the Australian Paper Clearing System assurances but is highly unlikely in practice to occur).

[31] *United City Merchants v Royal Bank of Canada* [1983] AC 168; [1982] ALL ER 780.

## Chapter 12

# CHARGEBACKS AND SIGNATURE CREDIT CARDS[*]

### 12.1 Overview

This thesis is about the efficiency of the allocation of loss resulting from fraud and the efficiency of any ancillary stop payment rights that the particular payment system may offer. Fraud has a rather specific legal meaning to lawyers that is not always shared by consumers.[1] If Jane, a consumer, buys an old book from a book dealer and is assured that it is the first edition of it and she buys it on that condition and it later transpires that it is not, she will undoubtedly feel she has been duped, even though she most likely will have just a contractual claim for breach of condition[2] or a claim for statutory misrepresentations[3] rather than a tortious claim of deceit.[4] Therefore in the present context disputes about goods and services may include what in a popular sense would be viewed as fraudulent behavior. In the example above Jane would also have a right of chargeback if she bought the book with a credit card, a much easier remedy - as we shall see - than any contractual or tortious one.

### 12.2 Outline of this Chapter

This chapter will examine whether the right of chargeback with signature credit cards is efficient by addressing the following questions.

---

[*] Pages 4-15 of this are based on an article published by Robin Edwards, 'Does Law Follow Money?' (2009) 21 *Bond Law Review* 41-64.

[1] *Derry v Peek* (1889) 14 App Cas 337.

[2] *Trade Practices Act 1974* (Cth) s 70; *Goods Act 1958* (Vic) s 18.

[3] *Trade Practices Act 1974* (Cth) s 52; *Fair Trading Act 1999* (Vic) s 9.

[4] In *Derry v Peek* (1889) 14 App Cas 337, 344 it was held (Lord Herschell) that 'to prevent a false statement being fraudulent , there must be , I think, always be an honest belief in its truth'.

- What is chargeback?
- Is chargeback preferable to litigation?
- How does chargeback differ from cheque stop payment?
- How extensive are chargeback rights?
- How did chargeback develop?
- What are the arguments for and against chargebacks?
- What does American law provide in regard to chargebacks?
- How was chargeback transplanted to Australia?
- Is chargeback efficient in regard to disputes about goods and services?
- How does chargeback apply when there are forged credit card signatures and is this efficient?
- Is chargeback efficient?
- What changes, if any, should be made to the law?

### 12.3 What is chargeback?

Chargeback involves debiting the merchant's credit card funds after the funds have been paid to the merchant. This may occur when a customer disputes a credit card transaction. To understand what a chargeback involves a simplistic diagram will aid understanding.

| | | |
|---|---|---|
| **Card holder** → | 3. Contract for purchase from merchant | ← **Merchant** |
| ↓ | | ↓ |
| 1. Contract with conditions for use by cardholder | | 2. Contract with terms & conditions for use by merchant |
| ↑ | | ↑ |
| **Card issuing Bank A** → | 4. Contract between banks for payment & reimbursement. | ←**Merchant's Bank B** |

Taking a simple example of a credit card, there are at least four agreements. First, there is an agreement between the consumer and the bank (the card issuer) setting out the terms and conditions for use of the credit card.[5] Second, there is an agreement between the merchant and the bank (often called in credit card jargon the 'acquirer' since it acquires the signed vouchers or electronic equivalent from the cardholder and acquires the rights of the merchant to payment) and this details the merchant's responsibilities in terms of obtaining payment from the bank. Third, there is the agreement between the consumer and the merchant for the purchase of goods and services with the credit card. With a purchase over the internet using a credit card number there will be at least two banks involved: the cardholder's bank (the issuer) and the merchant's bank (the acquirer). These will not normally be branches of the same bank. Fourth, there will be the agreement between the banks for payment and reimbursement.

Basically the chargeback process is initiated by the cardholder. The cardholder's bank contacts the merchant's bank with the reason for the complaint and the card payment to the merchant is reversed. The onus is then on the merchant to combat this by showing that the complaint and the reversal is not justified.

Chargeback rights may be able to be utilised by the cardholder for the following reasons

- unauthorised transactions
- non-delivery of goods or services
- disputes about goods and services

[5] The first mass credit card on the scene in Australia in 1973 was the bankcard. A flood of bankcards was unleashed by nine banks which constituted a consortium. In less than a year there were over half a million bankcard holders. These bankcards were not solicited by customers. They were sent out without any written or oral request. The system operated on a paper basis.

The use of chargeback for unauthorised signature is rarely contested but the use of chargeback to cover contractual claims against merchants has been a source of controversy. In the minds of many consumers, disputes over goods and services as well as non-delivery of goods or services smack of fraud too. These aspects will therefore be concentrated on in regard to signature use of credit cards.

### 12.4 Why chargebacks are preferable to litigation

When a consumer has an argument with a merchant about the provision of goods and services, often with allegations of fraud, the credit cardholder can prevail upon the card issuing bank to ask the merchant’s bank to reverse the payment already made to the merchant when the cardholder purchased the goods or services. The cardholder usually makes the request at the time when he or she receives the credit card bill but it may be made before this or sometime afterwards, for example, when the cardholder receives the goods dispatched to him or her. Being able to pull back payment is an obviously powerful weapon in the hands of the cardholder. Absent chargeback rights if the merchant has been paid, the consumer's remedy is only to litigate. Often the amount in question makes this a dubious possibility.

Strictly speaking the charge back is about the bank obtaining a refund from the merchant not about whether the card holder can stop payment, although from a practical point of view the cardholder may see it as amounting to the same. Even with the manual use of a card once it has been instigated there is no way that payment can be stopped.  Typically banks' terms and conditions relating to credit cards point this out.

*Credit card payment not an irrevocable payment*

In some ways, the charge-back provisions detract from the attractiveness of credit card payment from the point of view of the merchant. In Australia when credit cards operated without charge-back provisions (or when cardholders were not aware of them) the merchant was assured of payment, all other things being equal. The introduction of charge-back provisions relegates credit card payment to a situation similar to that of payment by cheque: it is not an irrevocable payment if the cardholder can compel the card issuer to invoke the charge-back provision against the merchant.

### 12.5 Charge back rights more extensive than right to stop payment on a cheque.

Clearly charge-back rights imply that payment is conditional. Moreover, the right to payment is arguably more tenuous than payment by cheque. Under Australian law a cheque can always be a countermanded by the drawer,[6] but this will not always prevent the drawer from being sued on the cheque, especially if the cheque has been passed onto a holder in due course who will be able to enforce it against the drawer free from any disputes between the drawer and the payee.[7] Even in a legal action by the payee against the drawer a defence by the drawer to the action is not easy to establish. The fact that the drawer has a right of set-off or a counterclaim against the payee stemming from the contract of sale will not necessarily provide a defence to a claim on the cheque. Judgment will be entered for the payee but the drawer can pursue his claims against the payee in another legal action. Leave to defend the claim will only be granted if the cheque is affected with fraud, illegality or failure of consideration.[8]

---

[6] *Cheques Act 1986* (Cth) s 90.

[7] *Cheques Act 1986* (Cth) ss 29, 38, 49, 50.

[8] *Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GMbH* [1977] 1 Lloyd's Rep 463.

Charge-back rights are more akin to a cheque being paid and then the drawer having the right to unravel the whole payment transaction. Clearly if rights of charge-back can be invoked by the cardholder they are more extensive than those of a drawer of cheque since complaints about the quality of the goods and services will suffice to support the charge-back.

## 12.6 How chargeback developed in America

To understand how chargeback developed in America it is necessary to avert to some of the theoretical discussion of credit cards since this relates to whether consumers should be able to set up defences vis-à-vis the merchant against their banks.

Despite credit cards being common through out the world since the early 1970s their exact legal nature was, and still is, somewhat obscure in the common law world. There are a number of theoretical explanations, some of them more consistent with the proposition that defences including fraud against the merchant should be able to be set up against the issuing bank, others inconsistent with this idea. At least three theories competed.

*Letter of credit analogy*

A letter of credit is used to provide sound financial banking to the buyer's undertaking to pay.  Likewise with a credit card  "supplier and customer have for their mutual convenience each previously arranged to open an account with the same company,  and agree that any account between themselves may, if the customer wishes, be settled by crediting the supplier's and debiting the customer's account with that company."[9] With a letter of credit the thing that triggers liability to pay the beneficiary is the conformity of the documents with

[9] *Re Charge Card Services* 1987] Ch 150; [1986] 3 ALL ER 298, 303.

the principal's instructions- the applicant cannot interfere with payment if it is an irrevocable letter of credit unless clear fraud is established. Likewise, so it is argued, with a credit card: the vouchers or electronic equivalent submitted by the merchant give rise to an independent obligation on the card issuer to pay. It has, however, been doubted whether the credit card is really like a letter of credit.[10]

If a credit card is somewhat like a letter of credit it would follow that the credit card holder would not be able to set up against the issuing bank defences the cardholder may have against the merchant since letters of credit have always been considered independent of the underlying contract. However, it has always been held that the letter of credit's famed independence can be undermined by fraud.[11]

*Assignment theory*

The second plausible theoretical explanation of a credit card is that it involves an assignment by the merchant to the bank of 100 cents in the dollar of the debt owed by the consumer to the merchant and the merchant receives a lesser sum in return from the card issuer. With an assignment of a debt the assignee takes subject to defences and counterclaims that could have been raised by the debtor vis-à-vis the assignor.[12] However, if the assignment theory were valid it would support the notion,[13] that a credit card holder would be able to set up

---

[10] Ibid.

[11] *Sztejn v J Henry Schroder Banking Corp.* 31 NYS (2d) (1941) 631, 634.

[12] *Roxburghe v Cox* (1881) 17 Ch D 520.

[13] However, the assignment theory is not without its problems. What is there to assign? If one regards payment with a credit card as being final, with the cardholder debt not reviving if payment is not made by the card issuer, then there is nothing to assign. The terms of credit and the risk of non-payment are basically in the contract between the cardholder and the issuing bank. The merchant accepts payment by a credit worthy paymaster not by the consumer and knows nothing about the credit terms: *Re Charge Card Services* [1987] Ch 150; [1986] 3 ALL ER 298. This case seems to hold that the bank is not acting as the cardholder's agent in paying the merchant. Rather the merchant accepts payment by the bank (subject to the terms and conditions between the bank and the merchant) in lieu of the cardholder's payment

against the issuing bank defences and counterclaims the cardholder may have against the merchant.[14]

*Direct obligation theory*

The third idea was the direct obligation theory. Under this theory there is a direct obligation by the issuing bank via the card holder to pay the merchant's bank. Thus according to this theory there is no debt from the cardholder to the merchant to assign – the paper may be assigned to the issuing bank but it is not the obligation that is assigned.

## 12.7 Arguments in favor of chargeback

With no clear theoretical basis for credit cards, consumers in the 1970's argued that defences should be able to be set up against the issuer for the following reasons.[15]

*The close connection argument*

Consumers argued that banks were in good position to monitor merchants than consumers since banks were the ones were the ones who decided to extend the

---

obligation. In other words *Re Charge Card* establishes that payment by credit card is not like payment with a cheque where if the cheque is not paid the debt revives and the drawer is still liable to pay for the goods and services. The merchant accepts payment by credit card in full discharge. This can create a problem if the card issuer becomes insolvent, as was the case in *Re Charge Card*. But some have doubted whether this interpretation is always correct: Alan L Tyree, 'Riedell Gets a Credit Card' (2002) 13 *Journal of Banking and Finance Law and Practice* 301.

[14] If the transaction were characterized as an assignment it could have caused grave problems under article 9 of the *Uniform Credit Code*. If it was viewed as a sale of the merchant's receivables to the bank, the bank as a factor would have to file a financing statement indicating the merchant as a debtor.

[15] See, for example, Note 'Preserving Consumer Defenses in Credit Card Transactions' (1971) 81 *Yale Law Journal* 287.

credit card facility to the merchant.[16] Moreover it was argued that banks were in a good position to spread losses from seller misconduct or take out insurance rather than having it fall upon an individual consumer.[17]

*Substance not form*

Consumers argued also argued that if a consumer buys goods on credit from the merchant and they are defective, the consumer can set up against the merchant defences stemming from the contract when the merchant seeks payment. If it is a third party that is supplying the credit, why should not the consumer be able to set up against that third party credit provider defences the consumer could set up against a direct supplier of credit?

*Credit cards as cash not credit*

Another argument was that often when a person pays with a credit card he or she uses it just as a convenient means of paying and avoiding having to carry cash. Such a person will pay their card bill on time and will not in fact want credit. The card is used as cash. If a consumer agrees to pay cash for goods, receives the goods but does not pay, the consumer in an action by the seller against him for the price can always try and argue that the goods were not

[16] This idea is frequently encountered in the English common law world., As a principle , it has already been adopted in Australian legislation, the rationale being that the supplier of credit will be able to monitor merchants and only have links with reputable ones. In Australia, for example, s 73 of the *Trade Practices Act 1974* (Cth) provides that a linked credit provider may also be liable for loss and damage resulting from misrepresentation, breach of contract, breach of the implied conditions and the like. The cardholder may also set this liability up as a defence against the card issuer. But the defences available to the credit provider will mean that it is unlikely that the credit card issuer will be liable. First, was the credit a result of approach induced by merchant? The credit supplier is only liable if the answer is positive. Moreover, the credit provider is only liable if it has actual or implied knowledge of “bad reputation” of merchant. [16]

[17] The idea is now perhaps somewhat dubious where a credit card is used over the internet and the merchant is on the other side of the world. The credit card issuer has no idea of the reliability of the merchant - the most that it can hope for is that the merchant’s bank has wisely agreed that the merchant can have a card facility of the same mark.

what were bargained for. If such defences can be set up against a merchant seeking to recover, why should not a person using a credit card as cash have the same rights?

## 12.8 Arguments against chargebacks

*Goods with the cardholder*

It could be argued that the merchant has parted with possession of the goods or rendered the service; so, to allow the cardholder to set up defences against the card issuer will effectively mean that the merchant is not paid. This is therefore arguably too draconian a solution. The merchant would have to bring legal proceedings against the cardholder and this might prove to be difficult, especially if the cardholder were in another jurisdiction. (This is especially true nowadays when goods or services are bought over the internet using a credit card number.)

*Payment by credit card the only source of payment*

The direct obligation theory and the English case of *Re Charge Card Services* [18] supported the notion that, in the absence of fraud, the merchant is entitled to look only to the card issuer for payment. If this is correct and the debt does not revive, so it can be argued, then an action for the price may not be legally possible, even setting aside the practical barriers to an action. There is no obligation of the cardholder to pay the merchant, since the latter only looks to the card issuer for ultimate payment. Hence to allow the cardholder to set up defences against the merchant against the card issuer is not consistent with the *Re Charge Card Services* principle that only the card issuer is responsible for payment.

[18] [1986] 3 ALL ER 289.

*The credit card issuer only providing payment*

It could also be argued that banks do not want to be involved in disputes about the quality of goods and services in regard to which they are not in position to make any judgment. (This is especially true now if the merchant is on the other side of the world and the goods have been bought over the internet with a credit card number- the card issuing bank will not be in a position to vouch for the integrity of the merchant or his goods.) Moreover, if the card issuer bank and the merchant's bank combine to blackball the merchant it might constitute a conspiracy at common law or breach of antitrust laws. Card issuers argued that with credit cards they are not closely linked credit suppliers to the merchants and should not have to bear any liability for breaches of the contract between the merchant and the cardholder. The letter of credit analogy somewhat supported this argument – the issuing bank of a letter of credit does not become embroiled in arguments regarding the goods.

*Abuse by cardholders*

If the law allows cardholders to set up against the issuing bank defences the card holder may have against the merchant it could be abused by the cardholder who could make spurious allegation about the goods which would result in the merchant having payment taken away. Unscrupulous cardholders could thus exploit the system and the merchant would have no effective remedy, especially if the cardholder is in another country.

## 12.9 The American legislation.

Since the nature of a credit card transaction was theoretically obscure and since the pro consumer arguments and those contra arguments of the banks were both compelling it seemed in the early 1970's that courts in America could go either way on the issue of whether cardholder complaints against the merchant could be set up against the card issuer.

*State legislation*

Some states passed their own laws on it. In 1970 Massachusetts passed a law that allowed for cardholder defences against the merchant to be set up against the issuer irrespective of the amount of the purchase and the location of the purchase.[19] Arizona allowed defences to be set up but only in regard to consumer durables. The state of Vermont also allowed to defences to be set up against the issuer but the sale transaction had to take place in that state and the card issuer had to be a Vermont bank.

*The Truth – in – Lending Act*

In 1971 Brandel and Leonard wrote an impressive article which balanced the arguments of consumer groups and the banks and suggested a statutory compromise which is remarkably similar to the one eventually adopted.[20]

Section § 170 of the *Truth – in - Lending Act* allows cardholders to raise against the card issuer any claims or defences they may have against the issuer subject to four conditions: (1) the cardholder must make a " good faith attempt" to resolve the dispute with the merchant, (2) the transaction must be above $50, (3) the transaction must occur within the same state or within 100 miles of the cardholder's billing address, and (4) the claims or defences against the merchant are limited to the balance on the card when the cardholder notifies the card issuer or the merchant of the problem. This is theoretically consonant with the assignment theory of credit cards, even though this is widely discredited explanation of credit cards.

[19] *Massachusetts.General. Laws*, Ch 255, § 12 F.

[20] Roland Brandel and Carl Leonard, 'Bank Charge Cards: New Cash or New Credit' (1971) 69 *Michigan Law Review* 1033.

*Limitations*

But there are serious limits to charge- backs in regard to claims stemming from the underlying transaction. First, the good faith requirement of trying to resolve the dispute with the merchant is meant to make the consumer seek out the primary cause of the problem. Second, creditors are not liable (and not therefore subject to charge-backs) in respect of disputed transactions of less than US$50. The rationale for this limitation is that anything smaller should be looked upon as the equivalent of a cash transaction. Nor are they liable in respect of dispute transactions that occur outside the cardholder's state or more than 100 miles from the cardholder's mailing address. The apparent rationale for this restriction is to make feasible the idea of policing merchants that honor cards. Nowadays this is a serious limitation with the widespread use of credit cards over the internet. It could also be a problem even with card present signature transactions, the subject of the present chapter. In one US case the appellants maintained with some cogency that if the one hundred mile limit was enforced, 'an unscrupulous merchant could defraud travelers almost at will, secure in the knowledge that it is unlikely that the traveler would return to a remote location to press a claim against the merchant.'[21] Some US courts have bent over backwards to find a solution to the 100 mile restriction; for example, in *Hyland v First USA Bank* [22] the cardholders bought in Turkey what was a genuine antique Kilim – they were reassured by the bank that if they sent it back, thus complying with good faith requirement of trying to resolve the dispute, the bank would help them recover their money. The bank then reneged on this but the court was prepared to hold that there was a waiver by the bank of the 100 mile requirement and the cardholders were able to successfully chargeback the purchase. Another problem with the 100 mile requirement is actually deciding where the transaction took place.[23]

---

[21] *Singer v Chase Manhattan Bank*, 890 P2d 1305,1306 (Nev 1995).

[22] 1995 WL 595861 (E.D.Pa.Sep.28, 1995).

[23] *Plutchok v European American Bank*, 540 NYS 2d 135,137 (Dist.Ct.)1989.

*The Fair Credit Billing Act*

However, the law on chargebacks in the US does not stop with 'quality' disputes with the merchant. The *Fair Credit Billing Act* is a section of the *Truth-in Lending Act* [24] that provides the bones that are then fleshed out by Regulation Z. [25] This also provides for a bill error system which allows cardholders to dispute a bill that has a charge for goods or services not accepted by the cardholder or not delivered (the cardholder must give written notice to the card issuer within 60 days of receiving the disputed bill).[26] The card issuer must reply in writing within 30 days and make corrections to the account of the account holder within 90 days where an error is proven.[27] If the card issuer does not comply with these requirements, the right to collect is forfeited.[28] These procedures are repeated and amplified in Regulation Z.

Thus if a consumer buys  with a credit card defective goods or services whether in person or using the phone, mail or internet and refuses to accept them or the goods or services are delivered late or not at all, and the merchant fails to resolve the dispute, the cardholder may notify the card issuer of a 'billing error' since this term includes a charge on the credit card statement for goods or services that the cardholder has paid for but never received or were different from those agreed upon. If the consumer has accepted the merchant's goods or services but afterwards is not happy with their quality, he or she  is no longer entitled to use this bill error procedure to remedy his dissatisfaction.

[24] Title 1 of the *Consumer Credit Protection Act* (1968), 15 USC §§ 1601-1667f.

[25] 12 CFR part 226 (1999).

[26] *Fair Credit Billing Act* 15 USC§ 1666(b) (3) (1974).

[27] *Fair Credit Billing Act* 15 USC§ 1666(a) (1974).

[28] *Fair Credit Billing Act* 15 USC§ 1666(e) (1974).

It is worthwhile reflecting on the apparent reasons for chargebacks. It seems to be protection for people who buy goods or services on credit – hence the non-applicability to transactions under $50 which are to be treated like cash. However, many people just use credit cards instead of cash. This is both true in America and Australia. In Australia it prompted banks to push for an annual fee for credit cards to 'catch' people who were just using it as a cash alternative and picking up affinity points.

The above American laws seem to be the genesis of the charge-back clause to be found almost universally in merchant- bank agreements. Normally, credit card issuers (from whom the cardholder has obtained the card) and acquirer institution (with whom the merchants deals) operate according to the bylaws and operating regulations of the credit card company, for example, Visa or MasterCard, and these rules are supposed to be then mirrored in the agreement between merchant and acquirer institution. This is, at least, supposed to be the situation in regard to international transactions but is not always the case in regard to local transactions. Nevertheless, charge-back provisions in the bank-merchant agreement to be used locally can be also found in jurisdictions that do not even have the equivalent of Regulation Z.[29]

---

[29] The following from Hong Kong (where there is no equivalent of regulation Z) is an example of a charge-back clause in a merchant- acquirer bank agreement.

The Company (the acquirer bank) shall have the right at any time without notice *to charge the merchant's account, to withhold payment on any sales draft* (credit vouchers) presented to the company by the merchant at any time or to bill such bill to be payable on receipt thereof for the total value face amount of all sales drafts where

> …
>
> (f) The cardholder *disputes the sale quality or delivery of the merchandise or the performance quality of services* in relation to such sales drafts;
>
> (g) Such sales draft was drawn by or credit given to the merchant in circumstances constituting a breach of any term, condition, representation, warranty or duty of the merchant hereunder;
>
> (h) sales of merchandise performance of services or use of the credit card involve a violation of law or the rules or regulations of any governmental agency local or otherwise. (Italics added)

## 12.10 The transplant of the chargeback concept to Australia and how it applies

*Outline of Australian credit card systems*

The first multi outlet credit card in Australia was Bankcard which was founded in 1974 and was issued by a consortium of banks but was only effective, that is, accepted by merchants in Australia and New Zealand and the Cook Islands. (Overseas Australian travelers in those days used traveller's cheques or a revolving letter of credit or the cash services of overseas correspondents of Australian banks).Eighteen months after its launch it had 1,054,000 cardholders and 494 merchants had signed up. Each bank issued its own version of the 'universal' Bankcard and was solely responsible for credit rules and customer relations.[30] Bankcard had a virtual monopoly in Australia up until the introduction of Visa and MasterCard in the 80s. In 2006 the Bankcard Association of Australia announced that it was closing down operations and by the end of 2006 no merchants in Australia were accepting Bankcard. It was closed down on the 24th April 2007.

*No defences or counterclaims allowed*

Initially, most agreements for cardholders contained an undertaking by the bank not to raise against the bank any defence or counterclaim which the cardholder could raise against the merchant.[31] Chappenden in the early 1970s tentatively suggested that the direct obligation theory (the cardholder is a mere borrower from the bank – hence no set up of defences allowed) as opposed to the assignment theory (defences allowable) was 'generally accepted as being

---

[30] <http://www.bankcard.com.au/> at 17/9/08.

[31] William J Chappenden, *Bank Credit Cards* (1973) 5 *Commercial Law Association Bulletin* 19, 21.

the one the courts will follow in the UK and in Australia.'[32] This probably explains such an undertaking by cardholders in their Bankcard contracts.

As late as the early 90s the Bankcard conditions of use provided that where the there was a dispute concerning goods purchased the cardholder's right were against the merchant and not the bank.[33]

*Banking and Financial Services Ombudsman's role*

However, it was not long before the Banking and Financial Services Ombudsman- now called the Financial Ombudsman Service- began to look at the matter more closely and came to play a crucial role in changing the law in regard to credit cards in Australia. Therefore a sketch of this unique institution is appropriate, noting at the outset that it is not the result of any legislation or government initiative but is an industry initiative.

Although not part of the formal legal system the Ombudsman works according to the law; according to good banking practice - the use of the word 'good' indicates that not all banking practices will be given due weight – indeed some banking practices might be bad; according to applicable industry codes or guidelines (in this area the Ombudsman will at times be guided by non-legal codes, for example, the Advertising Industry Code of Ethics or the Electronic Funds Transfer Code);and, finally, according to what is fair in all the circumstances.[34]

---

[32] Ibid, 21; see also Report on Fair Consumer Credit Laws (The Molomby Report) 41.

[33] Australian Banking Industry Ombudsman's Annual Report 91-92, 60-61.

[34] Financial Ombusman Service Ltd – Banking & Finance Terms of Reference, 1.3.

In one of Australian Banking Industry Ombudsman's 1996-7 Annual Report, the Ombudsman (now Financial Ombudsman Service **)** made the following point in regard to 'charge-backs':

> The Operating Rules are not part of the contract between the cardholder and the bank, but are part of the contract between the banks. They identify the rights and obligations of members of a scheme such as Visa or MasterCard worldwide. Their impact is felt when a customer disputes a transaction on a credit card and the customer asks the bank to reject the charge made to the account. This is called a 'charge-back'. The Rules determine when a bank can make a charge-back and this restriction is often based on time limits within which the charge must be requested.
>
> It would be helpful if the need for strictly observed time limits, as contained in the conditions of use for the card, was specifically brought to a customer's attention. Consumers could then better appreciate that these time restrictions are vital. They are imposed on the bank by the Rules, and once the time has expired there is little more the bank can do.[35]

*Codes in Australia that allow for chargeback*

In Australia there are two initiatives that relate to charge-backs: the Electronic Funds Transfer Code (the EFT code) and the Code of Banking Practice. As the EFT code does not apply to credit cards used manually i.e with a signature, no reference will be made to it in this chapter.

The original Code of Banking Practice of 1993 was developed originally developed by a joint task force of the Treasury and the Trade Practices

[35] Australian Banking Industry Ombudsman's Annual Report 96-97, 32.

Commission (now called the Australian Competition and Consumer Commission) in response to a government inquiry into banking. There had been a lot of criticism of banks, especially in regard to guarantees. However, the original Code of Banking Practice made no mention of chargebacks.

The original Code of Banking Practice was reviewed in 2001 and the Australian Banking Industry Ombudsman (AIBO), subsequently called the Banking and Financial Services Ombusman and now the Financial Ombudsman Service, made a submission proposing the inclusion of an obligation on banks to place a stop on a cardholder's account when a customer has disputed the transactions debited by a merchant. The Ombudsman took the view that it would improve and clarify the banker/customer relationship if the Code could be expanded to identify as good banking practice that, in situations where a transaction was disputed, a customer would be offered the option of placing a stop on the account, if the banking system allowed it, similar to the stop effected when a card is reported lost or stolen.[36] This recommendation was not, however, taken up.

The Ombudsman's proposal is interesting in that it seems almost to consider the bank card issuer as the agent (this is dubious if *Re Charge Card* is correct), but even if this were correct, it does not take into account the fact that under the credit card scheme the card issuer is contractually liable to pay the merchant providing that the merchant fulfils his or her side of the bargain.

As mentioned the Ombudsman's experience is 'that member banks will attempt to charge-back disputed transactions where they can'.[37] It was the view of the Ombudsman that this was good banking practice and that this was

[36] Australian Banking Industry Ombudsman Review of the Code of Banking Practice, Issues Paper, February 2001, 3-5.

[37] Ibid 85.

one of the objectives of the Code, upholding standards of good practice and service, even though it may not be the cardholder's strict legal right.

In 2001 the Australian Securities and Investment Commission, a Commonwealth body that is charged with protecting consumer's interests in regard to financial services, made this point about chargebacks in its submission:

> Consumer rights under the chargeback system have not previously been understood by consumer or consumer advocates, and in large part, this has been due to the lack of transparency about these arrangements. In turn this has had an impact on the extent that consumers have been able to utilize the arrangements. Making the chargeback system more transparent is a very important reform for consumers.

The fact that consumers or consumer advocates have not understood consumer rights under the chargeback system is perhaps evidenced by the fact that a joint submission to a review of the Code of Banking Conduct 2001 by the Consumer Credit Legal Centre (NSW), Consumer Credit Legal Service (VIC), Consumer Credit Legal Service (WA), Consumer Law Centre (VIC), Care Financial Counselling Service, Financial Services Consumer Policy Centre does not even mention chargebacks. Consumer and Business Affairs Victoria, a Victorian state funded body, in its submission merely stated it supported the Review interim recommendations in regard to chargebacks.[38]

The Australian Code of Banking Practice that came into force in August 2003 provided as follows in regard to charge-backs (s 20) and followed exactly the interim recommendations of the Review:

---

[38] Consumer and Business Affairs Victoria submission to the Viney *Review of the Code of Banking Conduct*, 2001, 4

Charge-backs

> We will, in relation to a credit card transaction:
> (a) claim a charge-back right where one exists and you have disputed the transaction with us within the required time frame;
> (b) claim the charge-back for the most appropriate reason;
> (c) not accept a refusal of a charge-back by a merchant's financial institution unless it is consistent with the relevant card scheme rules; and
> (d) include general information about charge-backs with credit card statements at least once every 12 months.

It is interesting to read a major Australian bank's 'translation' of this into the terms and conditions between the cardholder and the bank.

> Each card scheme's rules allow us to dispute an authorised transaction for you in certain circumstances if we do so within strict time limits. If the credit card scheme's rules allow us to do so, we will claim a refund of a transaction ('chargeback') for you. Usually we can only do this if you tried to get a refund from the merchant first and were unsuccessful.[39] You should tell us if want us to chargeback a transaction for you within 30 days of the statement date so that we do not lose our chargeback rights. If you tell after this time, and we cannot chargeback the transaction, you will continue to be liable for that authorised transaction.[40]

*Reasons for chargebacks*

[39] Presumably there must be terms in the operating rules of some cards whereby the bank's right of charge-back is conditional upon the cardholder trying to obtain a refund from the merchant.

[40] From the author's contract with his bank, CBA (on file with author).

The various credit card systems have various reasons codes for chargebacks, for example, unauthorized purchase, fraud, goods did not arrive, goods defective. Visa Australia has a 24 Reason code. The one headed “Not as described or defective”, for example, provides as follows:

> Goods or services received were not as described on the transaction receipt or other documentation presented to the cardholder or, if a Mail/Phone Order or on-line purchase, as described by the merchant. Or, the merchandise was received damaged, defective or otherwise unsuitable for the purpose sold. Cardholder must attempt to return the merchandise or resolve the dispute before contacting his bank.[41]

Many consumers will often regard goods or services that do not comply with the contract as evidence of fraud. Once there is a chargeback the onus is on the merchant to reverse it. To rebut the chargeback the merchant must give:

> A detailed written rebuttal addressing the cardholder’s claim (point by point) and any supporting documentation to prove the case. Rebuttal must address what steps were taken to resolve the complaint before it became a chargeback.[42]

*Chargebacks are private*

It is not difficult to see that the cardholder is somewhat a stranger to the chargeback procedure since chargebacks are a part of a private system between the banks. There is therefore a lack of transparency. It seems as though the card holder is initially taken by his word and a chargeback made. This private system does not tell us how much weight is given to the merchant’s rebuttal as opposed to the cardholder’s allegations. If the card issuer believes the

[41] <https://direct.53.com/help/53direct/Visa%20Chargeback%20Reason%20Codes.htm> at 1/4/2008.

[42] Ibid.

merchant and this is wrong, the consumer will have to take it to the Financial Ombudsman Service. Despite the lack of transparency and perhaps unfairness the embodiment of chargeback rights into the Code is a welcome consumer protection development. The problem with the use of credit cards is that the consumer will be at gross disadvantage if the goods or services are not what the cardholder ordered. Usually the amount involved will not justify litigation and cross-border transactions (which can happen within Australia) involve jurisdictional problems.

*Conclusion*

In the past the relative certainty of payment with credit cards meant that the risk in the transaction was effectively born by the consumer cardholder**.** The cardholder paid with his card and hoped that the goods or services were in conformity with the contract and that he or she was not going to be the victim of sharp practices. Various methods can be utilised to overcome or minimise the problem, for example, state enforcement of consumer rights,[43] consumer group enforcement,[44] self-regulation by merchants,[45] and external institutions that guarantee performance.[46] But it is submitted, however, that a right of charge back that can be exercised by the cardholder is a simpler and more effective way of protecting cardholders.

However, it is quite extraordinary that such a powerful consumer ‘weapon’ has sneaked into Australia through the backdoor as a result of American legislation

---

[43] In Australia, for example, the Australian Competition and Consumer Commission (ACCC) can initiate proceedings to protect consumers; in the US the Federal Trade Commission (FTC) and the Attorneys General act as consumer protection agencies.

[44] See, eg, article 11(2) of the *European Commission Distance Contracts Directive* which allows consumer organizations to take action to protect consumer interests.

[45] See, eg, trade associations.

[46] Some credit cards extend the normal manufacturer’s warranty; see, eg, Commonwealth Bank of Australia, Platinum and Gold Credit cards. Gerling, a German insurance company, has e-commerce insurance that covers defective goods and non-delivery: http://www.gerling.com/

that is reflected in standard merchant credit card agreements. It is also extraordinary that it is fairly hidden. Despite the Code of Banking Practice's recommendations about chargeback that are supposed to be reflected in a cardholder's agreement with the issuing bank, it is doubtful whether most consumers are aware of their chargeback rights.

Of course, it is also noteworthy that the Code of Banking Practice does not bind everyone who issues credit cards. It is also obvious from the terms of the provision of the Code of Banking Practice that not all card schemes allow chargeback or that the terms and time frames might be inimical to such rights. It would be more efficient and transparent if chargeback rights were contained in federal legislation along American lines but without any territorial restrictions.

**12.11 Cost efficiency of chargeback rule**

In this section the following Cooter and Rubin efficiency rules will be used to inform discussion about the basic thrust of current chargeback rights:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Who can best bear the loss?*

Here, it should be noted that the issue is a bit like the issue with a letter of credit: who should have the money pending legal resolution? In theory, at least, the application of chargeback may not be the ultimate resolution of the dispute. Of course, in practice, given the amount involved there is probably not going to be any litigation.

Since chargeback means that, in effect, the banks remove themselves from the dispute between the cardholder and the merchant, the choice is between the merchant and the consumer. Clearly the party which is in the best position to bear the loss will nearly always be the merchant - the loss, for example, can be spread over the whole of its operations and even effectively passed onto to all consumers. Moreover, it is likely that a merchant can access appropriate insurance and thereby reduce the risk. However, for a cardholder defective goods or services may represent a considerable loss unless the customer can recover this loss through litigation.

Moreover, chargeback rights help redress the contractual imbalance. Typically, consumers are in a poor position to negotiate the terms of a contract between themselves and merchants. If the consumer pays cash and the goods or services are defective, he or she must sue on the contract – the payment system, cash, by its very nature does allow reversal of the payment. The consumer is put on the back foot. He or she must commence legal proceedings. Cooter and Ruben point out that consumers typically do not take up their legal rights, that is, there is an under-enforcement.[47] On the other hand, chargebacks take away the money from the merchant and the merchant must justify that the goods or services complied with the contract to have the chargeback reversed. Thus chargebacks are therefore an important tool in redressing the contractual imbalance.

*Which party can most cheaply reduce the loss?*

Efficiency demands that a legal system attribute liability to the person that can reduce the loss at the lowest cost. Between X and Z, which is best placed to avoid the loss? If it is cheaper for X to do it than Y, then the law should

[47] Robert D Cooter and Edward L Rubin, 'A Theory of Loss Allocation for Consumer Payments' (1987) 66 (1) *Texas Law Review*, 80-81.

impose liability on X. Charge-back rights that can be exercised by the cardholder would appear to act as a deterrent to curb merchant errant behavior. Non-payment would appear to be an effective punishment for contractual non-compliance as well as fraud. Moreover, records of merchants who have excessive chargebacks are subject to bank control by way of higher charges and they may even have their credit card privileges removed. Contrast this with payment by cheque – any merchant can accept a cheque or a bank cheque in payment. The merchant does not have to obtain bank approval from the bank to have to do this. But having to obtain bank approval for a credit card facility acts as a spur for the merchant to monitor operations to ensure that goods and services supplied abide with the contract since the merchant knows that there is a possibility of a chargeback. The efficiency of the market place is thus improved since unscrupulous merchants are less likely to be granted credit card privileges.

*Which rule is the cheapest to apply?*

Efficiency demands that the enforcement of contractual rights be as cheap as possible. Broadly speaking the simpler the process, the better. Reversal of payment by the purchaser is certainly simple but will it be abused by cardholders?

In Australia there are no reliable statistics on chargebacks. Moreover, even if there were they might not tell the real story. For instance, it is probably easier for a cardholder to maintain a chargeback on the basis of fraud (e.g my sister used my card) rather than because the goods were defective and the merchant might not dispute this, even though the real reason is that the goods were defective and there was no fraud involved. Likewise a merchant might chose not to dispute a spurious chargeback for defective goods and services because the merchant has to pay a fee when there is a chargeback and merchants who have excessive chargebacks have to pay a greater discount rate. In short, even if there were statistics on chargebacks in relation to disputes they might not tell the real story.

Objections by card issuers to charge-back rights being conferred upon card issuers mainly centre around the fact that it is inappropriate that such rights be given, especially in regard to quality disputes about goods or services whether they involve fraud or not.

Some of the card issuers objections are: first, non-payment is not an appropriate remedy if the cardholder's objection is about the quality of the goods or services - it is alleged that a refund of the purchase price (effectively what a charge-back entails) is draconian since in many cases if the defective goods can be repaired then damages are the usual remedy[48] ; second, cardholders may abuse charge- back rights and the system will not allow card issuers to screen out charge-back requests from cardholders with a record of abuse; third, the exercise of charge-back rights may strain relations between card issuers and merchants; fourth, extensive use of charge-back rights may mean that merchants will charge more to people using credit cards.[49]

Taking these objections, one by one, first that non-payment is excessive, especially if it is about a quality dispute. The answer to this would be that charge back rights could be made subject to the cardholder returning the goods before the cardholder exercises the right of charge-back (usually chargeback rights depend anyway on the cardholder making a genuine attempt to resolve the dispute with the merchant). Second, as to the possibility that there will be abuse by cardholders, charge-back rights merely provide that the loss falls upon the merchant who is arguably in a better position to sustain or pass on

---

[48] Stephen Gethin, 'Codes of Conduct and Credit Card Chargebacks' (2003) 19 Australian *Banking & Finance Law Bulletin* 3.

[49] Ibid.

these costs and is better equipped to pursue the cardholder on the contract if there is an abuse of the charge-back rights. As to the third objection- the straining of relations between card issuer and merchant- this would seem unlikely if the goods were returned. The fourth objection, namely fees being charged for the use of credit cards, such a practice underlines why the loss should fall upon the merchant rather than the card holder since the merchant can protect himself against abuse. Moreover, in many countries it is a wide spread practice for merchants to charge more for use of credit cards than cash to make up for the merchant fees they have to pay card issuers.[50] Indeed, one of the newer supermarket chains in Australia, Aldi, puts on a one per cent extra charge for credit card purchases.

This is not to suggest that chargeback rights are not free from problems. In America charge –backs can account for up to 0.20 per cent of transactions volume but many of the problems with charge-backs stem from inadequate billing: for example, the name on the bill of the retailer is different from the name that the cardholder recalls; there are not enough details on the bill; the merchant sends only part of the goods but for the whole amount. [51] However, these problems can be solved by retailers having more sophisticated information and billing systems.

Undoubtedly chargebacks involve costs to merchants and to banks which will pass these costs onto cardholders and customers; so the question is: do the benefits to cardholders and customers outweigh the costs?

Since reported credit card disputes are small *ipso facto* one can infer that chargebacks relating to disputes about goods and services are small indeed. If

[50] In Australia for many years the merchant – issuer contract provided that merchants were not to charge more for credit card purchases than they did for cash sales. However, this was found to be an illegal price-fixing agreement under the Australian *Trade Practices Act 1974* (Cth), s 45.

[51] < http://www.orcc.com/card/transaction-world2.asp.> at 7/12/08.

we assume this is the case it supports it suggest that either cardholders are not using chargebacks or that merchants accede to chargebacks. If the latter is the case it supports the argument that chargeback is efficient since it corrects the imbalance in contractual power and this is efficient.

Is there anything to be learnt from the US chargeback system in terms of efficiency or fairness? The territorial restriction in America now make no sense given how credit card networks operate. On the other hand, the idea that if there is a dispute about the quality of the goods that the goods should be sent back to the supplier as a precondition of the exercise of charge-back seems sound, although it is probably implicitly covered by the condition in Australia that the cardholder must attempt to sort out the dispute with the merchant before invoking chargeback rights.

*Forged credit card vouchers and efficiency*

Sometimes fraud will be disguised as a contractual dispute and vice versa. However, a patent instance of fraud is forgery of the cardholder's signature. The rules for allocation of loss from fraud with manual use of credit cards are largely determined by contract in conjunction with chargeback rules of the various credit card systems**.** Placing the loss initially on the cardholder for unauthorized losses until notification induces the cardholder to notify the card issuer. With obvious forged credit card vouchers, that is, where the merchant has not properly checked the signature, the chargeback rules usually allow payment to the merchant to be reversed, so the loss falls on the merchant: this accords with Cooter and Ruben's rules about loss avoidance and loss spreading. If the merchant has properly checked the signature on a voucher then credit card rules usually provide that the card issuing bank bears the loss.[52] Obviously the issuing bank is in an even better position to spread the

[52] See, for example, General Conditions ANZ Merchant Services cl 6 (vi) 2008-10-02.

loss.  Moreover, in theory at least, placing some liability for paying out on a forgery act as a spur to credit card improvement by the banks.

Chargebacks for fraud with electronic use of credit cards will be dealt with in the next chapter.

*Conclusion*

In this section it has been shown that chargeback rights are efficient basically because they correct the imbalance of power inherent in the typical merchant-consumer contract. The reversal of the payment puts the merchant on his back foot instead of the other way round. This arguably improves the position of the cardholder in a dispute about goods and services with the merchant. Shifting the burden to the merchant to show that there has been compliance with the underlying contract arguably makes the system more efficient and fair. As there does not appear to be any reliable evidence of abuse of chargeback rights – the tiny number of credit card disputes by the Financial Ombudsman Service implicitly supports this- one could conclude that the cost to merchants that would be passed onto cardholders is outweighed by the benefit to consumers in assuring contractual compliance**.**

**Summary of recommended change**

- The gist of American law on chargebacks absent any territorial restrictions  should be put into Australian federal legislation.

- Allegations of contractual non compliance should require the buyer to send the goods back to the seller or, at least be able to show a bona fide attempt to do so, as a precondition to the exercise of chargeback rights and as part of a requirement that the buyer should make an attempt to first settle the matter with the seller.

## Chapter 13

## ELECTRONIC FUNDS TRANSFERS AND CHARGEBACKS*

### 13.1 Overview

Credit card numbers are now widely used over the phone and the internet to purchase goods and services. Obviously this lends itself to abuse by fraudsters.

Amongst other things the Electronic Funds Transfer Code (EFT code) applies to credit cards when they are used over the phone but not when a consumer uses a credit card manually, that is, by having the credit card swiped and signing a credit card voucher. (It may well be that signature credit cards become obsolete as banks begin to heavily promote PIN credit cards.)

There are, of course, other forms of electronic payment like debit cards, BPAY and PayPal to name a few that are widely used. Payment with these is 'instanteous' and payment completed by the debiting of the payer's account whereas with electronic use of credit cards and credit card numbers there is a time interval between purchase of the goods and receipt of the bill by the cardholder.

All of this raises the issue of where does the consumer stand if he or she wishes to 'stop' or 'pull back' electronic payment, especially where has been fraud involved. Can chargeback that primarily exists in relation to credit cards be utilized? And, if it can, is it efficient in an electronic context?

---

* Pages 21-24 to be published as Robin Edwards 'PayPal and Chargeback' accepted for March edition of *Journal of Banking Finance Law and Practice* 2010.

## 13.2 Outline of this Chapter

This chapter will examine whether the right of chargeback with EFT payments is efficient by addressing the following questions.

- What does Australian law provide in regard to EFT chargebacks?
- What does case law reveal about the efficacy of EFT chargebacks?
- Can chargeback be excluded by the merchant?
- How do credit card chargebacks relate to EFT payment systems like BPAY and PayPal?
- Why should not chargeback apply to debit cards?
- Is chargeback efficient in an electronic context?

## 13.3 EFT Chargebacks

The EFT code provides as follows:

> Unauthorised credit card and charge card account transactions
>
> 5.11 Where an account holder complains that there is an unauthorised transaction on a credit card account or a charge card account, the account institution shall not hold the account holder liable for losses under clause 5 for an amount greater than the liability the account holder would have to the account institution if the account institution exercised any relevant rights it had under the rules of the credit card or charge card scheme at the time the complaint was made against other parties to that scheme.

The explanatory endnote 21 to the new EFT code says in regard to the above:

> Account institutions may be able to resolve *unauthorised transaction disputes* on credit exercising rights (such as the right to charge-back a transaction) against other parties to credit card or charge card accounts.

> This clause does not require account institutions to exercise any such rights. However they cannot hold account holders liable under clause 5 for a greater amount than would apply if they had exercised those rights. The relevant rights are those that exist at the time the complaint were made. A delayed complaint may mean the rights have expired by the time of the complaint. (Italics added)

In short if there is a dispute as to liability in regard to an unauthorised use of a credit card over the phone, for example, and the bank is able to show that the cardholder has contributed to the loss, then the loss to be borne by the card holder will be no greater than had the bank exercised its charge-back rights against the merchant. There may be no obligation on the bank to exercise its rights against the merchant but there is a strong incentive for it do to so. It should be noted that the EFT code only speaks about unauthorized transaction disputes.

Clause 5.1 of the EFT code, referring to liability for unauthorized transactions covered by cl.5, provides that 'This clause deals with liability for transactions which are not authorized by the user. It does not apply to any transaction carried out by the user or by anyone performing a transaction with the user's knowledge or consent.' As noted already, this combined with the definition of user in cl 1.5 can lead to problems in deciding what exactly amounts to an authorized transaction.[1]

The other source of chargeback law is s 20 of the Code of Banking Practice which, in the context of EFT, can also apply to authorized transactions about which there is a dispute. But this does not necessarily mean that fraud is not

[1] See Chapter 3, 17-20.

involved; it may, for example, involve a fraudulent seller who does not dispatch goods he has been paid for rather than an unauthorized transaction.

### 13.4 Cases on EFT chargebacks

Cases involving chargebacks are as interesting for the decisions as well as providing information about chargeback provisions themselves which are not normally publicly available.

*The Cosmedia case*

Chargeback provisions in the contract between the merchant and its bank are not publicly available but the 'charge-back' provisions relating to telephone sales – hence an EFT transaction- are well documented in *Cosmedia Productions Pty Ltd v Australia and New Zealand Banking Group Ltd*.[2] These provisions played an important role and underscore the importance of chargeback when fraud is involved with an EFT transaction. (And what could be easier for a fraudster than taking credit card numbers and using them over the phone or via the internet?)

Here Cosmedia Productions Pty Ltd was suing the bank under s 52 and s 53(g) the *Trade Practices* 1974 in the Federal Court before Sheppard J, alleging that the bank had made a representation that any transactions, if authorized, would not be the responsibility of Cosmedia, even if they subsequently were not honored by the card holders. The bank denied making such a representation and maintained it had said that transactions could be reversed, especially if there was a fraudulent transaction. Justice Sheppard ultimately accepted the bank's version of what had been said about the way the credit card operation worked and the case against the bank failed.

[2] (1996) ATPR ¶46-155.

However, the real genesis of the dispute was the large number of fictitious and fraudulent transactions that had been processed through Cosmedia's merchant facility. The apparent scam was to use a merchant credit credit card facility, obtain credit card numbers, put through sales, obtain the money from the bank before chargebacks by the real cardholders occurred.

The case is interesting since it outlines some of the terms of the merchant – bank credit card contract and therefore is worthwhile studying in detail.

Since the 'sales' in the US were mail and telephone purchases the following clauses played an important role.

Clause 4 of the general conditions provided for a number of situations in which a sales transaction would not be valid. These included cases where Cosmedia had failed to observe the agreement in relation to the transaction and also where the nominated charge card was used without the authority of the cardholder.[3]

Clause 5 of the general conditions provided that the bank might refuse to accept, or having accepted might *charge-back, any sales transaction if the sales transaction was not a valid sales transaction, the cardholder disputed liability for any reason or the cardholder asserted a claim for a set-off or a counterclaim*.[4] (Italics added)

[3] *Cosmedia Productions Pty Ltd v Australia and New Zealand Banking Group Ltd* (1996) ATPR ¶46-155, 53, 305.

[4] Ibid.

In addition to the general terms and conditions, there was a supplementary merchant agreement dealing with mail and telephone ordering. This provided for variations of some of the provisions of the general terms and conditions in the case of mail or telephone orders. Clause 13 of the general terms and conditions was varied by substituting a different para. (ii) which obliged the bank to credit Cosmedia's account with the full amount of all valid 'sales vouchers' issued by it 'on the basis that the debt due by the cardholder 'was' extinguished.'[5] Clause 14(2) was varied to provide that 'a sales voucher' was not to be valid if any signature on it was forged or unauthorised or, *in the case of a mail or telephone order, the transaction was not authorised by the cardholder or authorised user of a nominated charge card***.**[6] (Italics added)

The judge ultimately decided that the bank had the right of charge-back with mail and telephone orders since there had been many transactions which were not authorized by the cardholders. The judge was careful not to say the merchant was fraudulent but the case does reveal a very simple way to fraudulently obtain money using credit card numbers. Fortunately for the bank chargeback rights were upheld and the merchant's case against the bank failed.

*The Allen's case*

By way of contrast, in the New Zealand case of *Allen's Enterprises Ltd v Bank of New Zealand* [7]a charge-back by the bank failed   Again this involved the EFT use of credit card numbers over the phone. Unlike the case above involving fraud, this case involved a dispute as to authenticity of goods. Undoubtedly, however, the purchaser saw himself as being duped.

[5] Ibid 306.

[6] Ibid.

[7] (2001) 7 NZBLC,103251.

The case involved the purchase of an antique pottery horse from Allen's Enterprises Ltd (Allen's) in NZ. Payment was made by way of e Bay through an Internet auction. Under this arrangement Mr Tang, the buyer, authorised Allen's to charge $4,845 NZ to his Visa card and Allen's sent the horse to the buyer who lived in the US. Allen's in turn made a claim to BNZ with whom it had its merchant facility. BNZ then made a claim on Tang's bank (Citibank) which then reimbursed BNZ.

In the meantime Tang received the horse but thought that it was a fake and, declining Allen's terms of sale which provided that objects could be tested or lack of authenticity proved by expert documentation, sent the horse back to Allen's and claimed a refund. Allen's sent the horse to Hong Kong and obtained a certificate of authenticity and apprised Tang it would send him the horse or sell it and send him the net proceeds. There was no response to this proposal and Allen's sold the horse and sent Tang $1819 NZ.

Citibank claimed a refund from BNZ to which it agreed and BNZ then charged back the item for $3026 to Allen's under the merchant agreement (the difference between the original sale price $4845 and the subsequent sale price of $1819).

But Allen's disputed that BNZ had the right to charge it back pursuant to the merchant agreement. To understand the case it is necessary to examine the complex documentation that governed chargeback rights. The dispute hinged on the distinction between transactions that were not *valid* and those that were not *acceptable.*

Clause 9.2 in the merchant agreement provided that

> A transaction for a sale, refund or provision of cash, at our election is *not acceptable* if the cardholder:

> (a) disputes liability for the transaction for any reason; or
>
> (b) makes a claim for set-off or a counterclaim.

Clause 9.3 in the merchant agreement between Allen's and BNZ provided that the bank may refuse to accept a transaction if it is *not valid* or *not acceptable*, or may charge it back to you if we have already processed it as set out in clause 21.1 d) .

Clause 21.1 (d) then provided:

> You authorise us to withdraw from your account …….
>
> (d) all credit paid by us on sales and cash transactions which are *not valid* under this agreement…(Italics added)

It is to be noted that (d) above only refers to transactions that are *not valid.* Therefore Allen's argued that the transaction with Tang was valid and therefore BNZ did not have the right to charge it back. The transaction may not have been acceptable because of the dispute as to authenticity but BNZ had in fact accepted it, that is, paid for it. According to Allen's, it could only charge it back if it was not valid and it was valid. In short clause 21.1 (d) qualified clause 9.3.

BNZ argued that '*valid* ' in clause 21.1 (d) was used in a colloquial sense and that the commercial gist of the merchant agreement was that BNZ was not be liable if there were a dispute between the consumer and the merchant. BNZ pointed to clause 7.3 [c] under which the merchant promised that the cardholder was not disputing liability for any reason. It also pointed to clause 26 [c] according to which the bank gave no guarantee that a processed transaction was valid or acceptable.

Despite, these arguments the New Zealand High Court found in favour of Allen's. The court found there was no justification for the charge-back according to banking practice. The matter had to be decided in the light of the terms of the actual merchant agreement.

As to clause 7.3 [c] the court said this did not support the bank. If anything it supported Allen's argument. The merchant warrants when presenting the voucher to the bank that there is no dispute. This was precisely what happened when Allen's presented the voucher. (Tang at that stage had not made known his dissatisfaction with the horse to Allen's.)

BNZ argued that purchasers are inevitably not going to make known their dissatisfaction with their purchases to the merchant until after the merchant has presented the vouchers for payment to the bank. The judge doubted whether this would be true in every case; but conceded with overseas sales, it might be the case.

The bank argued that this would not give the charge-back provisions any practical room for application. But the judge was not very moved by this argument even if the bank's factual assertions were correct. He said it was comparable to a situation where a purchaser pays for goods with a cheque that is paid eventually into the merchant's account. If the purchaser is unhappy with the goods he has no right to expect that the cheque payment be wound back after it has been processed. He must pursue his remedies directly against the merchant on the contract.

Justice Fisher J found that words *' not acceptable*' in clause 9.2 were referring to reasons for not accepting payment by BNZ in the first place. But BNZ had in fact paid Allen's. The words *' not acceptable'* had nothing to do with BNZ's right of charge-back. In the opinion of the court the wording of clause 9.3 and associated provisions was clear in its meaning. BNZ's right to charge-back under clause 9.3 had to be interpreted in the light of clause 21.1(d). Fisher J could see no reason why cl 21.1 (d) should be relegated in importance as a source of meaning. There was therefore no need to resort to commercial transactions or to the operating systems between the banks to assist in interpretation. Knowledge of practices and systems within the banking world could not be imputed to Allen's. True, under clause 2(a) of the merchant agreement there was reference to wider documentation, regulations and bylaws as might be provided by BNZ. However, there was no such provision to Allen's.

The bank argued that Allen's interpretation would leave the bank in the invidious position of having made a refund it would have no recourse to the merchant. But the court commented that BNZ capitulated to the claim by Citibank on behalf of Tang too quickly. There was a valid contract and Tang had no right to rescind the contract.

Moreover, the court pointed out that even if the wider system were looked at (note that this argument was explicitly rejected by the court), it would not lead to the invidious position alluded to by the bank. Under the wider system, ‘Reason code 53’ provided that a charge-back can take place ‘if the cardholder returns merchandise or cancelled services that did not match those described on the transaction receipt or other documentation presented at the time of purchase’. According to the judge, the mere fact that the cardholder disputes liability is not enough. There must in fact be a discrepancy between the goods received and the contract. This was not the case on the facts before the court. Even if there were a discrepancy between the goods and the contract and the merchant is in fact liable to make a refund, it would be liable to indemnify a bank that has made a refund on the merchant's behalf.

In short

1. The contract between the merchant and the bank was determinative in regard to the bank's right of charge-back.
2. The bank's right of charge-back could not be determined by reference to operating systems and practices to which the merchant was not a party nor had been provided with copies thereof.
3. The bank did not have to refund a cardholder just because of an allegation that there was a breach of contract between the merchant and the cardholder.

Clearly the *Allen's* case makes something of a mockery of the chargeback system since the merchant who supplied goods that the consumer was not happy with did not 'pay' for this failure – the merchant's bank did. It is true that these costs could be passed onto other users of the system but it is the merchant who was in the best position to avoid the loss in the first place.

Probably the same result would not be reached in Australia since agreements between the merchant and banks do not limit the right of charge-back to transactions that are 'not valid', these being the fatal words at least from the bank's point of view, used in Cl 21.1 (d). One major bank in Australia provides that the bank can charge-back a transaction if it has already been processed if the transaction is invalid or unacceptable. [7a] A transaction is unacceptable if the cardholder disputes liability for any reason including fraud or claims a set-off or a counterclaim.

*The Westpac case*

Another case that documents charge-back provisions in merchant agreements is *Westpac banking Corporation v Murphy,* a decision of the Court Appeal, Supreme Court of New South Wales.[8]

---

[7a] On file with author.

[8] [2005] NSWCA 277.

Here a solicitor, Mr Murphy, sought amongst other things, to have the bank's summary judgement set aside. The facts that gave rise to this were as follows. Mr Murphy agreed to accept payment from a client on a credit card. The client was interstate and provided Mr Murphy with a written authority use the credit card to deduct fees and disbursements. The client was dissatisfied with the some of the services and said that 11 items totaling $68,230.71 between the 18/9/02 and the 19/3/03 had not been authorized by him. On the 23/4/03 the client wrote to Mr Murphy, canceling the authority. In the meantime Mr Murphy's merchant account had been credited with the disputed fees. Probably fearing the bank's exercise of the charge back right, Mr Murphy cancelled his merchant agreement with the bank. The bank sought to recover the money from Mr Murphy. His basic defence was that there was no genuine dispute between him and the client. This had to be determined according to the terms and conditions of the facility which could be found in the offer letter and:

- Merchant Business Solutions Terms and Conditions booklet
- Merchant Operating Guide.

In particular cl 6, especially cl 6.3, was of crucial importance. It provided as follows:

> *6.0 Invalid Transactions*
>
> 6.1 A transaction is invalid if:
> (a) the transaction it records is illegal;
> (b) the price charged to the Cardholder for an item of goods or services is more than the price at which you would supply the item to the Cardholder for cash;
> (c) the transaction is split into two or more transactions on the same Card to avoid having to obtain an authorisation (each transaction will be invalid);

(d) the signature on the voucher or any other Cardholder authorisation on the voucher is forged, obtained by fraud or deception, unauthorised or otherwise invalid;

(e) particulars on the voucher are not identical with the particulars on the Cardholder's copy;

(f) the Card relating to the transaction is not current at the time of the transaction;

(g) the Card is listed on a current warning bulletin or restricted card list we issue to you;

(h) the voucher is incomplete or illegible; or

(i) you do not observe this Agreement in relation to the transaction.

6.2 …

6.3 We may refuse to accept, or may charge back, any transaction if:

(a) the transaction is invalid;

(b) the *Cardholder claims the transaction is invalid or disputes liability for any reason;*

(c) the Cardholder asserts a claim for set off or a counter claim.

Chargebacks may be processed to your Account up to 12 months after the date of the original transaction. (italics added)

Clause 4.1 of the Merchant Operating Guide also related to chargebacks. As relevant, it was in the following terms.

*4.1 Chargebacks*

A chargeback is a debit entry to your Account processed by us, and is the reversal of a credit previously made to your Account, in circumstances described in clause 6.3 of your Merchant Business Solutions Terms & Conditions.

> Chargebacks occur when you are in breach of the terms of our contract, when a cardholder disputes a transaction, or where the transaction is invalid (see clause 6.1 of your Merchant Business Solutions Terms and Conditions). The most common reasons for chargebacks are:
>
> - *a cardholder claims that the transaction is invalid or disputes liability for any reason.*
> - *Transactions which are invalid or which the cardholder claims are invalid or disputed for any reason will be charged back to your account. It will then be up to you to resolve the matter directly with your customer.* (Italics added)

Mr Murphy argued that cl 6.3 had to have an implied term of reasonableness read into it; and, if such was read into it, then summary judgment was not appropriate since no evidence about the reasonableness could be heard. The Court of Appeal held that there was no warrant for reading such a term into the clause. Indeed business efficacy would be impeded by such a term since the intent of the clause was to enable the bank to extricate itself from disputes between the cardholder and the merchant. Accordingly, the order for summary judgment was upheld.

Three clear points arise from the case, remembering that the cardholder had given the merchant authority to deduct from his credit card account : first, the terms and conditions of the facility are of vital importance; second, by terminating the facility before the bank could exercise its right of chargeback, the merchant put the bank on its back foot since it had to seek the money from him; third, mere allegations of dissatisfaction by the cardholder sufficed to relieve him from liability on his card via chargeback.

*Conclusions*

The above cases show how crucial the wording in chargeback agreements is and how, witness the *Allen's* case, one word can decide the outcome of a case. The similarity in wording between banks suggests that they have been adapted, often not very well, from standard agreements supplied by the major card systems.

### 13.5 Can chargeback rights be excluded?

The *Murphy* case shows a vulnerable aspect to chargeback rights: such rights cannot be exercised against the merchant if the agreement with the bank is cancelled. This is why the bank had to pursue Murphy, the merchant. Another weakness might also be the possibility of the merchant in the contract between cardholder and merchant excluding chargeback rights.

It is clear that the rights and obligations of the merchant are found in his contract with his or her bank (A) including the possibility that money paid to the merchant can be pulled back from the merchant (chargeback). On the other hand, the cardholder's rights and obligations are found in the contract with the card issuing bank (B) supplemented by the EFT code (if applicable) and the Australian Code of Banking Practice. Under cl 3.2 of the latter those banks which subscribe to it undertake to comply with the code if it imposes any additional obligation upon it beyond what the law imposes except where doing so would lead to a breach of law (for example, a privacy law). Arguably facilitating a chargeback is something 'beyond what the law imposes' although this is debatable. In addition under cl 39.1(a) (i) the banks warrant that they will be bound by the Code in respect of any banking service that is provided to customers. Thus it would seem any attempt by the issuing banks to take away cardholder's rights to chargeback if they subscribe to the code would be in breach of s 12 DB (1)(G) (false and misleading representations) of the *Australian Securities and Investment Act* 2001.

Is there anything in the merchant's card agreement with bank A that prevents the merchant from excluding restricting or limiting the cardholder's charge back rights?

Visa and Master card merchant agreements do allow for local variations but most of them allow chargeback in certain circumstances. The following is typical of such clauses.

> The Company (the bank) shall have the right at any time without notice *to charge the merchant's account, to withhold payment on any sales draft* (credit vouchers) presented to the company by the merchant at any time or to bill such bill to be payable on receipt thereof for the total value face amount of all sales drafts where
> ……
> (f) The cardholder *disputes the sale quality or delivery of the merchandise or the performance quality of services* in relation to such sales drafts;
> (g) Such sales draft was drawn by or credit given to the merchant in circumstances constituting a breach of any term, condition, representation, warranty or duty of the merchant hereunder;
> (h) sales of merchandise performance of services or use of the credit card involves a violation of law or the rules or regulations of any governmental agency local or otherwise. (Italics added)[9]

The charge-back provisions relating to telephone sales in the merchant agreement are well documented in *Cosmedia* but nothing in that agreement

[9] Those between a merchant in Richmond, Melbourne, and a major bank. On file with the author.

(which had a provision allowing charge back) as disclosed in the case would prevent a merchant from agreeing to payment by a cardholder on the basis that the cardholder waive his or her rights to chargeback.

Moreover perusal of several Australian merchant credit card agreements do not seem to expressly or impliedly prevent the merchants from accepting payment from the cardholder on the basis of a waiver of chargeback rights by the card holder in the cardholder –issuing bank contract.[10]

Since merchants commonly have advertising saying they will accept payment by credit card and, assuming that rights of chargeback are fairly well known by cardholders, would it mean that accepting payment on the basis of waiving chargeback rights be misleading and deceptive within the terms of s 12 DB (1)(G) of the *Australian Investment and Securities Act* 2001? This would hardly be a tenable argument if the exclusion or limitation clause was made clear to the cardholder before the purchase by credit card. The merchant would not be excluding the cardholder's rights in terms of conditions express or implied in the contract of sale relating to the sale of the goods or services merely restricting a right attaching to the form of payment. By way of comparison it would be somewhat like a merchant agreeing to take payment by cheque on the basis that the drawer does not stop payment.

Could the exclusion or waiver of chargeback rights be attacked as unconscionable on the basis that chargeback rights cover not only disputes about the quality of goods or services and non-delivery but also situations where there has not been an authorization by the cardholder of the purchase in the first place?

[10] Ibid.

But would having the cardholder waive rights to chargeback be, in practice, effective? Under Australian law the cardholder's rights to chargeback derive from the contract between the issuing bank and the cardholder supplemented by the Electronic Funds Transfer Code (the EFT code) and the Code of Banking Practice. This would mean that the merchant would have to try and stop the cardholder from invoking these rights. This would mean having to notify the issuing bank not to exercise charge back rights on behalf of the cardholder. This could occur sometime after the purchase is made since under some credit card schemes, chargebacks can be exercised up to 6 months or even longer after the sale. What would the legal basis for such a request?

Presumably it would be that if the issuing bank facilitated a chargeback request from its customer cardholder it would mean that the issuing bank would be inducing a breach of contract between the merchant and the cardholder.[11] But this would mean that the issuing bank would have to be apprised of the terms of this contract since it must be shown that the defendant to an action for interference with a contract has actual or constructive knowledge not only of the contract but of the terms which may be broken.[12] Since the merchant would not know which cardholders were going to breach their agreement with the merchant the merchant would have to notify all card issuing banks that credit card payments would only be accepted from cardholders who waive their rights of chargeback and give the details of the waiver. It would also be also wise, although not necessary, for the merchant to notify the bank with which the merchant has her or his facility since details of charge back are in this contract. ( As noted before there would seem to be nothing in the merchant-bank agreement that would prevent the merchant from accepting credit card payment on the basis that cardholders waive rights to

[11] The tort of inducing a breach of contract has been described by Lord MacNaugten in the following terms 'A violation of legal rights committed knowingly is a cause of action , and it is a violation of legal rights to interfere with contractual relations ships recognised by law if there be no sufficient justification for the interference': *Quinn v Leatham* [1910] AC 495, 510.

[12] *Long v Smithson* (1918) 118 LT 678 Div Ct; *British Homophone Ltd v Kunz and Crystallate Gramophone Record Manufacturing Co Ltd* [1935] All ER Rep 627.

chargebacks.) But could the issuing bank argue justification for inducing breach? This defence is not well defined but the following dictum of Romer LJ is often quoted as a guide:

> Regard might be had to the nature of the contract broken; the position of the parties to the contract; the grounds of the breach; the means employed to procure the breach; the relation of the person procuring the breach to the person who breaks the contract; and…to the object of the person in procuring the breach.[13]

But the issuing bank B could hardly argue its own chargeback obligations vis-à-vis the cardholder as a justification since the cardholder has agreed to give up or waive those very rights. A more tenable argument might be that chargeback rights are essential to the functioning of the credit card scheme and that forcing the cardholder to give up those rights would endanger the scheme. It is doubtful whether this would be sufficient justification since the justification defence to inducing a breach is rather narrow and does not, unlike the defence to the tort of conspiracy, extend to protecting trade or vital interests of the defendant.

If the banks concerned decided that they did not want this merchant because of his attitude to chargebacks, could they collectively decide not to deal with the merchant? This would seem to be problematic in terms of either the common law tort of conspiracy or collective refusals to deal under the *Trade Practices Act*1974 (Cth), although the former does, as noted, allow a defence of protecting trade or vital interests and the latter does provide for authorisation on the basis of public benefits. Would wide spread use of exclusion or waiver of chargeback rights by merchants imperil the credit card schemes or defeat the purpose of the chargeback provisions in the Code of Banking Practice and

[13] *Glamorgan Coal Co v South Wales Miners Federation* [1903] 2 KB 545, 574-5.

would this be a sufficient justification on a public benefits basis? The bank card scheme operated successfully for many years without chargebacks and it was quite common until recent years for cardholder contracts to provide that disputes over goods or services acquired had to be sorted out directly by the cardholder with the merchant.[14] So justification of a boycott by banks of merchants who exclude charge back rights would not be likely to succeed.

The other alternative, if the cardholder exercised rights of chargeback, would be for the merchant to bring a legal action against the cardholder for breach of the agreement between the cardholder and the merchant whereby the cardholder agreed not to pursue such rights. From a practical point of view this would be fraught with problems, especially where the purchaser lived at a distance to where the merchant was located and when the amount concerned was not substantial.

*Conclusion*

From a practical point of view for a merchant to effectively exclude chargeback rights as a condition of accepting payment with a credit card would be difficult. However, such an exclusion clause might be quite effective in persuading consumers not to pursue their chargeback rights.

---

[14] The Royal Bank's VISA cardholder agreement (Canada) is typical. Problems with a Purchase

If you have problems with anything you buy using your Visa Card or your Visa Account number, you must pay the amount owing on your Visa Account and settle the problem directly with the store or merchant. In some circumstances, we may be able to provide assistance in resolving disputed transactions. If you wish to discuss a dispute, you may contact us toll-free during regular business hours at 1-800-769-2512.
<http://www.rbcroyalbank.com/cards/documentation/ch_agreements/ch_agreement.html> at 3/6/2009.

### 13.6 Credit card chargebacks, giros and other systems

The EFT code makes explicit reference to chargeback and, this combined with chargeback rights under the Banker's Code, raises the question whether these credit card rights apply to some of the newer forms of electronic payment if used in conjunction with them.

#### 13.6.1 BPAY

One of the newer electronic ways of making payments is BPAY. This is basically a simple electronic giro whereby the consumer 'pushes' a payment to the payee (details will be given further on). Can a payer use credit chargeback rights with BPAY and effectively 'pull back' the payment to the payee?

This would seem to depend on common law principles applicable to payment systems, the application of various codes, and the various contracts between the parties.

The key issue here would appear to be this: is the BPAY payment conclusive, leaving only settlement arrangements, or does the use of a credit card in conjunction with BPAY, make the credit card dominant, with the possibility of there being a charge-back?

BPAY has been described in these terms:

> It is an electronic payments system allowing customers (individuals and businesses) to instruct their financial institution to pay amounts to nominated people or institutions (ie billers).
>
> The BPAY scheme involves the following steps:
>
> 1. The customer (payer) calls their bank (payer institution) and asks them to pay a bill. The advantage to the customer is that they can pay a number of bills for any of the biller institutions participating in

> BPAY through the one financial institution. The payer institution debits the Payer's account with the amounts to be paid.
>
> 2. The payer institution collates information concerning the bills to be paid and the amount paid and transmits that information to the Central Interchange Processor (CIP).
>
> 3. The CIP is the 'batch processing' vehicle. Payments are batched and sent to the 'biller institution' (ie, the biller's bank-eg, Telstra's bank). The CIP is not a settlement centre. It is simply a processing centre that receives information as to the bills that are being paid. This information is received from the payer institution. The CIP then passes on information of bills paid to a multitude of biller institutions.
>
> The CIP is a 'score keeper'. They tell all the financial institutions participating in the BPAY scheme the amounts they owe and the amounts that are owed to them. Existing settlement procedures are used to settle the dollar amounts owing between the financial institutions participating in BPAY.
>
> 4. The biller institution receives the information from the CIP as to the bills that have been paid to the billers that are its customers. The biller institution in turn then sends information to each biller of their accounts that have been paid, so that they can update their own account receivable system. This involves a big cost saving for the biller, as, for example, they do not have to supply the telephone system to accept payments. The biller will negotiate a fee for the BPAY service with their biller institution, and this fee will depend on the volume and nature of the billing transactions.[15]

The curious thing is that financial institutions allow their customers to use credit card accounts to pay their BPAY payments as well as allowing

[15] Alan Tyree and Andrea Beatty, *The Law of Payment Systems* (2000), 177.

customers to pay by debiting an account. This is curious since most giro systems work on the basis of ‘cash’ being transferred. Before examining whether payment by way of BPAY used in conjunction with a credit card is final or not, it is helpful to understand the legal basis of giro systems.

*Nature of giro systems*

These systems are common in England and in Europe. A giro system in its simplest form involves a transfer of funds made by the bank at the request of its customer to the account of a payee at another bank. The giro system in England allows the payer to instigate the transfer from a bank other than the customer's. But the BPAY system seems to be a restricted giro system in the sense that the payer can only use his or her bank or financial institution to make the transfer. In England, on the other hand, the payer using the giro can access other financial institutions other than his own. The BPAY system is a credit application. It is ‘pushed’ by the payer.[16]

It would appear that money transfers with giro systems do not amount to an assignment of a debt (bank X owes to A) transferred to an agent (bank Y of B). If it were an assignment then payment would be complete once notice of the assignment was given to the debtor (bank X) by the assignor (A).[17] Revocation would not therefore be possible if a money transfer were truly an assignment.[18]

[16] The terms ‘push’ and ‘pull’ are frequently used to describe payment systems. Where the payer begins the payment process it is described as being ‘pushed’ and where the payee initiates the process it is described as being ‘pulled’. Somewhat confusingly a cheque is described as being ‘pulled’ since the cheque is typically put into the payment system by the payee, although it is written by the payer.

[17] Assignment can be pursuant to statute eg *Property Law Act 1958* (Vic) s 134 where notice to the debtor is necessary to complete the assignment or in equity where notice to the debtor affects priority between competing assignees but is not essential for the validity of the assignment.

[18] Peter Ellinger, *Modern Banking Law* 1987, 366.

Now a giro system needs some sort of clearing system. Taking a simple transfer from one party, A, to another, B, where they both have their accounts at the same bank, appropriate debit and credit entries are made in the accounts of A (a debit) and B (a credit). If A and B have their accounts with different banks, X and Y banks, then a balance is worked out between the total of amounts transferred on a given day and the appropriate adjustment is made with the banks' settlement accounts at the central bank (settlement). Clearance is therefore basically working out the state of the accounts between the respective institutions. Settlement, on the other hand, is referring to payment between the institutions.

Giro systems need agents to work. Typically the payer gives a mandate to the transferring bank which, in turn, issues a specified order to the recipient bank. The role of agents can complicate determining whether a payment is final or nor, that is, whether revocation is possible. In particular the role of the recipient bank can be crucial. Sometimes it is difficult to say whether the recipient bank is acting as an agent of the sending bank or whether it is acting on behalf of the payee.

*Finality of payment*

The key issue here is once again whether payment is final. Does the payee or transferee have to be notified by the receiving bank before payment is complete? The case of *Rekstin v Severo Sibirsko Gosudarstvennoe Akcionernoe Obschestvo Komseverputj*[19] seems suggestive of the proposition that notice to the payee is essential before payment is complete. A Russian trading company transferred funds into the account of a Russian Trade delegation that was held at the same bank purely to escape execution of judgement by a judgement creditor. After transfer, but before notice was given

[19] [1933] 1 KB 47.

to payee, the judgment creditor garnisheed the balance of the transferor's account and the court held that the amount was still owing to the transferor by the bank.

However, an important point about this case is that there was no money owing by the transferor to the transferee. It was a ruse by the transferor to place money beyond the clutches of his judgement creditor. The bank had no actual or even apparent authority to receive the payment on behalf of the Trade Delegation. The issue of notice to the payee was therefore something of a red herring.[20] In a subsequent case *Momm v Barclay's Bank InterX bank* [21]the court found that the transfer was completed when the bank decided to unconditionally credit the payee's account, as evidenced by the initiation of the computer process for so doing. Actual payment to the payee's account was not even necessary in such circumstances and notice to the payee was not necessary for payment to be complete. Here, of course, the bank had authority to receive the payment. Notice to the payee may be necessary if the bank does not have authority, in which case the bank is really seeking ratification of an unauthorised receipt.[22]

*Unfettered use of the funds*

Allied to the issue of finality of payment is the position of the payee. Does the payment take place when the payee's bank is notified or when the money is available to the payee? The usual view is that there is no payment unless the payee has unfettered use of the funds. This is based on the very peculiar facts in *AA/S Awilco of Oslo v Fulvia SpA di Navigazione of Cagliari (The*

---

[20] Alan Tyree, 'Deposits by Strangers' (2003), 14 *Journal of Banking and Finance Law and Practice*, 42.

[21] [1977] QB 790.

[22] Andrew Robertson, 'Concepts of payment in Domestic and International Funds Transfers' (1992) 3 *Journal of Banking and Finance Law and Practice* 16,19.

*Chikuma*)[23] where under Italian law, although the payee was allowed to draw funds under an irrevocable payment, he was not entitled to interest on the amount until the 'value date'. The House of Lords therefore decided that the payee did not have unrestricted use of the funds even though the amount of interest was trifling. The payee did not have the equivalent of cash and therefore payment was not complete.

*Can the payer countermand?*

Payment will not be complete if the payer can countermand payment. Here the nature of the payment system and banking practice can be important. It may even be that the nature of the system can be decisive. In *Delbruek & Co v Manufacturers Hanover Trust* Co[24] the plaintiff asked the defendant bank to transfer an amount to the account of Herstatt at the Chase Manhattan Bank. This was done by way of the CHIPS system. Less than half an hour later, the plaintiff asked its bank to reverse payment. The plaintiff sued its bank for failing to obey instructions. But the Second Circuit Court of Appeals held that the payment was irrevocable once the message was sent. It was banking practice to regard a CHIPS transfer as irrevocable. By using the system the plaintiff implicitly agreed to be bound by the nature of the system. A similar finding was made in *Dimond (HH) (Rotorua 1996) v Australian and New Zealand Banking Group Ltd*[25]

*Conclusions about Giros*

The following conclusions about giro systems at common law can now be drawn.

---

[23] [1981] 1 WLR 314.

[24] 609F.2d 1047 (1979).

[25] [1979] 2 NZLR 739.

First, the bank that accepts the credit instructions acts as an agent of the payer. It therefore should follow the instructions of the payer. But this can depend on the terms of the contract between the payer, the principal, and the bank, the agent. In reality, the agent, the bank, might dictate the agency agreement.

Second, the bank that accepts the credit does so on behalf of the payee. Agents must act within actual authority or within apparent authority. If the bank has no authority to accept the payment, then payment is not complete: *Mardorf Peach & Co Ltd v Attica Sea Carriers Corp of Liberia (The Laconia)*.[26]

Third, payment is not complete until the payee has unrestricted use of the funds: *AA/S Awilco of Oslo v Fulvia SpA di Navigazione of Cagliari (The Chikuma*).[27]

Fourth, payment is not complete if the instructions to pay have been revoked: *Dimond (HH) (Rotorua 1996) v Australian and New Zealand Banking Group Ltd*.[28]

*Do credit card chargeback rights apply to BPAY ?*

However, it is not at all clear that at common law the cardholder can compel the bank to invoke the charge-back provision against the merchant when BPAY isused. In relation to cheques it has been held that the customer is entitled to obtain for the benefit of its customer any advantages under the clearing house rules: *Riedell v Commercial Bank of Australia Ltd*[29]. But this decision seems to rest on the idea that banks in both paying and collecting cheques act as agents; and, as such, owe their principals, the customers, a duty

[26] [1977] AC 850.

[27] [1981] 1 WLR 314.

[28] [1979] 2 NZLR 739.

[29] [1931] VLR 382.

to always act in their best interests. However, *Re Charge Card* states that the bank is not acting as the cardholder's agent in paying the merchant. [29a] Rather the merchant accepts payment by the bank (subject to the terms and conditions between the bank and the merchant) in lieu of the cardholder's payment obligation. In other words *Re Charge Card* establishes that payment by credit card is not like payment with a cheque whereby if the cheque is not paid the debt revives and the drawer is still liable to pay for the goods and services. The merchant accepts payment by credit card in full discharge. This can create a problem if the card issuer becomes insolvent, as was the case in *Re Charge Card.* In short, on the basis of *Re Charge Card*, the traditional view is that with a credit card the bank is not the agent of the cardholder and owes no duty to obtain for the benefit of its customer any advantages of the credit card scheme other than those outlined in the contract between the cardholder and the bank. But some have doubted whether this interpretation is always correct.[30] The argument is that use of the credit card does involve the card issuer becoming the agent of the cardholder and that therefore the bank has an obligation to use the system in the best interests of its principal, the cardholder, that is, to invoke the procedures for charge-back. However, the authorities cited to support this theory are not directly on the point.[31]

The traditional view of how a credit card works (*Re Charge Card*) does not support the view that the card holder has any implicit legal right to make the issuer bank charge-back a transaction to the merchant since according to this case the card issuer is not viewed as an agent of the card holder. However, there are valid doubts as to whether the characterisation in *Re Charge Card* is correct in all credit card situations.

---

[29a] [1986] 3 ALL ER 298;[1986] 3 WLR 697.

[30] Alan L Tyree, 'Riedell Gets a Credit Card' (2002) 13 *Journal of Banking and Finance Law and Practice*,301.

[31] Tyree, above n 20, 302.

*The agreement between the payer and his or her financial institution*

The argument that there are no rights of charge-back with BPAY would involve using the concepts derived from the common law in regard to giro systems: the payer's bank is the agent of the payer and BPAY is the agent of the payee. If the payee is entitled to treat the funds as its own then payment can be regarded as final.

Obviously the agreement between these parties plays a crucial role in determining whether or not payment with BPAY is final or not. It is therefore instructive to examine a major bank's terms and conditions in regard to BPAY.

*Bank X's terms and conditions for BPAY*

The agreement in the terms and conditions relating to Telephone Banking cover BPAY payments.[32] Since telephone banking involves electronics one could justifiably ask why Bank X's terms and conditions of Internet Banking Service do not apply since BPAY can be accessed through the computer as well. Clause 44 of Internet Banking Service attempts to circumvent this problem by providing that

> BPAY may be available to a user if the user is registered for the service. The terms and conditions relating to BPAY which are contained in the terms and conditions relating to the X bank Telephone Banking Service apply if a user uses BPAY through the Service but are taken to be modified so they incorporate relevant aspects of these terms and conditions.[33]

---

[32] <http://www.anz.com/australia/persbnk/BankingOptions/PhoneBanking.asp> at 29 May 2009 .

[33] ANZ Electronic Banking Conditions of Use;

http://www.anz.com/australia/persbnk/bankingoptions/BPAY.asp at 29 May 2009.

In other words if BPAY is used with Bank X then the conditions of Telephone Banking plus the terms and conditions of Internet Banking Service apply (suitably modified) if the payer is using the net!

First, it appears that, as between the payer and the financial institution that is a member of BPAY, if payment instructions are done properly then payment is irrevocable. The following clauses in the terms and conditions relating to telephone Banking would seem logically to support this conclusion.

> Payments
>
> (a) The X bank will not accept an order to stop a BPAY Payment once instructed to make that BPAY Payment.
> (b) …………… (not relevant)
> (c) Subject to 22, billers who participate in the BPAY Scheme have agreed that a BPAY payment you make will be treated as received by the biller to whom it is directed

However, the same terms and conditions then provides:

> 16 (b) When a credit card is used to pay a bill through the BPAY Scheme, the X bank treats that payment as a credit card purchase transaction.

It would be reasonable to interpret ‘credit card’ as referring to the payer's credit card account. This would be consistent with the fact that the bank's terms and conditions relating to Telephone Banking provide that a BPAY payment can be made from *any* account provided that there are sufficient funds or credit available and the biller agrees to accept the account (clause 16).

Now, the same bank's Credit Card Terms and Conditions in the General Explanatory Information (said not to form part of the customer's agreement with the bank) set out the card holder's rights in regard to charge-back:

> Authorising And Stopping Transactions
>
> You cannot stop a transaction
>
> Your *use* of the *card* is an unchangeable order by *you* for the *X bank* to process the transaction. No facility exists to stop payment of a transaction prior to its presentation for processing. However, if *you* dispute a transaction, and *you* are not able to resolve the dispute with the merchant, the *X bank* may seek to obtain a refund for *you.* The *X bank* is only able to do this within certain time limits. The time limits vary between 30 days and 120 days depending on the credit card scheme and the type of dispute. Accordingly, *you* should notify the *X bank* in writing of disputed transactions as soon as possible. The *X bank* may require *you* to provide additional information to substantiate the dispute. Whether the *X bank* will seek to obtain a refund for *you* is entirely in the *X bank's* discretion, and the *X bank* has no obligation to do so.

This appears to represent the principles of conduct in relation to credit card chargebacks contained in the Code of Banking Practice.

(It is not surprising that the 'rights' of charge-back are not included in the agreement between the bank and the customer since it is dubious whether the card holder can enforce rights that are actually in the contract between the merchant and the bank in regard to the credit card.)

The tentative conclusions to be drawn would be as follows in regard to Bank X and the 'right' to credit card charge-back in regard to BPAY:

1. The customer has agreed with the bank that the BPAY instruction to pay is irrevocable.
2. Billers have agreed that a BPAY payment is received by them on the day that BPAY payment is made.
3. Since the payment with a credit card used with BPAY is treated as a credit card purchase transaction this means that the card user may be able to prevail on the bank to obtain a refund pursuant to the bank's terms and conditions relating to credit cards, unless these terms and conditions are inconsistent with the combined terms and conditions of the combined telephone and EFT conditions.

Arguably, it is submitted that they are not inconsistent since stopping or revoking an order to pay is not exactly the same as seeking a refund with a charge-back. The no-recall or irrevocability of payment would seem to be in the nature of completion of payment terms. Charge-back is more in the nature of recovery of payments already made.

Perhaps a further reason for believing that charge-back is available is because billers often agree in their terms with BPAY that they will accept payment with credit cards. Some billers, however, have chosen not to accept credit cards via BPAY. One major bank stipulates that payments to billers who have chosen not to accept credit cards via BPAY will be treated as a cash advance. Charge-back rights do not, of course, apply to cash advances. This would seem to imply that the same bank must logically treat payments to billers who have chosen to accept credit cards via BPAY as being subject to charge-back rights

*Arguments why chargebacks do not apply to BPAY*

The main argument here is that BPAY is the payment system and that just because consumers want payment to come out of their credit card account (presumably to defer actual payment and to earn loyalty points) this does not mean it is a payment to the merchant using the credit card system. The credit account is merely the source of payment rather than the method of payment. Certainly BPAY takes the view that having a credit card account as the source of payment does not give rise to chargeback rights. BPAY's question and answers provide as follows:

> Do charge-backs apply for BPAY payments made from a credit card account?
>
> Some credit cards allow you to receive a refund if you do not receive goods or services you have paid for using their credit card. This facility is not available for BPAY payments sourced from a credit card account. You should contact your financial institution for terms and conditions.[34]

*Conclusions as to whether chargebackrights apply to BPAY*

Whether payer may using a credit card account with BPAY can access chargeback rights is not at all clear. One of the advantages of the BPAY system is that it is imposed between the payer's bank and the biller, so that the biller does not receive or have access to the payer's account details or any other information including credit card numbers. All this suggest that perhaps, on balance, chargeback rights do not apply when a credit card account is the source of payment.

**13.6 2 PayPal**

PayPal is another system where an intermediary, PayPal, is placed between the payer and the payee. Again the advantage of this is that confidential

---

[34] <http://www.BPAY.com.au/consumers/BPAY/BPAY_qa.aspx#qa133> at 30 May, 2009.

information such as bank account details and credit card details are not available to the payee. The system has been described in the following terms:

- PayPal operates an Internet payment system that provides a means by which businesses and individuals can send and receive online payments. Its payment system employs the existing financial infrastructure of bank accounts and credit cards, but permits individuals and businesses (particularly small businesses) to send and receive online payments using only PayPal as the intermediary.

- In order for such a PayPal fund transfer or purchase to occur, both the transferor (usually a buyer) and transferee (usually a seller) must be PayPal account holders. However, PayPal does not itself extend funding or credit to its account holders. Rather, PayPal account holders must fund their PayPal accounts by a separate payment source – in many cases, by a credit card account. PayPal account holders may use their PayPal accounts to make purchases from sellers who also have PayPal accounts. When a consumer makes a purchase using a PayPal account, the sum is made available by the funding source and transferred by PayPal to the intended PayPal 'end-seller.'[35]

In the early 2000s PayPal's American terms and conditions assured users that they would enjoy the rights and privileges expected of a credit card transaction. In particular they provided that PayPal's 'Buyer Protection Policy' (a system whereby PayPal sorted out differences between consumers and merchants) 'did not replace or reduce any other consumer rights that users may have, including reversal rights that may be granted by a User's credit card

[35] <http://www.lawrencechard.com/paypalfined.html> at 1 June 2009.

issuer.'[36] Such chargeback rights were especially important when consumers did not receive goods; often viewed by consumers as fraud.

In practice when PayPal users attempted to invoke chargeback rights with their credit card issuers because goods were not delivered PayPal terminated their claims under PayPal's Buyer Complaint Policy. In effect they were forced to choose between PayPal's scheme or chargeback rights. The New York State Attornery General investigated claims that claims that there was no reduction of chargeback rights was a misleading misrepresentation in 2004 and PayPal was ultimately fined.[37]

Furthermore, consumers with PayPal accounts who did not have goods delivered as per their contracts with sellers often sought to invoke chargeback rights with their credit card issuers. These attempts were often foiled by PayPal which questioned credit card chargebacks with the card issuers that often resulted in chargbacks being reversed and the original charges restored. This was against American Federal laws and New York state's Truth in Lending laws that, of course, provided credit card holders with chargeback rights if they did not receive goods.[38] As a result of negotiations by the New York Attorney General two major credit card issuers, American Express and Discover, agreed to provide such consumers billing credits.

PayPal was ultimately forced to revise its American User conditions and, in particular, was forced not to describe its services as having the same rights and privileges expected of a credit card transaction and to describe properly how invoking chargeback rights would effect rights under PayPal's Buyer Complaint Policy.

---

[36] Ibid.

[37] Ibid.

[38] 15 USC § 1666; GBL § 703).

*Conclusions*

Clearly American Truth in Lending Laws are seen as providing chargeback rights when PayPal is used in conjunction with credit card accounts and American User conditions were accordingly made to reflect this. But even in Australia PayPal User conditions contemplate chargeback rights being invoked. The process is by it explained by PayPal in the following terms:

1. Buyer requests chargeback from credit card company.
2. Buyer's credit card company notifies PayPal's merchant bank of the chargeback and debits funds from PayPal.
3. PayPal places funds related to the chargeback on a temporary hold from seller's PayPal account.
4. PayPal immediately emails seller for additional information that can be used to dispute the chargeback.[39]

PayPal points out that merchants who accept credit card payments must contemplate the possibility of chargebacks losses as a cost of doing business. It also accurately points out that chargebacks are extraneous to the PayPal system and that all the PayPal does is to aid merchants and give the tips on how to combat chargebacks.[40]

This, of course, begs the question of why BPAY does not have the same policy and system. Presumably BPAY does not consider that credit card chargeback are legally available if a payer uses a credit card account as the source of payment. If this were so one wonders why PayPal facilitates credit card chargeback rights. The different treatments of chargeback rights are therefore anomalous.

---

[39] <https://www.paypal.com/au/cgi-bin/webscr?cmd=xpt/Marketing/securitycenter/sell/ChargebackGuide1-outside> at I June 2009.

[40] Ibid

## 13.7 The credit/ debit card stop payment anomaly

Another anomalous feature in the context of electronic payments is the different treatment of reversal rights in regard to credit and debit cards.To a consumer there is the physical similarity between credit cards and debit cards. Physical similarity is perhaps a crude indicator of attendant rules but it often works. A cheque is different from a credit card and there are different rules in regard to stopping or reversing payment. However, a credit card is similar to debit card. Indeed, it is possible to have a card that has both a credit and debit function on the one card. It would not be surprising for consumers to think that there would be the same rule in regard to stopping or reversing payment. Yet this is not the case.

It is worthwhile exploring this inconsistency since the concept of efficiency would uphold that similar things should be governed by one rule rather than several so as to avoid confusion costs.[41] First, there will be error costs imposed on those consumers who think that there is the same rule and then find themselves bound by a rule they did not anticipate. Second, if there is unwarranted diversity in regard to stopping or reversing payment it will entail learning costs on those consumers who think that there might in fact be different rules but are not sure and wish to find out what the real situation is.

*Inconsistency between chargeback rights in regard to credit cards and debit cards*

The US law from whence Australian chargeback rights derived seems to be quite clearly consumer protection orientated, namely, to protect borrowers.[42]

---

[41] Ronald Mann 'Making Sense of Payments Policy in the Information Age' (2005) 93 *Georgetown Law Journal* 633, 655-6.

[42] See Chapter 10 and text around footnote 18.

This is not new. The law has a long history of protecting borrowers, especially when they give land as security, for example, the prohibition on clogs on the equity of redemption, restraints on foreclosure, and the requirement that the mortgagee properly exercise his power of sale taking into account the interests of the borrower.

However, not all credit card holders are borrowers. Indeed, one Payments System Board Annual Report found that around two thirds of credit cardholders surveyed said that they usually pay off all credit cards each month.[43] In short most credit cardholders use credit cards as 'cash' cards. In the middle of 2008 major credit card companies began a campaign to use PINS instead of signatures with credit cards. The distinction, therefore, between a credit card used as a 'cash' card and a debit card becomes very blurred.

*What is the rationale for credit card 'quality' chargebacks if the cardholder does not borrow money?*

There are numerous advantages to using a credit card as a 'cash' cards: consumers obtain reward points; they do not have to carry cash; and have the benefit of chargeback.  Needless to say such persons are not particularly liked by banks. This explains why they introduced an annual fee to catch these 'free loaders'.

*How can chargeback rights be justified for such non-borrowing credit card holders?*

The only convincing argument is that chargeback rights help address the problem of the imbalance of bargaining power that a consumer faces when buying consumer goods. The seller has the advantage of repeat transactions,

[43] Payments System Board Annual Report 2006, 11.

better knowledge and, usually, the benefits of greater economic power.[44] Of course, it could be argued that giving ‘cash’ credit cardholders chargeback rights is too draconian since merchants are not paid; moreover, it is argued that most retailers will be amenable to complaints about defective goods and services. But this is not always true and is useless if the goods have been bought overseas or over the internet. Opponents of quality chargeback rights point out that if payment to the merchant is reversed it means that the merchant has to pursue payment against the buyer - well nigh impossible if the buyer is in a different jurisdiction.[45] However, this ignores how chargeback usually works in practice. At the behest of the cardholder the cardholder’s bank requests chargeback from the merchant’s bank which reverses payment to the merchant. The merchant has then the burden of showing that he or she has supplied conforming goods or services. Moreover, the cardholder is invariably asked whether he or she has tried to work things out with the merchant as a precondition to exercise of chargeback. In short, chargeback improves contractual performance. If a merchant has too many chargebacks, the credit card facility may be withdrawn, the ultimate penalty.

Opponents of quality chargeback rights also argue ‘quality’ chargeback rights allow cardholders to make spurious allegation about the goods or services which results in the merchant having payment taken away. Unscrupulous cardholders can thus exploit the system and the merchant has no effective remedy, especially if the cardholder is in another country or jurisdiction. But once again the merchant can resist the chargeback and have payment restored if the merchant can show he supplied conforming goods or services.

*Do ‘quality’chargeback rights apply where a credit card is used with a PIN?*

[44] See Chapter 2 text surrounding footnote 27.

[45] Stephen Gethin, ‘Codes of Conduct and Credit Card Chargebacks’ (2003) 19 *Banking Law Bulletin* 3.

There is no reason why chargeback rights conferred by the Australian Code of Banking Practice do not comply when a credit card is used with a PIN. Moreover, as we have seen, ‘quality’ chargeback rights still apply when a credit card is used as a ‘cash’ card.

*Is there any functional difference between a debit card and a credit card used as a cash card?*

With a debit card the money is taken almost immediately from the cardholder’s account and sent to the merchant’s account. Thus, the debit card holder pays straight away. It is almost like a cash payment. Debit cards appeal to people who cannot resist the lure of credit that a credit card offers. On the other hand with a credit card the merchant is paid once he has lodged credit card vouchers or the electronic equivalent, payment being, of course, subject to chargeback rights. The credit card holder will not pay until he receives the credit card bill if he or she is using the credit card as a cash card. To many cardholders the difference between a debit card and a credit card is negligible; the only advantage of the credit card used as cash being loyalty rewards and a short credit free period before payment is made.

*Should ‘quality’ chargeback rights apply to debit cards?*

If chargeback rights apply to credit cards used as ‘cash’ cards, why then should they not apply to debit cards? As we have seen the only convincing argument for ‘quality’ chargebacks rights for credit cards used as ‘cash’ cards is that they help correct the imbalance of the contract between merchant and consumer and this leads to more efficient outcomes. Surely the same argument applies to debit card payment. But should there be any limit on this given that debit card payment is like cash payment? In the US chargeback rights are subject to a $50 minimum purchase. There is perhaps an argument that there should be such a limitation in respect to debit cards. It would seem excessive and too costly to have quality' chargeback rights for the purchase of a block of chocolate with a debit card. But it should be pointed out that credit card purchases also allow purchases for a very low sum; so there is an argument too, that there should be some sort of minimum purchase amount with these too. However, credit cards are widely used for internet purchases where the consumer cannot see or inspect the goods, so chargeback rights are particularly important. Nevertheless, some sort of minimum purchase would not place too much of a restraint on chargeback rights for distance purchases.

Where a payment method mimics cash like debit cards there should be no reversibility for small purchases but chargeback rights should logically apply to bigger purchases since chargeback rights apply when a credit card is used as a cash card.

Of course, the immediate response to such a proposal with debit cards will be 'the seller has the money' but so does the seller with a credit card transaction; the seller, however, receives it subject to any chargeback rights that the seller has agreed to. The money can, of course, be taken away with chargeback rights unless the seller can show reason why the seller should not be subject to such a chargeback. There is nothing with credit card transactions that would act as an insuperable barrier to chargeback rights if they were mandated by legislation.

Indeed, it would appear that chargeback rights might already apply when a debit card is used with Scheme Debit scheme (owned by Mastercard and Visa) as opposed to a debit card used with EFTPOS (owned by the banks). With a debit card used with the EFTPOS scheme the consumer pushes the 'savings' or 'cheque' button whereas with a debit card used with the Scheme Debit scheme the consumer must push the 'credit' button to make it work. The latter apparently gives the consumer chargeback rights according to MasterCard

Australia vice-president of corporate affairs. Assuming this is correct it further adds to the argument that chargeback rights should be available in regard to all debit cards.[46]

### 13.8 The efficiency of chargeback rights in an electronic context

The following Cooter and Rubin efficiency rules once again are informative in regard to any discussion of the efficiency of chargeback rights in an electronic context:

- Which party can most easily bear the loss?
- Which party can most easily avoid the cause of loss?
- Which rule is the cheapest to apply?

*Loss bearing*

But any such discussion would traverse much the same efficiency grounds as covered in Chapter 12 and the reader is therefore referred to this again. It suffices, however, to recall that perhaps the most compelling argument in favor of chargeback rights is that it corrects the imbalance in power between consumers and sellers and, all other things being equal, helps arrive at a situation they would have arrived had their been no imbalance of bargaining power and lack of knowledge on the buyer's part. Such a right has been described as follows:

> The effect of the concept is to both discourage abuse and to equalize the bargaining/ dispute settlement posture of the parties by extending special advantages to the buyer.[47]

[46] John Kavanagh 'Chargeback to the Rescue', *The Age* (Mellbourne), 29 April 2009, <http://www.theage.com.au/articles/2009/04/27/1240684397992.html> at 6 November 2009.

*Loss avoidance*

But it should be recalled that taking the money away from the merchant may only be temporary – between consumer and merchant, the latter is clearly in the best position to bear the loss in the interim (this accords with the loss bearing principle) – since he can dispute the chargeback and produce evidence of contractual compliance or lack of fraud.

This naturally involves the principle of loss avoidance – the merchant is in the best position to avoid the loss in the first place. The merchant will often be in the best position  to detect the fraud

Furthermore, it is important to note that chargebacks assume an even greater importance in an electronic context. PayPal neatly summarises the most common reasons for chargebacks which include:

- Item not received- buyer pays for an item but never receives it.
- Item significantly different- buyer pays for an item but receives item significantly different than expected.
- Unauthorised use –a buyer's credit card number is stolen and used fraudulently.[48]

Obviously the last one involves fraud but the other two may also involve fraud too. Although unauthorized purchases over the internet is undoubtedly the major problem, 'different goods' and 'goods not received' are still a significant problem whose dimensions can be gathered from the following:

---

[47] Thomas O Mittelsteadt, 'The Stop Payment Right in an Electronic Payment Environment: An Analysis of the Transition Problems Involved when Integrating a Traditional Right into New Value Transfer Systems' (1981-1982) 17 *New England Law Review* 355, 365.

[48] <https://www.paypal.com/au/cgi-bin/webscr?cmd=xpt/Marketing/securitycenter/sell/ChargebackGuide1-outside> at 2 June 2009.

> Consumers International researchers placed over 400 orders on websites around the world. The orders were placed from 15 countries, being the home countries of participating Consumers International members. In 6% of these cases the goods never turned up and in a further 9% of cases when the goods were returned, no refund was ever received. Of the 20 goods items which were never delivered the consumer was charged in six cases and had to request a refund.[49]

Distance buying and selling always involves more likelihood of fraud. Despite clarion calls about electronic purses (smart card) and new forms of internet payments, credit cards are still the major form of payment over the internet. It is estimated that 85% of all Internet transactions are paid for using online credit card payments.[50]

From a purely practical point of view, chargeback is a valuable tool for consumers. The use of credit card numbers is obviously a vulnerable method of purchasing goods electronically but it is not one that is discouraged by card issuers or merchants, despite the likelihood of fraud. Despite complaints by merchants about chargebacks their continued acceptance of credit card payments underscores the strong likelihood that the gain to them outweighs the loss occasioned by improper use of chargebacks by consumers. As PayPal notes merchants should view chargeback losses as a cost of doing business.

*Rule simplicity*

The transparency of chargeback rules leaves a lot to be desired. Essentially the Code of Banking Practice and the EFT Code do not create chargeback rights,

[49] David K Round and Jeremy Tustin, ‘ Consumers as International Traders: Some Economic and Legal Issues Underlying Consumer Protection’ (2005) 12 *Competition and Consumer Law Journal* 14.

[50]< http://www.monstermerchantaccount.com/> at 24 October 2008.

they merely advocate that they should be facilitated by banks and others. As long as the origin of chargeback rules lies in the credit card system rules adopted by participants, a private system whose details can only be gleaned from odd cases on chargebacks, it will remain opaque and not truly open to public scrutiny. The fact that the Code of Banking Practice only binds those that adhere to it is another source of weakness too. Moreover, as has been discussed, the application of such rights in many cases is not clear. Indeed, why such rights should be extended only to credit card holders is not very logical either.

**Summary of recommended change**

- The gist of American law on chargebacks absent any territorial restrictions should be put into federal legislation.(already recommended in Chapter 12).

- Allegations of contractual non compliance (including fraud) should require the buyer to send the goods back to the seller as a precondition to the exercise of chargeback rights and as part of a requirement that the buyer should make an attempt to first settle the matter with the seller (already recommended in Chapter 12).
- Federal legislation covering chargebacks should extend to other forms of electronic payment like BPAY.
- Chargeback rights should also apply where debit systems mimic cash but with a $150 threshold before they apply and subject to the goods being returned to the seller.

## Chapter 14

## A UNIFORM STOP PAYMENT RULE

### 14.1 Overview

The disparity and apparent inconsistencies in the current system in regard to the right to stop payment have already been noted in this thesis but bear reiteration:[1]

- with cash there is no right to stop payment.
- with cheques the drawer has a right of stop payment (it is argued that this right should be strengthened: see chapter 10).
- with bank cheques there would appear to be no right of stop payment (it is argued that any doubt on this should be removed: see chapter 11).
- with payment with credit card there is, in effect, a right to stop payment because of the right of chargeback.( it is argued that this right should be strengthened: see chapter 12)
- with EFTPOS (electronic payment at point of sale) there would appear to be no right to stop or reverse payment ( it is argued that there should be: see chapter 13)

Given the variation in regard to stop payment rights and the desirability of such rights to correct the imbalance between consumers and sellers in terms of efficiency a number of recommendations were made in this thesis.

In regard to cheques and the right to stop payment it was recommended that the law should be changed by allowing the drawer a right to set up any dispute against the vendor where the vendor/payee brings an action on the stopped

[1] Chapter 1.

cheque.[2] It was recommended that the right to stop cheques should be explicitly extended to stolen cheques.[3] In addition it was advocated that banks should have reaccredit accounts in accordance with the stop payment order and that they have the burden of proving that no loss stemmed from their errors.[4]

On the other hand, this thesis has argued that if bank cheques are to be an effective cash substitutes, efficiency demands that purchasers not be allowed to use their disputes with the vendor, even if they involve fraud, to stop the banks paying out on the bank cheques.[5]

In regard to credit cards (including PIN ones) it was recommended that the gist of American law on chargebacks absent any territorial restrictions should be put into federal legislation. Allegations of contractual non compliance should require the buyer to send the goods back to the seller as a precondition to the exercise of chargeback rights and as part of a requirement that the buyer should make an attempt to first settle the matter with the seller.[6]

In regard to EFT it was recommended that Federal legislation covering chargebacks should extend to other forms of electronic payment like BPAY.[7] Chargeback rights should also apply where debit systems mimic cash but with a $150 threshold before they apply and subject to the goods being returned to the seller.[8]

With the exception of bank cheques this thesis has therefore argued that the stop/ payment/reversal right should be strengthened to correct the bargaining

[2] Chapter 10.

[3] Ibid.

[4] Ibid.

[5] Chapter 11.

[6] Chapter 12.

[7] Chapter 13.

[8] Chapter 13.

imbalance between consumers and vendors in the interests of greater efficiency. This raises the question whether it would be possible or desirable to have one rule across the board.

## 14.2 Outline of this Chapter

This chapter will examine whether uniform rules for fraud loss allocation is desirable and more efficient by addressing the following questions.

- What did the failed US *Uniform Payments Code* provide in regard to stop payments?
- What are the arguments in favor of uniform rules for stop payment?
- What are the arguments against uniform rules for stop payment?
- Should there be a distinction between a stop payment right for lost and stolen payment instruments and a right when there is a dispute between the parties?
- What are the efficiency considerations?
- Would such a rule be feasible in Australia?

## 14.3 Uniform stop payment right

The sixth part of the proposed American *Uniform New Payments Code* (UNCP) entitled Provisional and Final Payment of Orders covered amongst other things, the right to stop payment or reverse an order. The main reporter for this was Professor Scott.

*The UNPC rights to stop or reverse an order*

First, the proposed UNPC provided that there could be no stop or reverse of the US equivalent of an Australian bank cheque if the account institution noted the instrument boldly with words "not subject to stop or reversal".[9] (Remitters were to have stop or reversal rights on such instruments not so marked if they give such instructions to the payer account institution.)[10]

Second, it provided that a consumer drawer might exercise a non-waivable rights to stop or reverse any non accepted or uncertified order payable or paid for his account within three business days after the date of the initiation of the order, or the date it was received by the first account institution to transmit it, whichever is earlier.[11]

Third, a non-consumer drawer was to have the ability to waive such rights.[12]

## 14. 4 Arguments for and against a uniform stop payment right

At the time of the formulation of the UNPC consumers in America already had a right of reversal (chargeback) in regard to credit cards. (This chargeback right we have noted has migrated to Australia via credit card systems and now reposes in the Code of Banking Conduct.) Undoubtedly US credit card chargeback rights reflected a somewhat rare pro –consumer mood of US legislators that contrasts with, for example, the US right of stop payment with cheques whereby, if a bank disobeys a countermand the law places the burden on the customer to prove this and any resulting loss.[13] The latter has been referred to by one writer as a “wonder of bank lobbying”.[14]

*Facilitation of fraud*

---

[9] *Uniform New Payments Code* § 425 (13).

[10] *Uniform New Payments Code* § 425 (12).

[11] *Uniform New Payments Code* § 425 (2).

[12] *Uniform New Payments Code* § 425 (9).

[13] *Uniform Commercial Code* § 4-403 (1977).

[14] Peter Alces, ‘A Jurisprudential Perspective For The True Codification Of Payments Law’ (1984) 53 *Fordham Law Review* 83, 95.

Arguments against a universal consumer right of stop payment in the US were fairly predictable and usually centered around the difficulties it would impose on the various payment systems.[15] Others argued that it would facilitate consumer fraud since 'it gives consumers an absolute right to steal after making a simple phone call.'[16] (Of course, the same claim could have been made about consumer credit card rights of reversal- charge back- but this hardly caused the sky to fall in.)

*Alternative dispute resolution*

Another argument was that disputes with merchants could be better dealt with by small claims tribunals rather than by using financial institutions to monitor recalcitrant merchants.[17] Yet credit card chargeback in the US has always been viewed as a way of weeding out 'rogue' merchants – if there are too many chargebacks against a merchant  the banks may withdraw credit card facilities.[18]

*Costs too high*

Another contra argument, relating to efficiency, was that the cost of the right would be shifted to all consumers for the benefit of a few consumers and that the cost would outweigh the benefit.[19] This surely would be true of any right in regard to payment conferred by the law: banks will not bear it themselves if

---

[15] James Vergari, 'A Critical Look at the New Uniform Payments Code' (1983) 9 *Rutgers Computer & Technology Law Journal* 317, 328, 335.

[16] Roland Brandel, 'Remarks at the Uniform New Payments Code' 1983 Invitational Conference (Sept 30, 1983).

[17] Ibid.

[18] Chapter 12, 5-7.

[19] Peter Alces, above n 14,,110.

they can pass it on. This is not necessarily a bad thing if the right is worth having.

*The distortion argument*

One of the more serious criticisms is the counter argument to the proponents of the UNCP that the differences in legal rules distort consumer's selection of payment instruments.[20] The counter argument was that the influence of legal rules was not nearly as important as advocated by proponents of the UNCP and that availability was in fact more important. As one critic of the UNCP approach put it 'The employer pays by check not because it wants to have the right to stop payment, but because checks offer lower cost and better security than cash'.[21] Probably availability and convenience are powerful in determining choice of payment instruments but legal rules are also a powerful consideration; not many sellers of cars, at least in Australia, would accept private cheque for payment rather than a bank cheque or cash. Does this reflect common public knowledge that a private cheque may be bounce whereas a bank cheque will not? Or does it reflect the fact that there is a stop payment right attaching to the private cheque that basically does not apply to the bank cheque[22]? Since the two are entwined it is difficult to know.

It will usually be the merchant or vendor who will dictate the use of the payment instrument, especially if reliability of payment is a concern. Undoubtedly, knowledge of the reliability of various payment systems plays a part in the choice but this also reflective of legal rules. It is also not uncommon in Australia , for example, for consumers to give postdated cheques for payment if they do not have enough in their accounts. This reflects a

[20] See Official Comment 1 to Uniform Payments Code § 2.

[21] Anne Geary, 'One Size Doesn't Fit All – Is a Uniform Payments Code a Good Idea' (1983) 9 *Rutgers Computer & Technology Law Journal* 337, 338.

[22] There is, however, a strong argument that it may be possible for the purchaser of a bank cheque to stop the drawer bank from paying: see Chapter 11.

knowledge of legal rules that influences the selection of payment instrument. In short, convenience and availability are undoubtedly important in selection of the payment instrument but legal rules can also play a very significant role.

*Codification corrects bargaining imbalance*

One of Scott's reasons for codification, including the stop/reversal of payment right, was that it was necessary to have controls of contract since private contracts written by banks for consumers would shift risks to the consumer.[23] (A good example of this in an Australia context was, before the introduction of the Code of Banking Practice, the BankCard credit contract whereby cardholders were to pay their credit card bills even if the goods or services bought with it were shoddy. As late as the early 90s the Bankcard conditions of use provided that where the there was a dispute concerning goods purchased the cardholder's right were against the merchant and not the bank.)[24] Professor Alces also points out that contracts between customers and banks do not bind third parties; for example, it might affect rights of creditors and a uniform code could surmount this problem too.[25]

*Stop payment rights only for credit*

Some like Professor Alces, although highly critical of the UCP formulation of the stop payment right, have nevertheless been in favor of such a 'universal' right only if it was based on the cash/credit distinction, a familiar and acceptable distinction since it provides the basis for US credit card chargeback rights. He argues that banks would screen credit card applicants and weed out those likely to abuse the reverse payment right and that the cost of reversibility could be passed onto the customer who exercises the right.[26] He also argues

---

[23] Peter Alces, above n 14,100.

[24] Australian Banking Industry Ombudsman's Annual Report 91—92, 60-61.

[25] Peter Alces, above n 14.

[26] Ibid, 114.

that the right should be inalienable since it ‘guarantees real consumer protection controls on contract which are uncertain if the right may be waived ’and that such a right would be consistent with legislation with ‘cooling off’ periods.[27]

The main problem with Alces’ idea is that the right should pivot on whether or not credit is involved. He seems to see the right as something like an exchange: the banks get the right to charge interest and in return the consumer gets the right of reversibility.[28] This might arguably be a way to ‘sell’ the idea of a uniform right of stopping/reversing to banks. However, if banks were to receive a fee from the customer for the exercise of the right of reversal, they would stand to gain anyway. Merchants profit from the use of credit cards even when used as ‘cash cards’ since they increase sales. If credit cards are widely used as ‘cash’ cards then the only convincing rationale for having chargeback rights is they correct the imbalance between consumers and merchants in terms of bargaining power.

*Codification lessens transaction costs*

Alces also sees efficiency stemming from the right of reversal of payment in terms of providing solutions to third party problems (merchants and banks being the third parties in this context).

> The proposal [the right to reverse payment] provides law to govern those third party relationships, and may, in fact, supply that allocation of rights and duties for which the parties would bargain in the absence of prohibitive transaction costs.[29]

---

[27] Ibid.

[28] Ibid.

[29] Ibid.

This touches on Coase's theory.[30] Were it not for burdensome transaction costs merchants would agree to reversibility if they thought they would profit more from sales than they would lose from reversibility. (It might not cost a particular consumer much to find a merchant willing to accept reversibility in regard to a particular transaction but if one multiplies this by all consumer purchases, then the transaction cost become very high.) Alces argues that his version of reversibility would avoid this burdensome transaction cost.

Alces' proposal makes two strong points: first, the consumer stop payment should not be able to be waived – to obtain meaningful economies of scale this would seem to be necessary; and second, this non-waivable right would be likely to diminish transaction costs and therefore lead to greater efficiency.

*The confusion argument*

The argument in favor of a uniform rule for stopping or reversing payment is that a wide variety of rules relating to this causes confusion and that a uniform rule is more desirable from an efficiency point of view since it eliminates inefficiencies such as learning costs and error costs. The argument against this is that even if this were the case these costs may be outweighed by the benefits of a diversity of rules for stopping or reversing payment. Professors Gillette and Walt argue that the costs from confusion are probably not high enough to warrant a uniform rule for stopping or reversing payment and that US law occasionally makes appropriate adjustments anyway.[31] They cite the treatment of debit cards as an example. In America it is possible for debit cards to be signed or to have a PIN – the latter transactions are governed by the US Electronic Funds Transfer Act whereas signature ones are not. But enter Regulation E which provides that an electronic fund transfer includes any

---

[30] See Chapter 2 and text surrounding footnote 12.

[31] Clayton Gillette and Stephen Walt, 'Uniformity and Diversity in Payment Systems' 2008 83 *Chicago- Kent Law Review* 499, 518.

transfer "resulting from debit card transactions, whether or not initiated through an electronic terminal or not."[32] This means both are covered by the same law. They contend that confusion outside the debit card area which is addressed by the law anyway is unlikely to occur. This is a dubious proposition in regard to Australia especially in regard to debit cards and credit cards used as cash cards.

*Different costs argument*

Another argument against the pro uniform rule for stopping or reversing payment is that arguably there are different costs involved with each payment system. When there is a chargeback with a credit card a series of payment have to be reversed - the money is taken back by the issuing bank from the merchant's bank which in turn takes it from the merchant's account. Usually the cardholder has not paid the card issuing bank – indeed it is often when he receives the credit card bill that the cardholder disputes an item and initiates the chargeback procedure. Thus the credit cardholder typically has the money all along. If a reversal right existed in regard to debit cards it would involve taking the money from the merchant and reaccrediting the debit card holder's account which was debited when the debit card holder bought the goods or services. This would probably involve different costs if there were the same rule, so why have the same rule?

*The distortion argument*

The different treatment in regard to reversal of payment has been noted in regard to credit cards and debit cards and that this might even cause distortion in choice of payment instruments. Therefore a uniform right of stopping or reversing payment is desirable, so the argument goes.[33] However, this assumes

---

[32] 12 CFR 205.3(b)(v) (2007).

[33] Gillette and Walt, above n 31,526.

that consumers know about chargeback rights in regard to credit cards. There is no empirical evidence about consumer knowledge of chargebacks in Australia. It is interesting that chargeback does not appear to be a benefit of credit cards that issuers advertise yet they heavily advertise features such as extended warranties and purchase security and the like.[34] Does this mean that they assume all credit card holders are aware of charge back rights? Or that since all issuers must by law offer chargeback rights that there is no point in advertising these? Usually features such as extended warranties are given a relatively low exposure in advertising as ancillary features whereas positive matters like reward points and interest rates feature more prominently. This brings us to how consumers are likely to view stop or reversal of payment rights. Contemplation of such a right implicitly means that something has gone wrong. Behavioral economics suggest that an individual is likely to underestimate a negative future event unless someone in his or her immediate ken has recently experienced this.[35] It is therefore likely that chargeback rights do not loom very large on the horizon of consumers even if they know about them. If this was the case then it would suggest that the distortion in choice of payment instruments resulting from different stop or reversal of payment rights may not be as great a problem as imagined.

*The pro competition argument*

Assuming that consumers perceive chargeback as one of the benefits of using a credit card , then it could be argued that Visa and Mastercard have something of an advantage vis-à-vis other forms of payment. To make the payment system more competitive,   uniform rules for stop payment would be a positive step in the right direction.

[34] <http://au.creditcards.com/commonwealth-bank-credit-cards.php> at 19/11/08.

[35] Amos Tversky and Daniel Kahnemann, 'Judgment Under Uncertainty: Heuristics and Biases' (1974) 185  *Science* 1124, 1127-28.

### 14.5 Should a uniform rule make a distinction between a stop payment for lost or stolen instruments and a uniform right where there are disputes?

Others have suggested crafted general principles to guide any legislative attempt to have a general stop payment right for consumer payments. Professor Mittelsteadt makes a sensible distinction between stop payment rights in regard to stolen or lost instruments and those in regard to dispute settlement. He advocates the following in regard to stolen or lost instruments:

> (1) If there are no adverse claimants to the funds accessible by the lost or stolen device, the parties should be restored, without penalty, to their previous positions;
>
> (2) If there are adverse claimants to the funds, the quality of the adverse claim should be evaluated. Degrees of fault should be compared, and in traditional fashion, the loss should be shifted to the party most culpable. The amount of loss could be limited to a maximum amount in accordance with the modern consumer approach of penalizing culpability in the form of a fixed, maximum dollar risk. If authority to use was given, and the device was then used in an unauthorized fashion, the loss should be borne by the party who gave the original authority; and
>
> (3) The institution should not be liable unless it was itself careless or breached a contract.[36]

[36] Thomas O Mittelsteadt, 'The Stop Payment Right in an Electronic Payment Environment: An Analysis of the Transition Problems Involved when Integrating a Traditional Right into New Value Transfer Systems' (1981-1982) 17 *New England Law Review* 355, 434.

The above are essentially rules for allocation of loss as a guide for a legislative stop payment right. Mittelsteadt, however, does not make it clear how the two are linked. Usually, the stop payment right is regarded as a stop gap measurement with the ultimate loss being determined later on; so probably he is advocating that a right of stopping/reversing be worked out in the light of the loss allocation principles he also recommends.

**14.6 Stop payment rights in regard to disputes**

In terms of a uniform right of stopping/reversing payment when there is a dispute between buyer and seller Mittelsteadt recommends the following elements:

> (1) The dispute can be joined based on the allegations of the aggrieved party alone.
>
> (2) During the resolution process, the aggrieved party is given the benefit of the doubt and is subjected to no penalties or costs, and is allowed to retain both the funds and the underlying consideration.
>
> (3) The institution remains neutral and acts merely as an inter mediary which shifts funds between the parties based on predetermined rules. Liability flows to the institution only in those cases where it has breached a duty and thereby caused a loss.
>
> (4) If the dispute is invalid, the burden of going forward is placed on the party who has been deprived of the funds; the original disputant is allowed to retain both the funds and the consideration until ordered by a court to surrender them or until a voluntary agreement is reached. If the dispute is valid, the parties are free to make their own arrangements, at which time, the new deal can be voluntarily complied with, or, if not, the new deal might be enforced by other appropriate legal remedies. While this characteristic almost totally subordinates the rights of the

payee/seller to those of the payor/buyer, it is consistent with the general policy posture of equalizing the bargaining rights of the parties.

(5) Dispute stop payment should be mandated for both consumers and non-consumers. However, in the case of non-consumers, the parties should be permitted to vary the stop payment rules by contract. Such a concession would permit a system such as wire transfers, whose users are both sophisticated and in less need of protection, to operate without unnecessary legislativeinterference. Consumers could be protected by restricting freedom of contract in a fashion to guarantee a minimum level of protection.

(6) Finally, the concerns highlighted earlier should be an integral part of the final legislative draft. A unitary stop payment device is both practical and likely toproduce a salutary result; the ability to differentially price systems to advantage the provider should be minimized to curtail the risk of abuse.[37]

## 14.7 Efficiency considerations

*Lost or stolen instruments*

Mittelsteadt's underlying loss allocation rules about lost or stolen instruments reflect almost exclusively Cooter and Rubin's 'loss bearing principle' – which party can reduce loss at the lowest cost? Usually this will mean that the loss will be borne by the consumer. If a consumer loses his or her cheque book then according to Mittelsteadt clearly the loss will fall upon the consumer (see rule 2 above at paragraph 14.5). On the other hand, if the bank sends the cheque book through the mail with an envelope marked 'Cheque Book", then the loss would fall upon the bank (see rule 2 above at 14.5). Like wise if a

[37] Ibid.

credit card and PIN were sent through the mail together, the loss would fall upon the bank (see rule 2 above at 14.5).

However, another pertinent consideration – that his rules do not address - is to ask: what would act as a spur to banks to improve security? To say that a bank would 'not be liable unless it was itself careless or breached a contract' (see rule 3 above at 14.5) is hardly in itself going to encourage innovation in security. Lack of inherent security is the usual reason why in the case of lost and stolen instruments the consumer wants to stop payment. Would placing some of the loss on the bank unless it could show that it had made all efforts to improve the security act as an incentive? One would have thought, for example, that a photo of the customer on a credit card would act as a disincentive for a rogue to use the card in face to face situations. Likewise some smart cards have a system of locking the card, thus rendering it impregnable to predatory behavior.  A system of loss allocation that a legislature is to bear in mind when providing for a uniform stop/reversal payment right arguably should incorporate some spur to security innovation or amelioration.

Allocating the loss according to which person can most easily and cheaply avoid the loss – the second Cooter and Rubin 'principle' – seems an easy solution but the less obvious point has been described in the following terms ' .a party may be in an inferior position to avoid risks given current technology, but may be in a superior position to develop technology that avoids or reduces loss.'[38] This, it could be argued, is a fair description of the position of the banks.

*Uniform stop rule for disputes*

[38] Gillette and Walt, above n 31.

A stop/reversal right in regard to disputes has always been more controversial than such a right in regard to lost or stolen payment instruments, banks always arguing that they should not be the ‘meat in the sandwich’.[39] However, one of the oldest consumer payment instruments, cheques, have provided such a right for centuries. Indeed, many of Mittelsteadt’s principles above seem to draw on the stop right payment in regard to cheques; for example, that the aggrieved party be allowed to keep the funds and the underlying consideration. The other interesting point is that Mittelsteadt openly acknowledges (rule 4 above 14.6) that the rationale for a uniform right is to ‘equalize the bargaining rights of the parties.’ Much the same point has been made by others in these terms:

> Certainly in a situation, such as payment systems, where there is likely to be asymmetric information (since payment system providers are likely to be aware of the legal rules even if the system users are not) creating defaults that reflect a hypothetical bargain would appear useful in order to avoid advantage-taking.[40]

If it were possible to draft a uniform rule that represented what the majority of consumers want this would seem to be more efficient since a state supplied rule would act as a ‘normal’ or ‘default’ rule. The statute could then allow non consumer parties to bargain around this.[41] This would be more efficient that having consumers having to strike a bargain on the issue time and time again since one presumes that the law should represent what the majority of users would want. Freedom to strike private rules can be time consuming and obstructive to commerce, witness, the arguments that surrounded shipping containers sizes until a shared standard was struck.

[39] See text surrounding footnote 18 Chapter 12.

[40] Gillette and Walt above n 31, 503.

[41] This is essentially the system used in the *Cheques Act 1986* (Cth). Section 6, for example, allows parities to alter certain rights, duties and liabilities under the Act.

## Conclusions

In theory it might be possible to craft uniform rules for stopping payment and the arguments in favor appear to outweigh those against. However, it would be immensely difficult – probably even more difficult than crafting uniform rules for fraud loss allocation. The history of the failed US *Uniform Payments Code* is a salutary one. Any changes that were perceived to be inimical to the interests of financial institutions would undoubtedly be strenuously resisted. Nevertheless, despite these practical problems this thesis in theory maintains:

- That such a uniform right to stop payment would be more efficient than the inconsistency and inefficiency of current Australian stop payment rules.
- That said right should be along the lines of the never enacted US *Uniform New Payments Code* since is clear, concise and efficient compared with other attempts to formulate uniform rules.
- That the *Uniform New Payments Code* stop or reversal rules recognize that the two distinct reasons why consumers want to abort payment are loss or theft and these are, for the most part, treated separately.

# Chapter 15

# SEEKING SOLUTIONS: UNIFORM LAWS OR AMELIORATIONS TO DIVERSITY

## 15.1 Overview

Previous chapters have examined fraud loss allocation rules and the right to stop or reverse payment. Apart from chapters 9 and 14 that explore the possibility of uniform laws, each chapter has found that there are defects from the efficiency perspective in the allocation of fraud loss and rights to stop or reverse payment and recommended a series of changes and ameliorations to both problems.

## 15.2 Outline of this Chapter

This chapter will examine whether uniform laws or ameliorations to diversity are more efficient:

- What is the result of applying Cooter and Rubin's rules?
- What is better for fraud loss allocation: ameliorations to diversity or uniform rules?
- What is better for stopping or reversing payment: ameliorations to diverse rules or uniform rules?
- What can be said about efficiency as a way of looking at these problems?

## 15.3 The application of Cooter and Rubin's rules to fraud allocation

*Fraud loss allocation*

By and large in regard to fraud loss allocation this thesis has argued in favor of more of the loss being put on the banks; for example, this thesis maintained that the loss resulting from fraudulent allocation of cheques should be put on the banks.[1] It was advocated that paying banks should bear the total loss for fraudulent and material alterations with a right, of course, against the person who has made the alteration; and that the inefficiency of subsequent party liability, for example, that of indorsers, be eliminated by making cheques not transferable.[2] This, of course, brings us to Cooter and Rubin's rules.

*Loss spreading*

The two aspects of Cooter and Rubin's principles that depart somewhat from the traditional method of allocating loss according to fault are the 'loss spreading' and the 'rule simplicity' principles, especially the former. To critics this seems to smack of socialism or even 'bank bashing'.[3] However, in reality it is nothing more than spreading the risk amongst all the users of the system. The cost is not actually borne by the banks. Where fault is too difficult to determine or too costly, it is submitted that it is common sense to spread the loss. Other writers without explicitly referring to efficiency have come to this conclusion; for instance Professor Tyree, referring to liability of collecting banks for conversion writes 'A more rational approach would be for the risks to be borne equally by all the users of the cheque system or, alternatively, by those who are demonstrably careless.'[4] Cooter and Rubin's principles basically say the same thing: where fault is clear the loss should fall there, so as to dissuade people from taking the risk and where this is not possible to determine easily or cheaply, the loss should be spread across the users of the system.

---

[1] Chapter 6, 12.

[2] Chapter 6, 13

[3] Alan Tyree, *Weerasooria's Banking Law* (2006), 119.

[4] Alan L Tyree, *Banking Law in Australia* (2002), 254.

*Loss avoidance*

Naturally, fault, and old friend in any discussion about allocation plays an important role. Indeed, traditionally this has been the way the law has allocated the losses. This has, of course, a strong efficiency aspect. Gillette and Walt write that 'legal rules should minimize the costs of payment systems; each system should allocate the loss of authorized use to the party in the best position to avoid it.'[5] This echoes Cooter and Rubin's second 'principle' about loss avoidance.

Allocating the loss according to fault, seems at first glance in the context of fraud allocation to point to the consumer – the consumer has allowed someone to lurk behind when entering a PIN in an ATM, the consumer has responded to 'phishing' emails that are obviously dubious, the consumer writes down the PIN and keeps it on his or her person, the consumer writes his signature on the inside of the chequebook cover - all of this seems to suggest that the consumer is the most likely candidate to bear the loss. However, setting aside the difficulty of actually proving fault, usually a costly exercise, this ignores the ability of the provider of the technology to improve or ameliorate the system to lessen fraud. Contrary to initial expectations, the superior risk avoider may in fact be the bank In many cases this thesis has argued that the best risk avoider is the bank since it provides the system and attributing the loss to the bank acts as a spur to improve the system to guard against fraud.[6] This is therefore counter intuitive, even though allocating loss according to fault is the traditional legal way.

[5] Clayton Gillette and Stephen Walt 'Uniformity and Diversity in Payment Systems' (2008) 83 *Chicago- Kent Law Review* 499, 532.

[6] Chapter 4, 17; Chapter 6, 12; Chapter 7, 23.

## 15.4 Fraud loss allocation: ameliorations to diversity or uniform rules?

What are the benefits in diversity of fraud loss allocation rules even if they are improved as advocated by this thesis? Of course, the traditional argument in favor of uniform rules is that the same or similar problems should be dealt with in the same or similar manner.[7] But with different payment systems the mechanics are quite different. The authorization of a cheque or card present signature credit card is a valid signature whereas with EFT transactions it is the use of a PIN by an authorized user. Nevertheless, the underlying problem is the same.

*Current uniformity*?

Even without the changes advocated by this thesis, by and large, it could be said that there is certain uniformity anyway. Current fraud loss allocation rules put a great deal of the loss on the system provider – the bank is liable for paying out on forgeries subject to the estoppel and ratification exceptions[8], the bank is liable for losses resulting from a forgery if duly notified of the loss or theft of a signature credit card[9], the bank is liable for unauthorized EFT loss but can prove unless it can affirmatively prove that the user was fraudulent, disclosed the PIN, or was negligent in a certain specific ways.[10] The exceptions to system provider liability – where the consumer bears liability - are meant to induce caution on the part of the user.

*More losses on banks*

[7] Peter Alces, 'A Jurisprudential Perspective for the True Codification of Payments Law' (1984) 53 *Fordham Law Review* 83, 91.

[8] *Cheques Act 1986* (Cth) s 32.

[9] Chapter 4, 6-10.

[10] Electronic Funds Transfer Code of Conduct, cl 5.

This thesis has advocated changes and ameliorations to many of these rules that tilt the loss even further in the direction of the system provide. For example, this thesis advocated that EFT fraud loss allocation rule should be changed to a simple test of failure to report (if reported the loss falls on the bank)[11]; that signature credit card fraud loss allocation should provide that the credit card holder is only liable if he fails to report the unauthorized use of the card to the issuer ( a low threshold of $150 for failure to report would hopefully induce caution on the part of the cardholder)[12]; that on ordinary cheques the liability of indorser liability following forgery of the drawer's signature should be eliminated by making cheques not transferable[13] ; that on ordinary cheques banks should bear the total loss for fraudulent and material alterations with a right, of course, against the person who has made the alteration[14]; that with bank cheques where fraud has been involved with their issue if a holder has provided value, then the loss should be borne by the banks and banks should bear responsibility for lost cheques.[15]

All of these proposed changes have been advocated on the basis of rule simplicity, loss avoidance, and loss spreading. Take rule simplicity, this thesis, for example, submits that the current EFT Code rules are unduly complicated and advocates changes in favor of simplicity. Loss avoidance – this thesis advocates that banks could, for example, improve cheques to make them less prone to fraudulent alteration. Loss spreading – banks should, for example, bear the loss where they have been duped into handing over bank cheques in exchange for consideration that fails.

But do consumers bear these rules in mind when choosing or using different methods of payment? The matter has been put in this way: '…if users do not

[11] Chapter 3, 37.

[12] Chapter 4, 17.

[13] Chapter 5, 33.

[14] Chapter 6, 13.

[15] Chapter 7, 23 and Chapter 8, 17.

consider legal rules in choosing among payment systems, the legal rules[and effects] are unlikely to cause any distortion [in their choice].'[16]

Nevertheless, legal rules will still have distributive effects and not all users will be ignorant of the legal rules. Despite this, it is difficult to advance arguments in favor of different rules for fraud loss allocation when the basic problem is the same. It is difficult to disagree with the proposition that '... the same legal consequences should attach to all kinds of transactions where technology and the nature of the transaction [permit].'[17]

*Conclusion*

This thesis therefore advocates that in the best of worlds a uniform rule for fraud loss allocation across different payment systems along the lines of the ill fated American Uniform New Payments Code should be adopted.[18] Given that such a law would be likely to encounter great resistance from banks and other financial institutions, this thesis submits, as an alternative, the ameliorations to current fraud loss allocation rules that have been advocated throughout on the basis of Cooter and Rubin's efficiency principles.

## 15. 5 Stopping or reversing payment: ameliorations to diversity or uniform rules?

When it comes to arguments in favor of ameliorations to diversity as opposed to uniform rules the choice is more complicated. Arguably, these rights to stop payment or reverse payment are better known by consumers than rules for the allocation of fraud loss. Most consumers know that they can countermand

[16] Gillette and Walt, above n 5, 503.

[17] Memorandum from Hal Scott to National Conference of Commissioners on Uniform State Laws, 15th June, 1983.

[18] Chapter 8a.

payment on a cheque before it is paid.[19] Since cheque have been used by consumers for well over a hundred years – and have been written about in novels, plays, and non fiction - this is not surprising. It is submitted that probably chargeback rights in regard to credit card payment are less well known but all credit card terms are now supposed to mention these rights.[20] Thus, over time these rights will become well known.

*The benefits of diversity for stopping payment*

Diversity in regard to stopping or reversing payment may have practical benefits that outweigh the apparent inconsistency in treatment from one payment system to another.[21]

Parties may factor the possibility of a stop or reversal of payment into their bargain. A consumer, for example, buying goods at a distance might prefer to pay by cheque expecting the goods to arrive before the cheque is paid so that he might stop payment if they do not correspond with the contract. The vendor in such a case, if in business, might therefore increase his price across the board to cover situations where there is a stop payment. In other words parties can make all sorts of adjustments in the deal with a diversity of stop payment rights to accommodate their views on risk. Another example. Retailers welcome payment by credit card despite the possibility of chargeback since they calculate that the benefit of increased sales outweighs the possibility of the odd chargeback. Moreover, the retailer can make a surcharge for the use of a credit card and many now do so.[22] In short, different rules in regard to stopping or reversing payment – just one of the facets of the choice of a

[19] *Cheques Act 1986* (Cth) s 90.

[20] www.moneysavingexpert.com/news/cards/2009/09/ignore-cheques-to-bag-cashback-rewards at 23 October, 2009.

[21] Gillette and Walt, above n 5, 535.

[22] http://money.ninemsn.com.au/article.aspx?id=100231 at 23 October, 2009.

payment instrument – allow the parties a number of options that can weighed up and built into the calculation of the contractual risks.

The drafters of the Uniform New Payments Code (UNCP) based it on the apparently logical idea that 'functionally similar payment processes should trigger identical legal consequences.'[23] Some, however, argued that this would in the American context bring about some strange consequences: it would compress the reversibility time in regard to credit cards while applying reversibility to other forms of payment covered by the UNCP despite the costs across different types of technology.[24] The obvious answer to this would be to lengthen the time for reversibility, recognizing that there must be some certain cut off in time otherwise payees would be left in limbo, not knowing whether they could keep the money or have it snatched away. As for the different cost argument, any uniform reform will bring about different costs to participants. The argument in favor is that the costs are outweighed by the overall efficiencies gained.

It is submitted that if it is always, or nearly always, the same person or persons that can most easily minimize the costs of defective transactions including fraud, then this suggest that uniform rules are apposite. Merchants are in a good position to guard against fraud - they can check signatures on cheques and compare signatures on credit card vouchers with those on the credit cards. Moreover, they are also in a good position to make sure that goods and services supplied comply with the underlying contract – non compliance is often viewed by consumers as fraudulent. Of course, it could be argued that the consumer can inspect the goods prior to paying but most goods these days are packaged in such a way that inspection is not possible. Banks must also assess whether merchants are worthy of credit card privileges in the first place

[23] Notes 'Consumer Protection And Payment Systems: Regulatory Policy For The Technological Era'(1984-1985) 98 *Harvard Law Review*, 1870, 1882.

[24] Ibid.

and are in a good position to weed out those merchants who have bad chargeback records. Of all the parties the consumer is arguably in the worst position to guard against defective transactions including fraud. Credit card chargeback rights recognize this and this thesis has argued that there is no logical reason why such rights should not be extended to debit cards, given that many credit card holders use such cards as 'cash' cards. If the economic rationale for extending payment reversal rights is that it improves the bargaining power of consumers and is therefore more likely to eliminate defective transactions then this suggests that greater uniformity would be more desirable as it would be easier for consumers and merchants to be come familiar with one set of rules rather than different sets of rules.

*Conclusions*

Again in the best of worlds this thesis advocates the adoption of a uniform right of stopping or reversing payment along the lines of that of American Uniform New Payments Code (UNCP) in accordance with the view that efficiency would be improved by improving the bargaining position of the consumer vis-à-vis merchants. It is to noted that the UNCP exempted bank cheques from such a right. This is consonant with the view of this thesis that there should be no stop or reversal rights in regard to bank cheques. The case for a uniform right of stopping or reversing payment is perhaps not as convincing as that for a uniform rule for allocation of fraud loss since there are good arguments in favor of diversity; so this thesis therefore advocates ameliorations to existing rights to stop or reverse as an alternative, given that we do not live in the best of worlds.

### 15.6 Efficiency in perspective

It should be recognized that efficiency is just one way to look at law and its dominance as a perspective owes as much to the supremacy of the market place in America thinking in the last 50 years or so as to anything else. Different ways of looking at law have all had their day – centuries ago when monarchs held all the political power it was common to view law as being a reflection of divine law, guided by the hand of God himself (or herself).[25] With the French Revolution came the ideas of natural rights derived from nature itself that were used to overturn monarchs who trounced these rights - laws were therefore supposed to be represent these rights.[26] As science developed it became popular to view laws through the prism of science and so on. In short just about every generation develops one or two ways of looking at the law, apart for the traditional analytical-systematic method or approach.[27]

As pointed out already in this thesis, the efficiency prism is a useful way to look at law but it could be argued that in some ways it is just a surrogate way of detecting problems in the law that traditional legal examination would discover or advocate. For instance, this thesis argues in the light of efficiency that cheques should be made non transferable to eradicate the perceived inefficiency of indorser liability following forgery of the drawer's signature but this is a reform that has been frequently made without the use of any efficiency concepts.[28] Likewise, this thesis advocates that banks should not be able to stop payment on bank cheques if they have issued for consideration which has failed. The efficiency arguments in favor are rule certainty and the fact that bank cheques are used in bargained-for-exchanges where legal advice is likely to be sought.[29] However, similar arguments have been made in the

[25] Nicolas Mercuro & Steven G Medema, *Economics and the Law: from Posner to Post Modernism* (1999).

[26] See, eg, Déclaration Des Droits De L'homme Et Du Citoyen De 1789 where Article Premier says ' Les hommes naissent et demeurent libres et égaux en droits'.

[27] Chapter 2, 26.

[28] Robin R Edwards, 'The Case for a Non Transferable Cheque' *Banking Law Bulletin*, 1991.

[29] Chapter 10, 12-13.

past without resort to efficiency concepts.[30] Some advocates of economics and law would argue that if the same arguments are reached it is on the basis of the unreliable and inconsistent '*ad hoc* utilitarianism cum moralism so common to legal teaching and thought.'[31]

Efficiency, on the other hand, provides a well developed theoretical framework which has been admirably précised by Cooter and Rubin and this serves to detect and inform debate on such problems as fraud loss allocation and rights to stop or reverse payment. Many agreements between knowledgeable parties in the financial system bear testimony to the logic and efficiency of Cooter and Rubin's 'rules'. For example, the two major credit card companies' rules have been described as follows:

> Both the Visa and MasterCard companies….impose losses on member banks for an explicit failure to follow their precautionary rules. [Cooter and Rubin's loss avoidance rule]. Losses which occur despite these precautions are absorbed by the company and, of course, spread to customers through the pricing system. [Cooter and Rubin's rule about loss spreading]……If there is a dispute about a particular loss allocation, it is resolved by simple arbitration, which generally consists of a one page letter from each side and a one paragraph decision by a private arbitrator. [Cooter and Rubin's 'rule' about rule simplicity and ease of adjudication].[32]

The above represents an agreement between knowledgeable parties. Of course, what characterizes consumers in their dealings with banks is their knowledge

---

[30] Wickreema Weerrasooria 'The Australian Bank Cheque – Some Legal Aspects' (1976) 2 *Monash University Law Review* 180.

[31] F Easterbrook 'The Inevitability of Law and Economics' (1989) 1 (3) *Legal Education Review*, 7.

[32] Edward Rubin,'Efficiency, Equity and the Proposed Revision of Articles 3 and 4' (1991) 42, *Alabama Law Review* 551, 565.

deficit and it is fairly widely conceded that the law should attempt to formulate rules that the parties would have freely arrived at had they had the necessary knowledge.[33]Hence, this thesis argues that stop or reversal rights should be strengthened to correct the imbalance between banks and consumers and that fraud allocation rules be changed on the basis of efficiency.

Finally, in the limited context of this thesis it could not be said that efficiency is without any moral basis. For example, in regard to fraud loss allocation it has been generally advocated that consumers bear such loss as to induce caution  but where it is too difficult or costly to establish fault, then all users bear the loss via allocation to the banks. This 'insurance' principle is surely no more than the widely accepted idea that the feather weight of losses borne collectively is better than the dead weight of a loss falling on an innocent party. It is therefore submitted that the changes recommended by this thesis are not only efficient but also morally sustainable.

[33] Gillette and Walt, above n 5, 503.

# Bibliography


## Statutes and Codes

### Australia

*Bills of Exchange Act* 1909 (Cth).
*Cheques Act* 1986 (Cth).
*Goods Act* 1958 (Vic).
*Electronic Funds transfer Code* (1989) (revised 2001, amended 2002).
Australian Paper Clearing System Assurances.
Code of Banking Practice 2003 and amendments

### America

*Electronic Funds Transfer Act*, also known as Regulation E, Codified *15 USC*§ 1693g.
*Truth- in- Lending Act* (TILA) §133(a)(1)(B).*codified* 15 USC § 1643.
*Uniform Commercial Code* (UCC) Section 3.
*New Uniform Payments Code* (Draft No 8).

## Reviews and Discussion papers

Australian Banking Industry Ombudsman Review of the Code of Banking Practice, Issues Paper, February 2001.
Consumer and Business Affairs Victoria submission to the Viney *Review of the Code of Banking Conduct*, 2001,Electronic Funds Transfer Code of Conduct as revised by the Australian Securities and Investments Commission's EFT Working Group (issued 1 April 2001 amended 18 March 2002).
Discussion Paper on an Expanded EFT Code of Conduct Released by the Australian Securities & Investments Commission's EFT Working Group July 1999..
Explanatory Paper on proposed *Cheques* Bill prepared by the Attorney-General's Department, February 1984.
Jack (Chairman), Banking services law and Practice – Report by the Review Co*mmittee* (HMSO, 1989), 43.
The Molomby Report . Report on Fair Consumer Credit Laws 41.
Review of the Bills of Exchange Act 1909- 1958, 1964 (Manning Committee Report).
House of Representatives Standing Committee on Finance and Public Administration (Chairman Steven Martin) *A Pocket Full of Change: Banking and Deregulation* (1991
Reviewing the EFT Code ASIC consultation paper, January 2007.
Review of the Code of Banking Practice 2007-8.

Review of the Electronic Funds Transfer Code of Conduct 2007/08: ASIC proposals October 2008 (Consultation Paper 90).

## Books and articles

### A

Peter Alces 'A Jurisprudential Perspective For The True Codification Of Payments Law' (1984) 53 *Fordham Law Review* 83.
Mark Aronson and Jill Hunter, *Litigation: Evidence and Procedure* (1998).
Australian Banking Industry Ombudsman's Annual Report 91—92.
Australian Banking Industry Annual Report 1992-1993.
Australian Banking Industry Ombudsman Report 93-94
Australian Banking Industry Ombudsman Report 95-96.
Australian Banking Industry Ombudsman's Annual Report 96-97
Australian Banking and Financial Services Ombudsman Report 2002-3.

### B

Carl Baker, 'Recovery of Mistaken Payments Under the Liggett Doctrine: a Banker's "Plan B" '(2002) 13 *Journal of Banking and Finance Law and Practice* 259.
Douglas G Baird, 'The Future of law and Economics: Looking Forward' (1997) 64 *University of Chicago Law Review* 129.
Nicholas Bohm, Ian Brown, Brian Gladman, Electronic Commerce 'Who Carries The Risk Of Fraud?' <http://www.fipr.org/WhoCarriesRiskOfFraud.htm> at 16 November 2009.
Roland Brandel and Carl Leonard, 'Bank Charge Cards: New Cash or New Credit' 69 *Michigan Law Review* 1033.
Ellen Broadman, 'Electronic Funds Transfer Act: Is the Consumer Protected?' 13 *University of San Francisco Law Revue* 245.
William Buckland and Arnold McNair *Roman law and Common Law* (1965).
John. J. A. Burke 'Loss allocation rules of the check payment system with respect to forged drawer's signatures and forged indorsements: An explanation of the present and revised UCC Articles 3 and 4' (1993) *Uniform Commercial Code Law Journal* 41.

### C

*Chalmers and Guest on Bills of Exchange* (1964).
William J Chappenden 'Bank Credit Cards' (1973) 5 *Commercial Law Association Bulletin* 19.
Ronald H Coase, ' The problem of social costs', (1960) 3 *Journal of Law and Economics* 1.

Jules L Coleman,`Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law' (1980) 68 *California Law Review* 221.
Brian Conrick MJL Rajanayagam's *The Law of Negotiable Instruments* (1989).
Robert Cooter and Edward .Rubin, 'A Theory of Loss Allocation for Consumer Payments" (1987) 66-63 *Texas Law Review*, 63.
Denis Cowen and Leonard Gering, *Cowen on the Law of Negotiable Instruments in South Africa*, (1985).
Crawford and Falconbridge, *Banking and Bills of Exchange : a treatise on the law of banks, banking, bills of exchange and the payment system in Canada* (1986).

**D**

Leon Dabin, *Fondements du Droit Cambiaire Allemand* (1959).
Stefano Dellavigna and Ulrike Malmendier, 'Contract Design and Self Control: Theory and Evidence (2004) 119 *Quarterly Journal of Economics* 353
Discussion Paper on an Expanded EFT Code of Conduct Released by the Australian Securities & Investments Commission's EFT Working Group July 1999, 27.
Anthony Duggan, 'Is Equity Efficient?' (1997) 113 *Law Quarterly Review* 601.
Anthony Duggan, Michael Bryan, Francis Hanks *Contractual Non- Disclosure* (1994).

**E**

Frank H Easterbrook, 'The Inevitability of Law and Economics' (1989) 1 *Legal Education Review* 1.
Robin.Edwards, 'Fraud Loss under the Australian Electronic Funds Transfer Code'*Journal of International Banking Law and Regulation* 2009 vol 24 issue 7, 361.
Robin.Edwards,'The EFT Code Review: the rules versus standards (principles) debate' *Australian Banking and Finance Law Bulletin* 2009 vol 24 no 8, 125.
Robin Edwards, 'Credit cards: conundrums and cures (with words and music)' 77(12) *Law Institute Journal* 55.
Robin Edwards 'Bank Cheques & Solicitors' *Law Institute Journal* 1990 592.
Robin Edwards,'Does law follow money?' (2009) 21.1 *Bond Law Review* 41.
Peter Ellinger, *Modern Banking Law* (1987), 509.
Eliahu Peter Ellinger and CY Lee, 'The Liggettt defence: a banker's last resort' (1984) *Lloyd's Maritime and Commercial Law Quarterly* 459.
Richard Epstein, 'Law and Economics: Its Glorious Past and Cloudy Future' (1997) 64 *University of Chicago Law Review* 1167.

Isaac Erhlich and Richard A Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *Journal of Legal Studies* 257.

**F**

Feiwel (ed) *Issues in Contemporary Microeconomics and Welfare* (1985), 3.
Martha Fineman, 'The Hermeneutics of Reason: a commentary on Sex and Reason' (1993) 25 *Conneticut Law Review* 503.

**G**

Hans-Georg Gadamer, *Truth and Method* (1975).
Anne Geary, 'One size doesn't fit all- is a Uniform Payments Code a Good Idea' (1983) 9 (2) *Rutgers Computer and Technology Law Journal* 337.
Stephen Gethin "Codes of Conduct and Credit Card Chargebacks" (2003) 19(1) Australian *Banking & Finance Law Bulletin* 3.
Lawrence Gower, *Gower's Principles of Modern Company Law* (1979).
Stephen Gethin "Codes of Conduct and Credit Card Chargebacks" (2003) 19(1) *Banking Law Bulletin* 3.
Benjamin Geva, *Bank Collections and Payment Transactions: Comparative Study of Legal Aspects* ( 2001).
Benjamin Geva, 'The Concept of Payment Mechanism' (1986) 24 (1) *Osgoode Hall Law Journal* 1, 15.
Benjamin Geva, 'Allocation of forged cheque losses-comparative aspects, policies and a model for reform' (1998) 114 *Law Quarterly Review* 250.
Benjamin. Geva, 'The issuing Bank Defences against the Payee of a Bank Draft –addendum to 'The autonomy of the Banker's Obligations on Bank Drafts and Certified Cheques' *The Canadian Bar Revue* 280.
Benjamin Geva 'The Autonomy of the Banker's Obligation on Bank Drafts and Certified Cheques' [1994] 73 *The Canadian Bar Review* 21.
Clayton Gillette and Stephen Walt, 'Uniformity and Diversity in Payment Systems" 2008 (83:2) *Chicago- Kent Law Review* 499.
Professor Roy Goode, 'The Bank's Right To Recover Money Paid On A Stopped Cheque Law' (1991) 97 *Law Quarterly Review*, 254.
Professor Roy Goode, *Payment Obligations in Commercial and Financial Transactions (*1990), 11.

**H**

Halsbury's Laws of Australia, Vol X, Alan L Tyree, Jon D Stanford and Fadi Khoury BANKING AND FINANCE [45-670].
Elizabeth Hoffman and Matthew Spitzer, 'The Coase Theorem: Some Experimental Tests' (1982) 25 Journal of Law and Economics 73,
James Holden, *History of Negotiable Instruments in English Law* (1955).

William Searle Holdsworth, *A History of English Law*, vol 8, (1937).
Bryan.D,Hull 'Cashier's Cheques: Not as Good as Gold' *Journal of Banking Law and Practice* June 1992, 136.

**K**

Louis Kaplow, 'Rules versus Standards and Economic Analysis' (1992-93) 42 *Duke Law Journal* 557.
D Khoury '3rd Party Protection' (2004) 78 *Law Institute Journal*, 50.

**L**

Elizabeth Landes and Richard Posner, 'The Economics of the Baby Shortage' (1978) 7 *Journal of Legal Studies* 323.
Larry Lawrence ' Making Cashier's Checks and other Bank Checks Cost-Effective: A plea for Revision of Articles 3 and 4 of the Uniform Commercial Code' (1980) 64 *Minnesota Law Review* 275.
George Lowenstein and Richard H Thaler, 'Anomalies: Intertemporal Choice' (1989) *Journal of Economic Perspectives* 181.
Harold.Luntz, 'Banker and Customer: Reciprocal Absence of Duty of Care' (1996) *4 Torts Law Journal* 99.

**M**

Lord MacMillan *Law and Other Things* (1937).
Mainwaring, Neville (1985) 23 *Law Society Journal* 430.
R Makin "The Australian Bank Cheque - Some Further Legal Aspects (1976) 3 *Monash University Law Review* 66.
Ronald J Mann, *Payment Systems and Other Financial Transactions* ( 2003 ).
Ronald Mann 'Making sense of Payments Policy in the Information Age' (2005) 93 *The Georgetown Law Journal* 633.
Gary Minda, *Postmodern Legal* Movements (1995).
N Mercuro (ed) *Law and Economics* (1980).
John Henry Merryman in *The Civil Law Tradition* (1969).
Thomas O Mittelsteadt, ' The stop payment right in an Electronic Payment Environment: A Analysis of the Transition Problems Involved when Integrating a Traditional Right into New Value Transfer Systems' (1981-1982) 17 *New England Law Review* 355, 365.

**N**

Laura Nader, 'Disputing without the Force of Law' (1979) 88 *Yale Law Journal* 998, 1006.
H D Nilson, 'The Future of Credit Cards' (1979) 162 *The Bankers Magazine* 54.
Martha Nussbaum, 'Flawed Foundations: The Philosophical Critique of a Particular Type of Economics', (1997) 64 *University of Chicago Law Review* 1197.
Note 'Preserving Consumer Defenses in Credit Card Transactions' (1971) 81 *Yale Law Journal* 287.

**O**

*The Oxford Companion to Law* (1980).

**P**

Francesco Parisi, 'Positive, Normative and Functional Schools in Law and Economics' Law and Economics Working Paper Series, George Mason University School of Law, 2004, 4.
Robert Peters *The Commercial Bill Market in Australia* (1987).
Richard A Posner, *Economic Analysis of Law* (1992).
Richard A Posner, *Sex and Reason* (1992).
Richard A Posner, 'Some Uses and Abuses of Economics in Law' (1979) *University of Chicago Law Review* 281.
Postan *Private Financial Instruments in Medieval England* (1930).

**R**

Dale Reistad, ' Beyond the Credit Card' (1971) 154 *The Bankers Magazine* 96.
Andrew Robertson 'Concepts of payment in Domestic and International Funds Transfers' (1992) 3 (1) *Journal of Banking and Finance Law and Practice,* 16.
Robertson 'Bank Cheques - Nearly as Good as Cash' (1976) *Rydge's* 120.
Arnold Rosenberg, 'Better than Cash? Global Proliferation of Payment Cards and Consumer Protection Policy' *Columbia Journal of Transnational Law* (2006) 44(2) 520.
Edward Rubin,'Efficiency, Equity and the Proposed Revision of Articles 3 and 4' (1991) 42, *Alabama Law Review* 551.
Derek Roebuck, Srivastava and Zafrullah *Banking Law in Hong Kong* (1995).

**S**

Hal Scott, 'The Risk Fixers' (1978) 91 *Harvard Law Review* 737, 742.

*Select Cases on the Law Merchant*, 23 Seldon Society (Hall ed.1932)
Jack B Siegel,'The Electronic Fund Transfer Act - a Departure from Articles Three and Four of the Uniform Commercial Code' 1980 *Wisconsin Law Review* 1008.
Mita Sujan, 'Consumer Knowledge: effects on Evaluation Studies Mediating Consumer Judgements' (1985) 12 *Journal of Consumer Response*, 31.

**T**

Brian Tracey, 'Banks Employ Innovative Methods to Help Combat Check Fraud' (1994) 17 *American Banker* 24.
Alan Tyree and Andrea Beatty *The law of Payment Systems* (2000).
Alan Tyree, *Weerasooria's Banking Law* (2006).
Alan Tyree *Banking Law in Australia* ( 1998).
Alan L Tyree, *Banking Law in Australia* (2005).
Alan Tyree 'Deposits by Strangers' (2003), 14 *Journal of Banking and Finance Law and Practice*, 42.
Alan L Tyree, 'When rules collide: Liggettt meets Simms' (1990) 1 *Journal of Banking Finance Law and Practice* 213.
Alan L Tyree 'Riedell gets a credit card' (2002) 13 *Journal of Banking and Finance Law and Practice*, 301.
Amos Tversky and Daniel Kahnemann, 'Judgment Under Uncertainty: Heuristics and Biases' 185 (1974) *Science* 1124.

**U**

US Senate Report No 915, 95th Congress, 2nd session, 9408.

**V**

James Vergari 'A critical look at the New Uniform Payments Code' (1983) 9 *Rutgers Computer & Technology Law Journal* 317.
Roger Voegeli *La Provision de la Lettre de Change and son Attribution au Porteur* (1947) 261.

**W**

Alan Watson, *Legal Transplants : an Approach to Comparative Law* (1993).
Wikrema Weerasoria and Isaac Dallen ' National Bank's appeal in *Hokit;* Tailoring common law to the banker's needs' (1995) 11 *Australian Banking & Finance Law Bulletin* 64.
Wikrema S Weerasooria 'The Australian Bank Cheque - Some Legal Aspects' (1976) 2 *Monash Uiversity Law Review* 180.
John Wilkin 'Dishonour of Bank Cheques' (1994) 22 *Australian Business Law Review* 296

## Australian, British ,Canadian , Hong Kong, New Zealand and South African Cases

**A**

*AA/S Awilco of Oslo v Fulvia SpA di Navigazione of Cagliari (The Chikuma*) [1977] QB 790.
*Akrokerri (Atlantic) Mines Ltd v Economic Bank* [1904] 2 KB 465.
*Allen's Enterprises Ltd v Bank of New Zealand.*
*Arrow Transfer Co v Royal Bank of Canada* [1972] SCR 845, 873.

**B**

*Bank of England v Vagliano* [1891] AC 107.
*Bank of New South Wales v. Murphett* [*1983*] *V. R. 489*.
*Barclays Bank Ltd v W J Simms Son & Cooke (Southern) Ltd)* [1980] QB 677.
*Big Dutchman (South Africa) v Barclays National Bank* 1979 (3) SALR 267, 283.
*Bonior v A Siery Ltd* [1968]NZLR 254.
*Braithwaite v Thomas Cook Travellers Cheques Ltd*, [1989] QB 553.
*British and North European Bank Ltd v Zalstein* [1927] 2 KB 92.
*British Homophone Ltd v Kunz and Crystallate Gramophone Record Manufacturing Co Ltd* [1935] All ER Rep 627.
*Buller v Cripps* (1703) 6 Mod.29, 87 ER 793 (QB).

**C**

*Caltex Oil (Australia) Pty Ltd v The Dredge 'Willemstad'* (1976) 136 CLR 529.
*Canadian Pacific Hotels Pty Ltd v Bank of Montreal* [1987] 1 SCR 711.
*Caparo Industries Pty Ltd v Dickman* [1990] 1 All ER 568.
*Capri Jewellers Pty Ltd v Commonwealth Trading Bank of Australia* 1989) Aust Torts Reports 80-256.
*Carlill v Carbolic Smoke Ball* [1893] 1 QB 256.
*Re Cleadon Trust* [1939] Ch 286.
*Crantrave Ltd (in liquidation) v Lloyds Bank* [2000] 3 WLR 877.
*Commissioners of State Savings Bank of Victoria v Permewan Wright & Co.* (1914) 19 CLR 467.
*Commonwealth Trading Bank of Australia v Sydney Wide Stores Pty Ltd* (1981) CLR 304; 35 ALR 513.

*Cosmedia Productions Pty Ltd v Australia and New Zealand Banking Group Ltd* (1996) ATPR ¶46-155, 53, 305.
*Re Charge* Card *Services Ltd* [1986] 3 ALL ER 298; [1986] 3 WLR 697.

**D**

*Dimond (HH) (Rotorua 1996) v Australian and New Zealand Banking Group Ltd* [1979] 2 NZLR 739.
*Discount Records Ltd v Barclay's Bank Ltd* [1975] 1 WLR 315, 448.
*Donoghue v Stevenson* [1932] AC 562 .

**E**

*El Awadi v Bank of Credit and Commerce International SA Ltd* [1990] Q B 606.
*Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 71 ALJR 448.

**F**

*Fabre v Ley* (1973) 127 CLR 665.

**G**

*Glamorgan Coal Co v South Wales Miners Federation* [1903] 2 KB 545, 574-5.
*Greenwood v Martins Bank Ltd* [1933] AC 51.

**H**

*Hamzeh Malas & Sons v British Imex Industries Ltd*: [1957] 2 Lloyd's Rep 549, 550.
*Hannan's Lake View (Central) Ltd v Armstrong & Co* (1900) 16 TLR 236.
*Hasan v Wilson* (1977) 1 Lloyds Rep 431.
*Hedley Byrne & Co Ltd v Heller & Partners.* [1964] AC 465.
*Hill (t/a RF Hill and Associates) v Van Erp* (1997) 188 CLR 159

**J**

*Joachimson v Swiss Bank Corp* [1921] 3 KB 110, 127.
*John's Period Furniture' Pty Ltd v Commonwealth Savings Bank of Australia* (1981) 24 SASR 224.
*Johnson Matthey Ltd v Australia and New Zealand Banking Group Limited* (1989) Aust Torts Reports 80-256.

**L**

*Liggett (B) (Liverpool) Ltd v Barclays Bank Ltd* [1928] 1 KB 48.
*Lilley v Rankin* 56 QB 248.
*London Joint Stock Bank Ltd v MacMillan and Arthur* 1918] AC 777.
*Long v Smithson* (1918) 118 LT 678 Div Ct.
*Lloyds Bank Ltd v Brooks* (1950) 6 LDB 161.
*Lloyd v Grace Smith & Co* [1912] AC 716.
*Lloyds Bank Plc v Independent Insurance Co Ltd* [2000] 1 QB 110.
R Lowe Lippman Figdor & Franck v AGC (Advances) Ltd (1992) 2 VR 671.
*Lumsden & Co v London Trustee Savings Bank* [1971] 1 Lloyds' Rep 114
*Lyritzis v Westpac* [1994] FCA 1458.

**M**

*Majesty Restaurant Pty Ltd (in liq) v Commonwealth Bank of Australia Ltd* (1998) 47 NSWLR 593.
*Mardorf Peach & Co Ltd v Attica Sea Carriers Corp of Liberia (The Laconia)* [1977] AC 850.
*Miller v Race* (1785) 1 Burr 452,457 -460.
*Moss v Old Colony Trust Co* (1923) 140 N E 803.
*Motor Traders Guarantee Corp Ltd v Midland Bank Ltd* [1937] 4 All ER 90

**N**

*National Australia Bank Ltd v Hokit Pty Ltd* (1996) 38 NSWLR 377.
*National Westminster Bank v. Barclays Bank* [1975] 1 QB 654
*National bank of New Zealand Ltd v Walpole and Patterson Ltd* [1975] 2 NZLR 7.
*National Australia Bank Ltd v Nemur Varity Pty Ltd* [2002] VSCA 18, 9.
*Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146.
*Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GMbH* [1977] 1 Lloyd's Rep 463.

**O**

*Ontario Woodsworth Memorial Foundation* [1966] 58 DLR 21.

**P**

*Pavia & Co SPA v Thurmann – Nielsen*[1952] 2 QB 84, 88.
*Peacock v Rhodes* 2 Douglas 633m 99 Eng. Rep, 402 (K.B. 1781);
*Perre v Apand Pty Ltd* (1999) 198 CLR 180.
*Philpot v Briant* (1828) 4 Bing 717,720.
*Price v Neal* (1762) 3 Burr 1354, 97 ER 871

**R**

*Rekstin v Severo Sibirsko Gosudarstvennoe Akcionernoe Obschestvo Komseverputj*[1933] 1 KB 47.
*Ricky Yan v Post Office Bank* [1994] NZLR 155, 162.
*Riedell v Commercial Bank of Australia Ltd* [1931] VLR 382.
*Roberts v Malouf* (1929) 29 SR (NSW) 179.
*Royal British Bank v Turquand* (1856) 6 E&B 327.
*Ruben v Great Fingall Consolidated* [1906] AC 439.

**S**

*Selangor United Rubber Estates v Craddock* (no 3) [1968] 2 All ER 1073.
*Sidney Raper Pty Limited v Commonwealth Trading Bank of Australia* (1975) 2 NSWLR 227.
*Smith and Hayward v Lloyds Bank TSB* [2001] QB 541.
*Smith and another v Lloyds TSB Bank plc; Harvey Jones Ltd v Woolwich plc* [2001] 1 All ER 424.

**T**

*Tai Hing Cotton Mill Ltd v Lui Chong Hing Bank Ltd* [1986] AC 80.

**V**

*Varker v Commercial Banking Co of Sydney Ltd* [1972] 2 NSWLR 967.
*Vella v Permanent Mortgages Pty Ltd* [2008] NSWSC 505

**W**

*Walsh and Ors v Hoag & Bosch Pty Ltd* [1977] VR 178.
*West v Commercial Bank of Australia* (1935) 55 CLR 319.
*Westpac Banking Corp v Metlej*. (1987) Aust Torts Reports 8-102.
*Westpac banking Corporation v Murphy* [2005] NSWCA, 277.
*Wragge v Sims, Cooper & Co (Aust) Pty Ltd* (1933) 50 CLR 483.

**Y**

*Young v Grote* (1827) 4 Bing 253.

**Z**

*Zanda Investments Pty Ltd v Bank of America National Trust and Savings Association* (1994) 2 HKC 409; 1993 HKC Lexis 178

## American cases

**D**

*Delbruek & Co v Manufacturers Hanover Trust* Co <u>609F.2d</u> 1047 (1979).

**G**

*Gulf Refining Co v Williams Roofing Co* (1945) 186 SW2d 790.

**M**

*Medford Irrigation District v Western Bank* 66 Ore App 589; 676 P 2d 329 (1983).
*McIntyre v Harris* 709 N.E.2d 982 (Ill.App.1999).
*Minskoff v American Express Travel Related Services Co* 98 F.3d 703 (2d Cir.1996)

**T**

*TPO, Inc v FDIC* 487 F2d 131 (3d Cir.1973).