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Contracts: Risk of Unauthorized Use of Credit Card

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A department store issuing credit cards sought payment for purchases made through the unauthorized use of defendant's stolen credit card. Defendant, through no fault of his own, was unaware of the card's disappearance. Plaintiff relied on a risk-shifting clause contained in the application for the credit card, imposing liability on the holder for all purchases made through the presentation of the credit card until the issuer receives notice that the card has been lost or stolen.[1] The New York court denied recovery, *holding* that plaintiff had been negligent in its duty to protect the credit status of its customer. *Allied Stores of New York, Inc. v. Funderburke*, 52 Misc. 2d 872, 277 N.Y.S.2d 8 (N.Y. City Civ. Ct. 1967).

The earliest case dealing with the question of liability for the unauthorized use of a lost or stolen credit card analogized the card to a negotiable instrument, holding that the issuer was protected as a holder in due course.[2] This analogy was expressly refuted shortly thereafter in *Lit Brothers v. Haines*.[3] In *Haines*, the court was concerned with the liability of the holder absent a governing agreement; no risk-shifting clause existed between the holder and the issuer.[4] The court denied recovery stating that there was an absence of any contractual ele-

1. Specifically the application states that the holder will "pay for all purchases made by any person presenting the identification plate which Seller will lend me, until Seller receives my notice by certified mail that same has been lost or stolen." Allied Stores of New York, Inc. v. Funderburke, 52 Misc. 2d 872, 873, 277 N.Y.S.2d 8, 10 (N.Y. City Civ. Ct. 1967).

2. Wanamaker v. Megary, 24 Pa. Dist. 778 (Phila. Mun. Ct. 1915). The court reasoned that the merchant gave value without notice and was, therefore, a holder in due course of the debt-evidencing saleslip.

The loss of a credit card has also been analogized to the loss of currency. *See generally* Texaco, Inc. v. Goldstein, 34 Misc. 2d 751, 755, 225 N.Y.S.2d 51, 55 (N.Y. Mun. Ct. 1962). However, such an analogy is subject to criticism. When one loses his currency, his loss is limited to the amount lost. If the holder is liable for subsequent unauthorized purchases, the loss of a credit card represents an unlimited loss.

3. 98 N.J.L. 658, 121 A. 131 (Sup. Ct. 1923). Even if the credit card transaction could be analogized to a negotiable instrument, the true holder would not be liable on the forgery. *See generally* UNIFORM COMMERCIAL CODE § 3-404.

4. 98 N.J.L. 658, 121 A. 131 (Sup. Ct. 1923). The holder's credit "coin" was stolen and the loss was not reported to the issuer. Although it was apparent that the holder knew of the "coin's" disappearance, it was found that the holder was ignorant of the ability of an imposter to obtain goods merely by presenting his credit "coin." *Id.* at 659, 121 A. at 131. In light of present day sophistication regarding credit cards, it is questionable whether such a finding could be made today.

ment on which to hold the holder liable for the fraudulent purchases.[5] Recent authority seems to support this result.[6] However, these cases do not insure that the holder will not be held liable in tort or on an implied contract, even in the absence of an express contractual provision, where he fails to notify the issuer of the card's loss while *knowing* of its ability to be used fraudulently.[7] In *Gulf Refining Company v. Plotnik*,[8] defendant failed to report the loss of his credit card even after receiving forged invoices at billing.[9] Although there was no contract shifting the risk of unauthorized use of the credit card, the court held the holder liable for purchases by the thief on the theory that an implied contract existed between the holder and the issuer which placed a duty upon the holder to notify the issuer of the card's fraudulent use.[10]

To protect themselves issuers have generally included a risk-shifting clause within the framework of the credit card agreement. The enforceability of these provisions has been upheld. In *Union Oil Company of California v. Lull*,[11] the Oregon Supreme Court stated that the holder should be bound by the terms of the risk-shifting provision as they were not unreasonable.[12] In remanding for a new trial the *Lull* court held erroneous the trial court's instruction that defendant-holder would be excused from liability imposed by the risk-shifting provision if he exercised prudence in reporting the loss within a reasonable time.[13] The court further stated that the use of due care by the issuer or merchant[14] regarding the identity of the pur-

5. *Id.* at 659-60, 121 A. at 131.
6. Thomas v. Central Charge Serv., Inc., 212 A.2d 533 (D.C. Ct. App. 1965).
7. *See* Gulf Ref. Co. v. Plotnik, 24 Pa. D. & C. 147 (C.P. 1935).
8. 24 Pa. D. & C. 147 (C.P. 1935).
9. *Id.* at 148.
10. *Id.* at 151.
11. 220 Ore. 412, 349 P.2d 243 (1960).
12. *Id.* at 421-23, 349 P.2d at 247-48.
13. *Id.* at 412, 349 P.2d at 243.
14. Many credit card arrangements involve three parties, the holder, the merchant, and the issuer. Here the issuer pays the merchant for the invoices while collecting from the holder. It has been held that in such three-party situations the relationship between the issuer and the merchant with respect to the invoices is one of assignment and, therefore, any defense available to the holder against the merchant is also available against the collecting issuer. *See* Gulf Ref. Co. v. Williams Roofing Co., 208 Ark. 362, 367, 186 S.W.2d 790, 794 (1945). For a discussion of the assignment theory between the issuer and the merchant, as well as alternative theories, see Note, *The Tripartite Credit Card Arrangement: A Legal Infant*, 48 CALIF. L. REV. 459, 473-78 (1960). The issuer and the merchant may, of course, be the same party.

chaser[15] was essential to the issuer's recovery;[16] the mere presence of a risk-shifting clause was not determinative.[17] In reaching its conclusion the court analogized the risk-shifting clause imprinted on a credit card to similar provisions contained in savings passbooks noting that such provisions do not relieve the bank from using due care to identify the withdrawer in the interest of protecting the depositor.[18]

In the instant case, the New York court recognized that the risk-shifting provision was enforceable[19] but held that the terms[20] did not expressly provide for the holder's liability where he was unaware that the card had been lost or stolen.[21] The court reasoned that since there was no controlling agreement by which to affix liability between the parties, the decision should be governed by common law tort principles.[22] The court held that Allied Stores, in allowing two hundred thirty-seven credit sales for items totaling $2,460 within a thirty-day period, was

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15. In Gulf Ref. Co. v. Williams Roofing Co., 208 Ark. 362, 186 S.W.2d 790 (1945), the negligence of an issuer was held to be a bar to his recovery where he extended credit to an imposter—even in the presence of a risk-shifting provision.

16. 220 Ore. 412, 433, 349 P.2d 243, 252 (1960). The court further stated that the burden of proof as to the issue of due care rested with the issuer. *Id.* at 436, 349 P.2d at 254. This conclusion was adopted by analogy to negotiable instrument theory that if the instrument is lost or stolen, the burden is upon the holder to prove that he acquired the instrument as a holder in due course. *See generally* UNIFORM COMMERCIAL CODE § 3-307(3).

17. 220 Ore. 412, 349 P.2d 243. The court stated that a jury could conclude that the issuer (merchant) was negligent when the car driven by the imposter bore license plates of a state different from that shown on the credit card as the residence of the true holder. *See also* Gulf Ref. Co. v. Williams Roofing Co., 208 Ark. 362, 186 S.W.2d 790 (1945), where a gas station dealer allowed an imposter, using defendant's lost or stolen credit card, to charge tires of a size inconsistent with the size of those on his automobile, two car radios when his automobile already contained one, and to obtain cash instead of merchandise. The issuer was denied recovery.

18. Such provisions provide that the bank is not liable to its depositor for withdrawals made by imposters presenting the depositor's passbook unless the bank is notified of the book's loss or theft. *See* Kummel v. Germania Sav. Bank, 127 N.Y. 488, 28 N.E. 398 (1891); Commisso v. National City Bank, 174 Misc. 409, 412, 21 N.Y.S.2d 187, 190 (Sup. Ct. 1939). The analogy is not perfect, however, as banks have, unlike merchants, signature cards with which to verify the signatures of their withdrawers.

19. 52 Misc. 2d at 874, 277 N.Y.S.2d at 11. *See* Union Oil Co. v. Lull, 220 Ore. 412, 349 P.2d 243 (1960).

20. See note 1 *supra*.

21. 52 Misc. 2d at 875, 277 N.Y.S.2d at 11-12.

22. *Id.* at 877, 277 N.Y.S.2d at 13.

negligent in its duty to protect the credit status of its customer and, therefore, could not recover.[23]

This holding of negligence on the part of the issuer[24] relieves credit card holders of potentially ruinous liability if they have acted with due care. If the issuer gives an imposter an excessive extension of credit between billing dates, he will be denied recovery from the holder. Where the issuer has extended only a normal amount of credit to the imposter between billing dates, he has not been negligent and may recover such an amount from the holder.[25] Should the issuer extend an unexcessive amount of credit during successive monthly billing periods, the holder's liability could become very large, but such could only occur in the absence of the holder's due care. An inspection by the holder of his monthly statements and invoices would reveal the unauthorized purchases and would allow him ample time to notify the issuer that an imposter was in possession of his credit card.[26] Therefore, under the finding in *Allied*, the holder can be held liable, in absence of his own negligence, only for the unexcessive charges during one billing period.

After finding the issuer negligent, the instant court could have held that such negligence was a defense to the holder's liability under the risk-shifting provision.[27] Instead the court found the provision inapplicable because the holder was unaware of the card's disappearance and thus it was impossible for him to give the issuer notice of the loss. Only after this elimination of the contractual issue did the court conclude that under common law principles of tort law applicable, plaintiff had established

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23. The court argued:

> To pursue the plaintiff's position to an absurd end . . . depending upon how quickly plaintiff discovered suspicious sales, a customer could, without negligence on his part, be chargeable . . . for items totaling $10,000 or $100,000 as well as the $2,460 sought here.

52 Misc. 2d at 878, 277 N.Y.S.2d at 15.

24. *Id. But see* Uni Serv Corp. v. Vitiello, 53 Misc. 2d 396, 278 N.Y.S.2d 969 (N.Y. City Civ. Ct. 1967), where the holder was held liable even after the merchant extended credit beyond an agreed limitation of $250.

25. It is likely that the issuer or merchant, in furtherance of goodwill, would not sue its customer for such a small amount.

26. Similar theory is used in negotiable instruments law where there is a duty imposed upon the drawer to verify the vouchers returned by the bank, otherwise the loss which could have been prevented, had the vouchers been verified, will rest on the drawer. *See generally* UNIFORM COMMERCIAL CODE § 4-406.

27. *See* Gulf Ref. Co. v. Williams, 208 Ark. 362, 186 S.W.2d 790 (1945).

no right to recovery. Although the court's result is consistent with the policy of not allowing the issuer to contract out of his own negligence, the reasoning of the court could be fatal to such a policy. It can be argued that it is implicit in a risk-shifting provision that the holder will be liable until he notifies the issuer *whether or not he was aware of the loss.*[28] Even if it is not implicit, a clause would easily be drafted which would expressly provide for such liability. However, if the court is basing its decision on the question of negligence only after finding that no applicable contractual provision controls, the court could not logically deny recovery to the negligent issuer under such a redrafted clause. Arguably, it is better to hold that the negligence of the issuer or merchant is an absolute defense to a risk-shifting provision thereby preventing recovery by a negligent issuer regardless of the terms contained in his provision.

Writers have proposed that in cases where the holder and issuer are both found free from any negligence, the holder should be bound by the risk-shifting provision contained in his application for, or imprinted on, his credit card.[29] However, the arguments on behalf of such a conclusion are not persuasive. It is contended that the liability clauses are not unreasonable as the issuer assumes all risk of loss after notification while the holder assumes the risk of loss prior to such notice.[30] However, in a situation where the holder is blameless, as in the instant case where defendant failed to give notice because he was unaware of the card's disappearance, such a statement clearly fails to give equity to both parties. The holder assumes the risk during a period in which, because of his unawareness, he has no opportunity to protect himself, while the issuer assumes the risk only after he has been made aware by the holder of the fraudulent possession and use of the holder's credit card. Upon notification, the issuer can take steps for his protection. Thus, the above statement supporting the holder's liability under a risk-shifting clause is persuasive only when the holder knows that his credit card has disappeared and he fails to report such a disappearance. But in such a situation the issue of liability under the risk-shifting clause is relatively moot, as the holder has been negligent and the issuer can recover even in the absence

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28. *See* Union Oil Co. v. Lull, 220 Ore. 412, 421, 349 P.2d 243, 247 (1960).

29. *See* 43 N.C.L. REV. 416, 424 (1965); Comment, *The Lost Credit Card: The Liabilities of the Parties*, 30 ALBANY L. REV. 79, 89 (1966).

30. *See, e.g.*, Union Oil Co. v. Lull, 220 Ore. at 422, 349 P.2d at 247 (1960).

of the provision.[31] Therefore, the above contention offers little in support of enforcing the risk-shifting clause.

Another argument put forth by those advocating the enforcement of the clause in the absence of negligence by either party is that the credit card arrangement is of mutual benefit to both the holder and the issuer and, therefore, it is reasonable for them to share the risk of unauthorized purchases.[32] Undoubtedly the holder derives benefit from the credit card arrangement, for he can delay payment for a period of days and effectuate automatic credit through the mere presentation of his charge card. However, it is questionable whether this benefit is comparable to that derived by the issuer. One can imagine the devastating effect on large department stores, oil companies, and other retailers if credit card arrangements were removed from their operations. Not only would sales have to be made on a charge basis solely upon verification of the customer's credit at each purchase, severely limiting credit retailing in all large establishments employing hundreds of clerks and serving thousands of customers, but, should an imposter effectuate a charge on another's open account the merchant alone would suffer the loss.[33] Thus the merchant, through the credit card arrangement, effectuates identification of customers authorized to charge goods while at the same time shifting the risk of fraudulent purchases to the customer until he is notified that an imposter may have the card. In addition to these benefits, the issuer employing a revolving charge arrangement is receiving carrying charges well in excess of his costs.[34] If major enterprise wishes to set in motion such a self-benefiting arrangement likely to cause occasional loss through fraudulent purchases in the absence of any negligence, then it seems only just that the enterprise should be held accountable for such loss as an expense of the scheme.

If such strict liability is too harsh a burden to impose on the

31. Gulf Ref. Co. v. Plotnik, 24 Pa. D. & C. 147 (C.P. 1935).

32. *See* Comment, *The Lost Credit Card: Liabilities of the Parties,* 30 ALBANY L. REV. 79 (1966).

33. Writers who analyze the merchant's benefit of the credit card solely as one of marketing through credit sales are not precisely accurate. Credit sales are quite possible without the use of credit cards, as indeed sales on open account were used prior to the advent of the credit card. The precise benefit of the card, of course, is to effectuate immediate identification of one previously approved for credit.

34. An analysis of service charges used in credit card installment financing is offered in Note, *Regulation of Installment Credit Cards,* 35 U. CIN. L. REV. 424 (1966).

issuer, there are several reforms which could be used to give the holder greater protection than he presently has. The risk-shifting clause could be enforceable only if it has been properly brought to the attention of the customer.[35] Legislative reform has been enacted in New York which provides that such clauses will be enforceable only if they are conspicuously written or printed on the application or credit card in a size at least equal to eight point bold type.[36] In addition, because the purpose of the credit card is commonly thought to be identification rather than evidence of any contractual obligation,[37] it might be required that the risk-shifting clause be enforceable only if it is included in the holder's executed application, as well as on the reverse side of the card.

To prevent unlimited loss after the theft of a credit card, the customer could be required to indicate a limit to the amount of credit he wishes to receive and unless the customer consents to a greater limitation the issuer would be liable for all fraudulent purchases made in excess of the limit.[38]

Moreover, to prevent the card's use by an imposter, credit cards might be made nontransferable, thereby allowing the issuer to refuse credit to one he knows is not the registered holder of the card. In addition, it could be required that a small photo of the authorized holder appear on the reverse side of the charge card for further identification. While many nontransferable cards provide for the holder's signature on the face of the card to facilitate a comparison of the signature on the card with that on the sales invoice, such an arrangement is of questionable value because the imposter in possession of the credit card then knows the signature of the true holder. In such a circumstance the imposter can readily duplicate the signature of the holder, making himself appear to be the authorized user. For

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35. In Union Oil Co. v. Lull, 220 Ore. 412, 349 P.2d 243 (1960), the holder argued he was not bound to the terms imprinted on the reverse of the card as he was unaware of their existence. The court said, "In the absence of proof that the terms . . . were put in deceptive form which would mislead a reasonable person, and that defendant was so misled, he is bound . . . whether or not he read them." *Id.* at 420, 349 P.2d at 247.

36. N.Y. GEN. BUS. LAWS § 512 (McKinney Supp. 1966).

37. *See* Union Oil Co. v. Lull, 220 Ore. 412, 421, 349 P.2d 243, 247 (1960).

38. Such a limitation was contained in a credit card agreement in Uni Serv Corp. v. Vitiello, 53 Misc. 2d 396, 278 N.Y.S.2d 969 (N.Y. City Civ. Ct. 1967). Here the holder indicated a limitation of $250 on a place provided for such a limitation in the agreement. Credit was extended beyond such a limitation but the holder was held liable.