

# The Apportionment Of Credit Card Fraud Loss

## I. INTRODUCTION

The use of credit cards for consumer purchases is by no means a new development in the area of consumer credit. Credit coins, predecessor of the modern day credit card, were first used by retail department stores before the 1920's. However, it was not until the development of oil company credit cards and modern all-purpose credit cards that the industry attracted widespread attention and became of fundamental importance to our economy.<sup>1</sup>

In order to appreciate the complexity of the current credit card system and to fully understand the problems it has created, it is first necessary to identify and define the various types of contemporary credit card arrangements.

The traditional two party credit card arrangement is presently used by most retail department stores. These credit cards are used exclusively at a particular department store and are issued to those customers requesting them. A contract is thereby created between the store and the customer whereby the latter agrees to pay for all purchases made with his card. The store will then normally bill its cardholders directly, usually on a monthly basis. If the bill is not satisfied within a specified period, a monthly service charge must be paid. The

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<sup>1</sup>A recent House of Representatives Report estimated that an approximate total of 300 million credit cards are presently outstanding in the United States. There are 150 million independent retailer cards, 50 million bank credit cards, 6 million travel and entertainment cards, 1.5 million air travel cards, and 13 million miscellaneous credit cards. It is also estimated that in 1970 consumers will buy more than \$50 billion worth of goods and services through the use of credit cards. H.R. REP. NO. 91-1500, 91st Cong., 2d Sess. (1970) [hereinafter cited as H.R. REP. NO. 91-1500].

benefits afforded by the two party credit card are obvious. Issuers enjoy a stimulation in total sales while holders are allowed to purchase goods on credit.

The three party credit card arrangement currently used by oil companies and banks is somewhat more complicated. Under this system two contracts are involved. The first is between the card issuing company and the cardholder. For the privilege of purchasing goods and services on credit from participating merchants (normally identified by a display of the issuer's emblem), the holder agrees to pay the issuer for all purchases made with his credit card until the issuer has received written notice that the card has been lost or stolen. At the end of each billing period the holder is billed for his accumulated purchases. Upon receipt of his statement, the holder may either pay the face amount within a specified period, or pay according to a deferred payment schedule, subject to a service charge.<sup>2</sup> The second contract is between the issuing company and each merchant who participates in the plan. Pursuant to this agreement the merchant forwards all credit card sales slips to the issuer. In return, he receives an amount equal to the face value of the sales slips discounted by the issuer's charges for the credit card services.<sup>3</sup>

Another variation of the three party credit card arrangement is the so-called travel and entertainment credit card.<sup>4</sup> With a few exceptions this system is basically the same as that employed by banks and oil companies. Its primary appeal is to businessmen for use in the travel and entertainment fields, with most membership being drawn from individuals with incomes ranging from \$10,000 to \$20,000 per year.<sup>5</sup> Also, unlike other three party credit card systems, it does not offer a revolving credit arrangement. Thus, the total amount owed is payable in full upon each monthly billing.<sup>6</sup>

A great measure of the success enjoyed by the three party card system is no doubt attributable to the benefits it offers to all participating

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<sup>2</sup>*See id.*, at 2 for rate schedules.

<sup>3</sup>A typical bank credit card arrangement may or may not require that a participating merchant open an account with the card issuing bank. If it is compulsory, the merchant normally deposits the sales slips with the bank and receives a discounted credit to his account. H.R. REP. NO. 91-1500 *supra* note 1, at 10. *But see* 3 CCH CONSUMER CREDIT GUIDE, REPORT 49, at 4, 10/28/70 for a speech by Basil J. Mezines, the FTC Executive Director, wherein he stated that credit card plans requiring a merchant to open an account with the bank may have potential antitrust implications.

<sup>4</sup>Examples of this type of credit card are Diner's Club, American Express and Carte Blanche.

<sup>5</sup>H.R. REP. NO. 91-1500, *supra* note 1, at 40.

<sup>6</sup>An exception is that airline tickets may be paid for in pre-arranged installments.

parties.<sup>7</sup> The holder, merely by presenting his card, is granted instant credit at numerous retail outlets and allowed to delay payment for goods or services purchased. Credit cards benefit the issuer as a sales promotion device through the extension of credit to potential customers. The issuer also profits from service charges on overdue accounts and from the discounting of merchants' charge slips. Likewise, participating merchants benefit from the increase in sales volume they enjoy. As an additional advantage, the use of credit cards decreases the amount of cash handled by retail merchants, thereby lessening the danger of robbery.<sup>8</sup>

Accompanying the numerous benefits inherent in both the two and three party credit card systems, the ease with which these cards can be obtained and used has presented substantial problems. Of primary importance is the risk<sup>9</sup> of credit card fraud.<sup>10</sup> When a credit card is lost or stolen and used without the consent of the authorized holder, the question necessarily arises as to how the resulting loss shall be apportioned. Should it be absorbed by the cardholder, the issuer, or both?<sup>11</sup>

The purpose of this study in its analysis of the economic loss due to credit card fraud is threefold: (1) to first demonstrate that neither the courts nor the legislatures have thus far handled the above problem effectively; (2) to then show that the "liability-until-notice" system of fraud loss allocation presently employed by most card issuing companies is unsatisfactory; (3) to finally put forth suggestions for

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<sup>7</sup>52 MINN. L. REV. 885, 890 (1968) suggests that card issuers derive more benefits from the use of credit cards than do cardholders.

<sup>8</sup>Some service stations are experimenting with the policy of accepting only credit cards or exact change during late hours when robberies are most prevalent. H.R. REP. NO. 91-1500, *supra* note 1, at 55.

<sup>9</sup>Credit card fraud is presently costing Americans an estimated \$200,000,000 per year. Approximately 1.2 million credit cards are lost each year while an estimated 300,000 to 500,000 are stolen. H.R. REP. NO. 91-1500 *supra* note 1, at 2, 7. *See also* Kennedy, *The Plastic Jungle*, 31 MONT. L. REV. 29, 30 (1969) and Gallese, *Buy Now Pay Never*, Wall Street Journal, Nov. 18, 1970, at 1, col. 6, for evidence that much of the credit card theft which is presently occurring can be linked to organized crime. Apparently professional criminals often make use of stolen credit cards to travel around the country cost free.

<sup>10</sup>Credit card fraud can be defined as "a use of a credit card by a person, other than the cardholder, who does not have actual, implied, or apparent authority for such use and from which the cardholder receives no benefit," CAL. CIV. CODE § 1718 (a) (5) (West, Supp. 1971).

<sup>11</sup>This article does not focus on the liability of retail merchants. Although the issuer-merchant contract normally stipulates that the issuer may recover from a merchant who fails to exercise due care in accepting a forged credit card, this is seldom done. To do so would run the risk that some major retailers would discontinue to honor the issuer's credit cards. As a general rule, card issuers therefore prefer to sue the individual cardholders on the basis of their contractual relationship.

future legislation as to how losses resulting from the misuse of credit cards can be most equitably apportioned. For over fifty years the problem of credit card fraud loss has proven insolvable. With the advent of a credit-oriented society, the problem has recently magnified in importance. A remedy to the situation is therefore critical at this time.

## II. CASES INVOLVING CREDIT CARD FRAUD

There are surprisingly few cases dealing with credit card fraud loss when one considers the impact this problem has on our economy.<sup>12</sup> However, a careful analysis of the case law in this area surfaces two very important legal trends. From an evolutionary standpoint, it appears that as courts found loopholes in certain credit card agreements, card issuing companies continually modified their contract form. In so doing, they attempted to create a credit card arrangement that would best minimize their liability for fraud loss. Court decisions have therefore played a vital role in determining the form and nature of all contractual risk-shifting provisions up to the present time. The conflicting results of the reported cases also indicate that the courts have been either unwilling or unable to establish any uniform guideline as to how credit card fraud loss should be apportioned.<sup>13</sup> All that can actually be said for the conflicting opinions is that courts have had a great deal of difficulty in attempting to determine the exact nature of the legal relationship that exists between the parties in a credit card arrangement.

In looking at the cases individually, it is convenient to classify them as falling within one of three types of credit card plans: (1) that involving no written contract; (2) that involving a written contract which obligates the holder to pay for all purchases until his card is surrendered to the issuer; (3) that involving a written contract which obligates the holder to pay for all purchases until the issuer receives written notice that the card has been lost or stolen.

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<sup>12</sup>There are several reasons why there are so few recorded cases in this area. One factor is that many small losses simply are not sued upon by issuers for public relations reasons. Also, fierce competition among issuers to solicit cardholders has prompted them not to litigate in many cases. Perhaps the primary reason for the lack of cases is that cardholders often pay the amount in issue simply because they cannot afford a lawyer or because it would be more expensive to litigate the matter than to pay the claim.

<sup>13</sup>In fairness to the judiciary, perhaps the limited number of cases on the subject have not afforded them the opportunity to effectively solve the problem.

## A. NO WRITTEN CONTRACT

The earliest cases involving the misuse of credit cards and credit coins demonstrated the inability of courts to handle the problem of fraud loss apportionment with any degree of consistency. The absence of written contracts between card issuers and cardholders forced courts to construe the terms of the credit card agreements by implication. This perhaps partially explains why the decisions of these factually similar cases cannot be reconciled.

*Wanamaker v. Megary*,<sup>14</sup> decided by a Pennsylvania municipal court in 1915, was the first case of record to deal with the issue of credit card fraud loss. There the court prescribed a rule highly favorable to card issuers in generally stating that the holder of a credit coin was to be held liable for all unauthorized purchases made with his "coin". This was so even in the event that the card issuer was guilty of gross negligence in failing to ascertain the identity of an imposter presenting the "coin". This initial case therefore placed the entire risk of fraud loss upon the coinholder and, in effect, made him strictly liable for all fraud loss.<sup>15</sup>

In 1923, however, *Lit Bros. v. Haines*<sup>16</sup> expressly overruled<sup>17</sup> the holding of *Wanamaker*, in what was to be the first of several conflicting opinions in this area. The Supreme Court of New Jersey ruled that without proof of an agreement in which the holder consented to pay for all goods purchases by anyone presenting his coin, he would not be liable for any unauthorized purchases. The risk of loss which was placed entirely on the holder by *Wanamaker* was thus shifted to the issuer, absent an agreement to the contrary.<sup>18</sup>

The 1935 decision of a Pennsylvania lower court in *Gulf Refinery v. Plotnick*<sup>19</sup> substantially narrowed the liberal rule set forth in *Lit Bros.* and contradicted the prior holding of *Wanamaker*. As an im-

<sup>14</sup>24 Pa. Dist. 778 (Munic. Ct. Phil. 1915).

<sup>15</sup>Eight years later, in *Wanamaker v. Chase*, 81 Pa. Super. 201 (1923), a Pennsylvania court again ruled in favor of this same issuer. The holder was held liable for the unauthorized purchases since she applied for and received the coin with the understanding that anyone presenting the token and giving her name could purchase goods on her credit.

<sup>16</sup>98 N.J.L. 658, 121 A. 131 (1923).

<sup>17</sup>*Id.*, 121 A. at 131, 132.

<sup>18</sup>In a subsequent case, the court in *Jones Store Co. v. Kelly*, 225 Mo. App. 883, 36 S.W. 2d 681 (1931), reversed for the issuer though it did not depart from the rationale outlined in *Lit Bros.* The decision was based upon a finding that the credit coin had been used with the authorized holder's consent. The Missouri court stated at 36 S.W. 2d. 681, 683 that had the coin been used without the defendant's knowledge or consent he could not have been held liable for the resulting loss.

<sup>19</sup>24 Pa. D. & C. 147 (C.P. 1935).

plied condition of the credit card agreement, the court now imposed upon the holder and issuer a duty to exercise due care when using and honoring credit cards. Under this rule, a “negligent cardholder”<sup>20</sup> would be liable for the misuse of his credit card even though he had not previously agreed to assume liability for all unauthorized purchases. This case must be interpreted as contradicting both *Lit Bros.* and *Jones Store Co. v. Kelly*,<sup>21</sup> and limiting their application to instances where the cardholder was not negligent.

*Thomas v. Central Charge Service, Inc.*,<sup>22</sup> decided by the District of Columbia Court of Appeals in 1965, is the most poorly reasoned of all cases involving no written contract. The significance of this decision lies in its inconsistent application of rules of law set forth in two prior conflicting cases. In theory, the court appeared to adopt the rationale of *Plotnick* by stating that cardholders are under a duty to exercise reasonable care in using their credit cards. In practice, however, the court applied the rule introduced in *Lit Bros.* by recognizing that the cardholder was negligent,<sup>23</sup> but refusing to hold him liable on that basis.<sup>24</sup>

The apparent inconsistencies of these cases involving no written agreement is indicative of the difficulty experienced by the courts in attempting to define the rights and liabilities of cardholders and card issuers in this complex area of credit card misuse. Most of the decisions reached unsatisfactory results in that they placed the entire risk of fraud loss on either the issuer or holder. In *Wanamaker* the holder was held strictly liable for fraud losses regardless of negligence on the part of the issuer. On the other extreme, the courts in *Jones*, *Lit Bros.*, and *Thomas* held that the issuer must absorb fraud losses despite negligence on the part of the holder. Perhaps the most rational theory of loss allocation was pronounced in *Plotnick*, whereby a contract was implied and bound each party to exercise due care

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<sup>20</sup>The cardholder was negligent in *Plotnick* in that he received bills for the fraudulent use of his card, but failed to notify the issuer of its disappearance until 2½ months after the theft occurred. *Id.*, at 148.

<sup>21</sup>225 Mo. App. 883, 36 S.W. 2d 681.

<sup>22</sup>12 A. 2d 533 (D.C. Ct. App. 1965).

<sup>23</sup>The cardholder's negligence consisted of failing to notify the issuer of the loss of his credit card after discovering its disappearance. *Id.*, at 534.

<sup>24</sup>*Rayor v. Affiliated Credit Bureau, Inc.*, 455 P. 2d 859 (Colo. 1969), is also a post 1960 case which did not involve a written contract. A decision was rendered for the holder on the basis that he was not negligent and had not agreed to assume liability for unauthorized purchases. Although both *Thomas* and *Plotnick* were cited as authority for the decision, the absence of cardholder negligence precluded a literal application of the *Thomas* rationale. Given the additional factor of cardholder negligence it is unclear as to which of the above two conflicting decisions the Colorado Supreme Court would have followed.

in using and honoring the credit card. The decisions as a whole, however, offer no definitive rule as to how fraud loss shall be apportioned in the absence of a written contract between the parties. At best they stand for the general proposition that a cardholder is not automatically liable unless he has specifically contracted to bear the loss resultant from the unauthorized use of his card.

## B. LIABILITY-UNTIL-SURRENDER CLAUSE

The scattered results of the early cases made card issuers aware of the risks involved in allowing the courts to completely define the terms and conditions of their credit card arrangements. In an attempt to best protect themselves, and to inject an element of stability into the credit card system, issuers began including specific contract clauses in their written credit card agreements. This type of contractual arrangement forced the cardholder to bear the risk of loss for unauthorized purchases. Card issuers thereby hoped to minimize the role of the courts to merely enforcing the provisions of these contracts. The first such risk-shifting provision was the so-called "liability-until-surrender clause". Basically, it provided that the cardholder was to be liable for all purchases made with his card until it was surrendered to the issuer.

To date there have been only two reported cases involving a "liability-until-surrender" type of credit card agreement. The first was the 1943 decision of *Magnolia Petroleum Co. v. McMillan*.<sup>25</sup> In that case liability could have been predicated upon the cardholder's negligence in loaning his card to two friends and failing to report its misuse to the issuer. However, the Texas Court of Appeals ignored the issue of negligence, and based its decision upon a strict reading of the credit card agreement.<sup>26</sup> The cardholder was therefore held liable solely on the basis of his agreement to be responsible for all purchases made with his card prior to its surrender to the issuer.

On the other hand, the Supreme Court of Arkansas reached a contrary result when forced to construe a similar credit card agreement in the 1945 case of *Gulf Refinery Co. v. Williams*.<sup>27</sup> There, the court rejected the rationale of *Magnolia* by focusing its attention on

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<sup>25</sup>168 S.W. 2d 881 (Tex. Civ. App. 1943).

<sup>26</sup>The contract read as follows: "The named holder shall be responsible for all purchases made by use of this card, prior to its surrender to the issuing company, whether or not such purchases are made by the named holder or into the card described." *Id.*, at 881.

<sup>27</sup>208 Ark. 362, 186 S.W. 2d 790 (1945).

acts of negligence and bad faith. Because evidence pointed to specific acts of collusion between the imposter and retail dealers who honored the card,<sup>28</sup> the court refused to enforce the contract as written. Rather, it relied on an assignment theory in holding that a merchant's negligence or bad faith would defeat an issuer's claim for the strict enforcement of a surrender clause contract against a holder.

The fact that there are but two reported decisions dealing with surrender clause contracts is evidence that this type of risk-shifting provision was not used extensively.<sup>29</sup> Nevertheless, the conflicting results of these cases indicated that courts could no more uniformly apportion fraud loss under written credit card agreements than they had in the absence of such agreements.

### C. LIABILITY-UNTIL-NOTICE CLAUSE

When card issuers abandoned the use of the surrender clause, they began to incorporate a "liability-until-notice" clause in their credit card contracts.<sup>30</sup> It was less one-sided than the surrender clause and issuers hoped that courts would be more receptive toward it as a risk-shifting provision.<sup>31</sup> Basically, it placed the risk of unauthorized purchases on the holder until the issuer received written notice that his card was lost or stolen. Since most modern credit card arrangements employ the liability-until-notice clause, courts have been confronted with this provision in almost all recent cases of credit card fraud. The liability of the holder in such cases turns on the binding effect of this contract clause. The courts, however, have thus far failed to interpret the "notice clause" with any degree of consistency.

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<sup>28</sup>Id., 186 S.W. 2d at 793.

<sup>29</sup>Card issuers ceased using this provision voluntarily as they probably feared courts would overrule it as being overly harsh. There was also the obvious danger that it might discourage many potential customers. Indeed it was overly broad in considering that when a credit card is lost or stolen there is no way the authorized holder can surrender it to the issuer and thereby terminate his liability.

<sup>30</sup>A typical risk shifting clause found on the reverse side of a major oil company credit card read as follows: "This card confirms the authorization of credit during the period shown, to the person, corporation or firm whose name is embossed on the reverse side thereof. Such person, corporation, or firm assumes full responsibility for all purchases made hereunder by any one through the use of this card prior to surrendering it to the company or giving the company notice in writing that the card has been lost or stolen. Retention of this card or use thereof constitutes acceptance of all terms and conditions thereof." *Texaco v. Goldstein*, 34 Misc. 2d 751, 229 N.Y.S. 2d 51, 53 (1962).

<sup>31</sup>Macaulay, *Private Legislation and the Duty to Read - Business Run by IBM Machine, the Law of Contracts and Credit Cards*, 19 VAND L. REV. 1051, 1076 (1966) [hereinafter cited as Macaulay]. This article suggests that the notice clause was probably predicated upon the *Plotnick* case.



An analysis of the cases reveals two separate and distinct lines of judicial thought as to when notice clause contracts should be strictly enforced against cardholders. Representing the "strict contract" approach, some courts have consistently held for the card issuer by narrowly construing the contract against the holder. Under this view the credit card agreement will normally be enforced as written. Likewise, the negligence of a retail merchant in extending credit to an imposter is generally ignored. Therefore, under the "strict contract" approach, the risk of fraud loss is placed almost entirely upon the cardholder. Representing the more "liberal" approach, other courts have allowed the holder to avoid liability in certain instances notwithstanding the provisions of the issuer-holder agreement.<sup>32</sup> Courts subscribing to this latter view have circumvented the strict application of notice clause contracts by imposing upon issuers and retail dealers a duty to exercise due care when honoring credit cards. The liberal decisions are therefore based upon a fault concept, and exempt the holder from liability when negligence or bad faith on the part of the issuer or dealer can be shown.

### 1. STRICT CONTRACT APPROACH<sup>33</sup>

The first case to strictly construe a "liability-until-notice clause contract was the 1962 decision of *Texaco, Inc. v. Goldstein*.<sup>34</sup> When sued for the amount of unauthorized purchases made with his card, the cardholder asserted that the conditions of the credit card agreement had not been properly called to his attention. The New York lower court rejected this as a valid defense by holding the credit card contract to be decisive of liability. The court additionally refused to regard the negligence of a retail dealer as a factor to be considered in determining the liability of a card issuer.<sup>35</sup>

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<sup>32</sup>Courts subscribing to the "liberal" viewpoint are clearly basing their decisions upon a liberal reading of the contract rather than holding the notice clause to be void as contrary to public policy. However, the willingness with which the courts allow cardholders to escape liability is no doubt indicative of their disfavor of the clause.

<sup>33</sup>By strict contract approach, it is meant that some courts have consistently strictly construed the "liability-until-notice" clause of the credit card contract. A cardholder who fails to give the required notice is normally held strictly liable for unauthorized purchases made with his card.

<sup>34</sup>34 Misc. 2d 751, 229 N.Y.S. 2d 51 (1962).

<sup>35</sup>The court declared that "With the increasing use of the credit card and its growing importance to the economy, the imposition of a high duty of diligence upon the major oil companies in general, most of whom use the same or similar system of credit card transactions would result in an impairment of an important segment of our economic structure. We must take into consideration that for the most part, the dealers to whom the cards are presented are independent contractors engaged in private enterprise." *Id.*, 229 N.Y.S. 2d at 55.

In 1967, another New York lower court rendered a decision even more favorable to card issuers in the case of *Uni Serv Corp. v. Vitello*.<sup>36</sup> Here, the cardholder notified the issuer by telephone immediately after discovering that her credit card was missing. The court, however, construed the liability-until-written-notice clause so strictly that the cardholder was held liable for the unauthorized charges made subsequent to her telephone call. Likewise, even the negligence<sup>37</sup> of the card issuer did not prevent the court from strictly enforcing the contract.

Representing an even more rigid application of the "strict contract" theory than either *Goldstein* or *Vitello* was the 1969 decision of *Sears Roebuck and Co. v. Duke*.<sup>38</sup> In *Sears* the credit card contract was silent as to who bore the risk of loss for unauthorized use. The agreement, however, was interpreted by the Supreme Court of Texas to mean that the holder consented to pay for all purchases made with his card until the issuer was notified of its loss or theft. The court therefore took it upon itself to rewrite the contract in terms most favorable to the card issuer. It was additionally held that proof of a retail merchant's negligence in accepting a stolen credit card was a defense which must be affirmatively proved by the cardholder.<sup>39</sup> As a final measure, the court reinforced the rationale of *Goldstein* by holding that a card issuer need demand no more identification than the credit card itself when ascertaining the authority of a purchaser.

*Goldstein*, *Vitello*, and *Sears* are examples of cases in which courts have adopted a "strict contract" approach in apportioning credit card fraud loss. *Goldstein* and *Vitello* are similar in their refusal to recognize the negligence of a card issuer as having a bearing on the issue of liability. Instead, both courts held the holder liable for the misuse of his card by strictly enforcing the liability-until-written-notice clause of the credit card contract. The court in *Sears*, however, went a step further than either of the above cases. Although the agreement was silent as to the apportionment of fraud loss, the court held it to include the standard notice clause. The contract was then strictly construed against the cardholder on that basis.

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<sup>36</sup>53 Misc. 2d 396, 278 N.Y.S. 2d 969 (1967).

<sup>37</sup>The negligence of the card issuer consisted of extending almost \$700 worth of credit to an account whose pre-determined limit was set at \$250. *Id.*, 278 N.Y.S. 2d at 970.

<sup>38</sup>441 S.W. 2d 521 (Tex. Civ. App. 1969). *See generally* 21 BAYLOR L. REV. 547 (1969); 27 WASH. & LEE L. REV. 164 (1970).

<sup>39</sup>This holding is in direct conflict with the earlier cases of *Union Oil Co. v. Lull*, 220 Ore. 412, 349 P.2d 243 (1960) and *Diner's Club, Inc. v. Whited*, Civ. No. A 10872, Los Angeles Super. Ct. Aug. 6, 1964. These cases placed upon the issuer the burden of proving neither he nor his agents were negligent in accepting stolen credit cards.

## 2. LIBERAL APPROACH

Yet another line of cases has consistently allowed cardholders to avoid liability for fraud losses by liberally construing credit card contracts. In the 1960 case of *Union Oil Co. v. Lull*,<sup>40</sup> the Supreme Court of Oregon focused its attention on the negligence of the card issuing company in order to negate the binding effect of the agreement between the parties. The contract was interpreted as subjecting the holder to liability for the misuse of his credit card only if due care was exercised by the issuer and its agents in ascertaining the authority of a person presenting the card. The court furthermore placed the burden upon the issuer to demonstrate that its agents had exercised this standard of care. Admittedly, such a rule works an extreme hardship on card issuers. Retail merchants will normally be unable to recall the details surrounding any one particular sale. However, it must be emphasized that to place the burden of proof on the cardholder, as was done in *Sears*, offers no solution to the problem.<sup>41</sup> The holder is never present when the unauthorized purchases are made, and it would be impossible for him to prove that due care was not used. A better rule, therefore, is to place the burden of proof upon card issuers. Their agents are always present when the fraud occurs, and could record each purchase if necessary to prove that reasonable care had been exercised.<sup>42</sup>

Despite its factual similarity to *Sears*, the 1967 decision of *Allied Stores v. Fundurburke*<sup>43</sup> is the case which has most severely restricted the enforcement of the liability-until-notice clause.<sup>44</sup> Judgement was entered for the cardholder on the basis of what the court held to be an ambiguity in the credit card agreement. The holder had not contracted to assume liability for the misuse of his card when unaware of its disappearance. Because he was thereby unable to give the required notice, the New York lower court ruled the liability-until-notice contract to be inapplicable.<sup>45</sup> The court additionally based

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<sup>40</sup>220 Ore. 412, 349 P. 2d 243 (1960).

<sup>41</sup>See 43 N.C. L. REV. 416, 422 (1964-1965).

<sup>42</sup>In *Diner's Club, Inc. v. Whited* Civ. No. A 10872, Los Angeles Super. Ct. Aug. 6, 1964, the California court relied heavily upon *Lull* in holding that both the issuer and the holder owed one another a duty of care to see that irregular charges were not incurred. The decision of a lower court was then reversed on the grounds that the issuer had not met his burden of proof by demonstrating that due care had been exercised by its agents.

<sup>43</sup>52 Misc. 2d 872, 277 N.Y.S. 2d 8 (N. Y. City Civ. Ct. 1967).

<sup>44</sup>See generally 52 MINN. L. REV. 885 (1968).

<sup>45</sup>The court also ruled the cardholder to be free from fault by stating that the mere fact that a thief improperly used the defendant's card was not conclusive of negli-

its decision on a finding that the issuer was negligent in granting \$2,460 in unauthorized charges to an account whose predetermined limit was set at \$200.<sup>46</sup>

Thus, whereas *Union Oil* relied upon a finding of negligence to avoid application of the credit card contract, *Fundurburke* liberally construed the terms of the instrument in order to negate its binding effect. Both cases are therefore examples of some courts' distaste of the notice clause, and evidence a willingness to evade its strict application.

#### D. SUMMARY OF THE CASES TO DATE

An analysis of the reported cases reveals that the distribution of credit card fraud loss has traditionally been left to the card issuer. It is also evident that the issuing companies continually modified the terms of the issuer-holder agreement to insure that the cardholder would assume the risk of fraud loss.

The conflicting results of the early cases not involving written contracts demonstrates the initial inability of courts to formulate a consistent rule of allocating losses generated by credit card misuse. When later forced to deal with the problem in terms of written credit card agreements, the courts were again divided in opinion. Some courts refused to enforce the conditions of these contracts in the presence of negligence or bad faith on the part of card issuers or their agents. Other courts applied a more rigid standard by simply enforcing the issuer-holder agreements as written. As a result of this conflict of authority there exists no set of established judicial standards governing the circumstances under which credit card contracts will or will not be strictly enforced. Perhaps all that can be said is that in the absence of any evidence of negligence on the part of the issuer or its agents, liability will most likely fall on the cardholder who fails to report the disappearance of his credit card. The tremendous difficulty which courts have experienced in attempting to define the rights of the parties in cases of credit card fraud loss suggests that this is not an area that lends itself to effective judicial regulation. It would therefore appear that the burden rests upon the legislature to promptly formulate a set of positive guidelines governing the apportionment of credit card fraud loss.

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gence. *Allied Stores v. Fundurburke*, 52 Misc. 2d 872, 277 N.Y.S. 2d 8, 13 (N.Y. City Civ. Ct. 1967).

<sup>46</sup>*Id.* at 10, 14. When confronted with similar acts of negligence by an issuer, the court in *Vitello* did not hesitate to strictly enforce the credit card contract against the holder.

### III. EXISTING CREDIT CARD FRAUD LEGISLATION

Prior to 1967, New York was the only state to have enacted a statute aimed at limiting cardholder liability for the unauthorized use of credit cards.<sup>47</sup> To date, twelve additional states and the federal government have promulgated legislation concerning the apportionment of fraud loss.<sup>48</sup> Such legislative activity no doubt demonstrates an increasing awareness of the problem. However, an analysis of the enacted statutes reveals that neither state nor federal governments have thus far arrived at the means to most equitably distribute credit card fraud loss.

The California legislation<sup>49</sup> on this topic is representative of that

<sup>47</sup>L. 1967, ch. 753 (1967), *as amended* N.Y. GEN. BUS. LAW Sec. 512 (McKinney Supp. 1970-1971).

<sup>48</sup>California; CAL. CIV. CODE § 1718 (West Supp. 1971). Hawaii; 38 H.R.S. ch. 730, § 730-12 (Supp. 1970). Illinois; 121½ ILL. ANNO. ST. § 382 (Supp. 1971). Maine; 17 MAINE REV. STATS. ANNO. § 1635 (Supp. 1970-1971). Maryland; MAR. ANNO. CODE art. 83, § 21B (1969). Massachusetts; 42 M.G.S.A. ch. 255, § 12E (Supp. 1971). Minnesota; M.S.A. ch. 325, § 325.932 (Supp. 1971). New York; N.Y. GEN. BUS. LAW § 512 (McKinney Supp. 1970-1971), *formerly* L. 1967, ch. 753 (1967). North Dakota; 51 N.D.C.C. ch. 51-14.1-02 (Supp. 1969). South Dakota; 54 S.D.C.L. ch. 54-11, § 54-11-4 (Supp. 1970). Tennessee; 47 T.C.A. ch. 15, § 47-15-117 (Supp. 1970). Vermont; 9 V.S.A. § 4042 (Supp. 1970). Virginia; 11 C.O.V. ch. 6, §§ 11-30, 11-31 (Supp. 1970). Federal Law; Consumer Credit Protection Act, 15 U.S.C.A. §§ 1642-1644 (Supp. 1971).

<sup>49</sup>The only California legislation pertaining to the misuse of credit cards is found in § 1718 of the Civil Code. The statute reads as follows:

(a) As used in this section:

(1) "Credit card" means any instrument or device, whether known as a credit card, credit plate, or by any other name, issued with or without fee by a card issuer for the use of the cardholder in obtaining money, goods, services, or anything else of value, either on credit or in consideration of an undertaking or guaranty by the issuer of the payment of a check drawn by the cardholder.

(2) "Accepted credit card" means any credit card which the cardholder requested in writing or has signed or has used, or authorized another to use, for the purpose of obtaining money, property, labor or services on credit. A renewal credit card shall be deemed to be accepted if it is issued within one year after a prior card has been paid for or used. A credit card issued in connection with a merger, acquisition, or the like of card issuers or credit card services in substitution for an accepted credit card shall be deemed to be an accepted credit card.

(3) "Card issuer" means the business organization or financial institution which issues a credit card, or its duly authorized agent.

(4) "Cardholder" means the person or organization identified on the face of a credit card to whom or for whose benefit the credit card is issued by a card issuer.

(5) "Unauthorized use" means a use of a credit card by a person, other than the cardholder, who does not have actual, implied, or apparent authority for such use and from which use the cardholder receives no benefit.

enacted by several other states.<sup>50</sup> Comments relating to it will therefore be relevant to other existing legislation on the subject.<sup>51</sup> Although the California statute is slightly more liberal than the traditional risk-shifting provision found in most credit card agreements, it is unsatisfactory in that it leaves the basic framework of the liability-until-notice clause unchanged. It therefore partially acts to solidify the application of the liability-until-notice clause by recognizing it as a valid risk-shifting proposal. In fact, when the statute is carefully analyzed it is obvious that the basic form of loss distribution currently employed by most credit card companies has merely been restated in statutory form.<sup>52</sup>

Notwithstanding its shortcomings, it is apparent that California Civil Code 1718 does deviate somewhat from the conventional liability-until-notice clause. Standard credit card agreements place the risk of unauthorized purchases on the cardholder until the issuer receives *written notice* of a loss or theft. California Civil Code 1718 (c) broadens the notice requirement by providing that the holder's risk of loss is terminated when he "notifies" the issuer "by telephone, telegraph, letter or any other reasonable means."<sup>53</sup> The word "notifies" would also suggest that the requirement is satisfied when the notice is *communicated* by the cardholder, and not when *received* by the issuer.

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(b) The cardholder is not liable for any unauthorized use of a credit card which has not become an accepted credit card.

(c) If an accepted credit card is lost or stolen after the credit card has reached the cardholder, and the cardholder notifies the card issuer within a reasonable time by telephone, telegraph, letter, or any other reasonable means after discovery of the loss or theft or after the time in which a reasonable man in the exercise of ordinary care would have discovered the loss or theft, the cardholder is not liable for any unauthorized use of the credit card.

(d) This section applies only to credit cards originally issued or renewed on or after the effective date of this section. CAL. CIV. CODE § 1718 (West Supp. 1971).

<sup>50</sup>Maine; 17 MAINE REV. STATS. ANNO. § 1635 (Supp. 1970-1971). Massachusetts; 42 M.G.L.A. ch. 255, § 12E (Supp. 1971). Minnesota; M.S.A. ch. 325, § 325.932 (Supp. 1971). New York; N.Y. GEN. BUS. LAW § 512 (McKinney Supp. 1970-1971). North Dakota; 51 N.D.C.C. ch. 51-14.1-02 (Supp. 1969). Tennessee; 47 T.C.A. ch. 15, § 47-15-117 (Supp. 1970). Vermont; 9 V.S.A. § 4042 (Supp. 1970).

<sup>51</sup>The laws of these states (*see* note 50 *supra*) are similar to California legislation in requiring a cardholder to assume liability for unauthorized purchases made before he has notified the issuer of the loss or theft of his card. Their only significant difference from California is in fixing maximum amounts for which cardholders may be held liable notwithstanding their failure to give the required notice.

<sup>52</sup>CAL. CIV. CODE § 1718(c) (West Supp. 1971) generally provides that a cardholder's liability for unauthorized purchases is not terminated until he "notifies" the issuer that his card has been lost or stolen. *See* pgs. 393-397 *infra* for reasons as to why liability-until-notice is not a satisfactory method of allocating credit card fraud loss.

<sup>53</sup>CAL. CIV. CODE § 1718 (c) (West. Supp. 1971).

Subsection (c) also slightly modifies the standard credit card arrangement by allowing the cardholder both a reasonable time to notify the issuer after a loss is discovered, and also a reasonable time in which to discover the loss or theft. "Reasonable time", however, is not defined in the statute, and it remains to be seen just how broadly courts will construe the term.

Subsection (b) of the statute generally deals with the problem of unsolicited credit cards by providing that a cardholder is not liable for the unauthorized use of a card which he has not requested in writing nor previously used. However, subsection (b) has been largely superseded by the enactment of §132<sup>54</sup> and an amendment to §103<sup>55</sup> of the Federal Truth in Lending Act. Section 132 now prohibits the mailing of unsolicited credit cards. Unlike the California law, §103(1) expressly provides for the contingency of a card which has been requested in writing, but is stolen and fraudulently used before reaching the authorized holder. It states that no cardholder liability will accrue for the misuse of a card which has not been *received* by the holder. Thus, when evaluating this California statute as a whole, it must be emphasized that although it offers no definitive answer to the problem of fraud loss, it does shift the risk of loss more favorably toward the cardholder.<sup>56</sup>

Special attention must also be given to statutes enacted by several other states.<sup>57</sup> The laws of these states represent the most radical approach thus far adopted to minimize cardholder loss. They afford the consumer more protection than the California statute by imposing a maximum amount for which a holder may be held liable for any misuse of his credit card. The liability ceilings set by these states range

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<sup>54</sup>Consumer Credit Protection Act, 15 U.S.C.A. § 1642 (Supp. 1971).

<sup>55</sup>*Id.* at § 1602 (1).

<sup>56</sup>The failure of two bills to pass during the 1970 session of the California legislature suggests an unwillingness to enact proposals aimed at minimizing credit card fraud loss. Each of these bills was concerned with improving credit card identification systems in an attempt to aid merchants in detecting unauthorized users. S.B. 286 provided that a cardholder was not liable for unauthorized purchases made with a card not containing a signature panel. A.B. 856 provided that the issuer must place the cardholder's birth date, height, weight, eyes and hair color on the card before it could be validly used in California. It is unfortunate that these bills did not pass as they would have been a valuable supplement to CAL. CIV. CODE § 1718 (West. Supp. 1971).

<sup>57</sup>Illinois; 121½ ILL. ANNO. ST. § 382 (Supp. 1970). Maine; 17 MAINE REV. STATS. ANNO. § 1635 (Supp. 1970-71). Massachusetts; 42 M.G.L.A. ch. 255, § 12E (Supp. 1971). Minnesota; M.S.A. ch. 325, § 325.932 (Supp. 1971). New York; N.Y. GEN. BUS. LAW § 512 (McKinney Supp. 1970-1971), *formerly* L. 1967, ch. 753 (1967). North Dakota; 51 N.D.C.C. ch. 51-14.1-02 (Supp. 1969). Tennessee; 47 T.C.A. ch. 15, § 47-15-117 (Supp. 1970). Vermont; 9 V.S.A. § 4042 (Supp. 1970).

from \$25 to \$250.<sup>58</sup> Although such legislation may seem very progressive at first glance, it nonetheless provides no solution to the problem. Its sole effect is to minimize the loss ceiling while allowing the liability-until-notice system to remain basically unchanged. To the extent of the statutory maximum, cardholder liability is still predicated upon notice of loss or theft being given to the issuer. Although this legislation may therefore serve to reduce the total amount of cardholder loss, it is unsatisfactory in that it allows the risk of loss to remain largely upon the cardholder.<sup>59</sup> Therefore, like California law, the laws of other states offer only a poor compromise to the existing system.

The federal government has also taken cognizance of the credit card fraud problem by recently enacting legislation<sup>60</sup> aimed at minimizing cardholder loss. The statute, which went into effect on January 24, 1971, adds §§ 132, 133 and 134 to the Federal Truth in Lending Act.<sup>61</sup> It generally prohibits the issuance of unsolicited cards, and limits cardholder liability for unauthorized purchases to \$50. No cardholder liability accrues for unauthorized uses occurring after the holder has notified the issuer of the loss or theft of his card. Issuers are furthermore required to supply all cardholders with a self-addressed, pre-stamped notice for use in case of loss or theft. The act additionally places the burden of proving liability for credit card uses on the issuer, and provides for criminal penalties for some fraudulent card uses.

Although the exact effect the federal statute will have on state law has yet to be determined, it would appear that its purpose is to supplement existing state legislation rather than to pre-empt it.<sup>62</sup> The federal law must be seen as setting forth the minimum requirement under which card issuing companies must operate. The states would therefore seem free to make their regulations more strict than the federal statute, although they may not enact regulations which fail to meet its basic requirements.

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<sup>58</sup>N.Y. GEN. BUS. LAW § 512 (McKinney Supp. 1970-1971), *formerly* L. 1967, ch. 753 (1967) provides for liability ceilings ranging from \$25 to \$250.

<sup>59</sup>*See* pgs. 393-397 *infra*, for a further discussion as to why a limitation on cardholder liability is not a valid means by which to distribute fraud loss.

<sup>60</sup>Consumer Credit Protection Act, 15 U.S.C.A. §§ 1642-1644 (Supp. 1971).

<sup>61</sup>Consumer Credit Protection Act, title I., 15 U.S.C.A. §§ 1601-1665 (Supp. 1971).

<sup>62</sup>*Id.* §§ 1610(a), 1643(c). Also, in an address before the Practicing Lawyer's Institute on December 7, 1970, Mr. Carl D. Lobell (Weil, Gotshall and Manges, New York City, Member of Committee on Consumer Protection, Antitrust Section and Committees on Sections 7 and 8 of the Clayton Act, and American Bar Association) stated that states are free to make their credit card legislation more strict than the requirements of the new federal law.



Close scrutiny of the new federal law reveals that it is not nearly so innovative as it might seem at first glance. It is actually nothing more than a compilation of portions of existing state laws, and is therefore subject to similar criticism. Even though it offers no definitive solution to the problem of loss distribution the federal law does offer one benefit. It provides a set of uniform minimum requirements which must be satisfied in all credit card arrangements. Therefore, cardholders who reside in any one of the many states which have not enacted credit card legislation are afforded the protection offered by the newly enacted provisions of the Truth in Lending Act.

An overview of the manner in which legislatures have handled the problem of allocating credit card fraud loss indicates that they have not acted firmly enough in this area of growing importance. Perhaps all that can be said is that recent legislation no longer allows card issuers to promulgate a form of private legislation through the use of standardized contract provisions. Issuers have instead been forced to modify the traditional form of the liability-until-notice system of loss apportionment in order to comply with statutory requirements.

#### **IV. THE NOTICE CLAUSE**

An analysis of both case law and legislation pertinent to the problem of credit card fraud loss would seem to indicate that our legal system is not operating effectively in this area. This ineffectiveness is largely due to the fact that the liability-until-notice clause is still employed by most major card issuers. It is a risk-shifting provision that was developed over 30 years ago, and has been continually used by issuers because it affords them maximum protection from loss. Although the courts and legislature have lessened the harshness of its practical application, it nevertheless continues to govern the means by which fraud loss is apportioned. An equitable system of loss distribution will result only when it is completely abolished.

At first glance the notice clause may appear to be a reasonable and valid risk-shifting proposal. The cardholder originally has possession of his card and can best protect against loss by exercising due care in using it. When the cardholder reports the loss or theft of his card to the issuer, the risk of loss shifts to the issuer since he is in a better position to see that card is not fraudulently used. Close scrutiny of the notice clause, however, reveals that it is unsatisfactory in meeting the needs of the consumer from functional, philosophical and legal standpoints.

A. FUNCTIONAL STANDPOINT<sup>63</sup>

In a functional sense, it is doubtful that the notice clause presently serves its originally intended purpose. When first conceived, the primary reason for requiring the cardholder to report a loss or theft was to allow the issuer to notify his retail dealers that certain cards were no longer valid. This notification was traditionally termed a "hot list", and consisted of a list of credit card numbers that had been reported lost or stolen.<sup>64</sup> Theoretically, merchants checked the list on every credit card purchase, and honored only those cards whose numbers did not appear on the list.<sup>65</sup>

While this system may have once been an effective means of detecting unauthorized users of credit cards, it no longer achieves that purpose. Its current inadequacy stems from the fact that many issuers have discontinued circulating hot lists. With the rapid expansion of the credit card system, the practice simply became too expensive.<sup>66</sup> There is also evidence that hot lists eventually became so long that merchants could not reasonably be expected to check every purchase against the list.<sup>67</sup> Also, even when the lists are circulated and checked, there is often as much as a 30 day time lapse between the time the issuer receives notice and the circulation of the list is accomplished.<sup>68</sup>

In addition, many issuers do not follow the practice of changing a customer's account number after his card has been reported lost or stolen.<sup>69</sup> He is issued a new card bearing the same identification number as his old one, and told to report any unauthorized charges appearing on his monthly statement. Though this type of policy is obviously geared toward minimizing excess clerical expense, it also makes the use of hot lists impossible. In light of the practices followed by some card issuing companies, the practical utility of the notice clause is indeed questionable. It is therefore difficult to see how it serves its directed purpose of loss minimization.

## B. PHILOSOPHICAL STANDPOINT

From a philosophical standpoint the notice clause is an arbitrary

<sup>63</sup>As used here, "functional standpoint" refers to the manner in which card issuing companies apply the "liability-until-notice" clause after being informed that a credit card has been lost or stolen.

<sup>64</sup>Bergsten, *Credit Cards, A Prelude to a Cashless Society*, 8 B.C. IND. & COM. L. REV. 485, 505 (1967) [hereinafter cited as Bergsten].

<sup>65</sup>*Id.*, at 505.

<sup>66</sup>Macaulay, *supra* note 31, at 1109.

<sup>67</sup>H.R. REP. NO. 91-1500, *supra* note 1, at 8.

<sup>68</sup>Bergsten, *supra* note 64, at 505.

<sup>69</sup>Macaulay, *supra* note 31, at 1111-1113.

system of loss allocation that fails to consistently place liability where fault lies. This concept can best be illustrated by the use of examples. The standard liability-until-notice clause places the risk of unauthorized purchases on the cardholder in the interim between the theft or loss of the card and the cardholder's discovery of its disappearance.<sup>70</sup> Assume, as an example, that a cardholder's credit card is taken from him without his knowledge and through no fault of his own.<sup>71</sup> Here, where the cardholder is unaware of the loss and clearly free of any negligence, it is not fair that he should bear the entire risk of misuse when he can do nothing to minimize the risk.

As an additional example, assume the existence of two separate cardholders. Cardholder *A* is not negligent and is unaware that his credit card has been stolen and improperly used. In his next monthly statement, *A* discovers the irregular charges and immediately notifies the issuer of the theft. Pursuant to the credit card arrangement, *A* will be liable for the fraudulent purchases. Cardholder *B* negligently lost his credit card and became aware of the loss shortly thereafter. However, he failed to notify the issuer until he received his next monthly statement and was therefore liable for his card's misuse. Thus, whereas Cardholder *A* was completely innocent of any fault, his liability is equal to that of Cardholder *B* who was negligent both in losing his card and in failing to give the required notice after becoming aware of its loss. These examples therefore serve to illustrate the inequity of the notice clause in its failure to consistently allocate fraud loss according to the negligence or fault of credit card holders.

### C. LEGAL STANDPOINT

In addition to its functional and philosophical shortcomings, the legality of the notice clause is also vulnerable to attack. There is evidence to support the proposition that it is a contract of adhesion and therefore void as against public policy.<sup>72</sup> For this purpose, a contract

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<sup>70</sup>CAL. CIV. CODE § 1718 (West. Supp. 1971) has closed this loophole by allowing the cardholder reasonable time to discover and report the loss before the risk of liability attaches. The issuer should logically assume the risk of loss during this period since his agents will at least be in contact with an imposter. They will therefore be in a much better position than the cardholder to prevent fraud loss.

<sup>71</sup>In *Allied Stores v. Fundurburke*, 52 Misc. 2d 872, 227 N.Y.S. 2d 8 (N.Y. City Civ. Ct. 1967) the court stated that the mere fact that a credit card was being used without authorization as a result of a loss or theft does not necessarily mean that the cardholder failed to exercise reasonable care.

<sup>72</sup>For materials relating to contracts of adhesion *see generally* the following: Kessler, *Contracts of Adhesion - Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943); Ehrenzweig, *Adhesion Contracts In the Conflict of Laws*, 53

of adhesion may be defined as a standardized contract which is expertly drafted by a party of superior economic bargaining power, and is then presented to a weaker party as the only acceptable agreement. In such a contractual arrangement, the absence of any form of arm's length negotiation assures that all questions will be resolved in favor of the dominant party.

The policy of invalidating these contracts as being contrary to public policy was firmly established in the case of *Henningsen v. Bloomfield Motors*.<sup>73</sup> In that case a uniform disclaimer was used by virtually all automobile manufacturers so that anyone purchasing a new automobile was offered no real choice of contract terms. The court emphasized the disparity of bargaining power between the parties and held the clause void as being detrimental to the general public welfare. Since the *Henningsen* decision, it has been suggested that the adhesion doctrine is not limited solely to contracts involving the sale of goods.<sup>74</sup> Several commentators have gone so far as to suggest that it may properly be extended to the area of credit card contracts.<sup>75</sup>

Indeed it would appear that most modern credit card arrangements fall within the definition of an adhesion contract under the rule pronounced by *Henningsen*. The liability-until-notice clause is a standardized contract provision which most major card issuers presently incorporate in their issuer-holder contracts.<sup>76</sup> Due to his lack of bargaining power, the consumer who wishes to purchase goods on credit is therefore forced to accept this contract which has been unilaterally drafted by the issuer.

The probable reason why no court has thus far invalidated a credit card arrangement on public policy grounds is that the use of credit cards has not been considered an economic necessity. That is to say, a consumer could just as easily purchase products by cash or check as by the use of credit cards. However, even if this statement is accepted as true, a strong argument can still be made in favor of the adhesion theory. The thrust of the argument is that the consumer is invariably offered no choice regarding the terms of the contract. The only option

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COLUM. L. REV. 1072 (1953); Schuchman, *Consumer Credit by Adhesion Contracts*, 35 TEMP. L.Q. 125 (1962); Meyer, *Contracts of Adhesion and the Doctrine of Fundamental Breach*, 50 VA. L. REV. 1178 (1964); Note, *Contractual Limitations of Contract Liability*, 47 IA. L. REV. 964 (1961-1962); Comment, *Contracts of Adhesion Under California Law*, 1 U. SAN FRANCISCO L. REV. 306 (1967).

<sup>73</sup>161 A. 2d 69 (N.J. 1960).

<sup>74</sup>See 1 U. SAN FRANCISCO L. REV. 306, 309 and *Tunki v. Regents of University of California*, 60 Cal. 2d 92, 383 P.2d 44.1, 32 Cal. Rptr. 33 (1963).

<sup>75</sup>Bergsten, *supra* note 64 at 497, 498; Comment, 22 LA. L. REV. 640, 647-649 (1961-1962); Comment, 77 YALE L. J. 1418, 1423 n. 38 (1968); Comment, 48 CALIF. L. REV. 459, 487-488n. 135 (1960)

<sup>76</sup>See 6 CORBIN, CONTRACTS § 1472 (1951).

actually available to him involves either accepting the uniform notice clause contract or refraining from using credit cards altogether. This is certainly not a meaningful choice that serves to render the adhesion doctrine inoperative.

In addition to the consumer's lack of available options regarding contract terms, one must consider the role of the credit card in today's economy. A persuasive argument can be made that credit cards have become a virtual necessity to most people. Indeed, the development of a completely credit-oriented society has greatly magnified the importance of credit cards. The argument that a consumer suffers little detriment when "choosing" not to use credit cards is therefore much less convincing than it once was. Thus, the doctrine of adhesion stands in strong support for the abolishment of the notice-clause contract. By way of public policy, the protection afforded issuing companies by this provision undoubtedly extends beyond legitimate economic interests of distributing credit card fraud loss.

## V. SUGGESTED REMEDIES TO THE PROBLEM OF FRAUD LOSS APPORTIONMENT

Any solution to the problem of equitably apportioning and minimizing credit card fraud loss must effectively handle two interrelated issues. The first issue entails formulating a workable system of loss distribution which favors neither the issuer nor the holder.<sup>77</sup> This will obviously necessitate arriving at an effective alternative to the system presently in existence. The second issue involves minimizing the risk that a credit card will be fraudulently used. This could best be accomplished by the use of more sophisticated identification systems to deter imposters from using lost or stolen credit cards. Only when this is achieved will the loss that both issuers and cardholders are forced to presently absorb be substantially reduced.

One suggested solution to the problem of loss distribution has been to make the issuer assume all liability for such losses.<sup>78</sup> Such a proposal would not be feasible since it appears to make card issuers insurers of all credit cards they distribute.<sup>79</sup> It is therefore very doubt-

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<sup>77</sup>Cardholders and card issuers derive mutual benefits from the use of credit cards. (See discussion pgs. 377-379 *supra*.) It is therefore a reasonable policy to demand that each party assume an equal share of the corresponding risk of credit card misuse.

<sup>78</sup>52 MINN. L. REV. 885, 890 (1968).

<sup>79</sup>Some part of the total amount of fraud loss is undoubtedly attributable to the negligence of many credit card holders. To require that issuers absorb the entire amount of such loss pursuant to a formal plan of distribution would therefore be unreasonable.

ful that the legislature would be receptive to a proposition so favorably slanted toward the cardholder. Aside from this factor, such a system of loss allocation would not benefit the holder nearly so much as would appear at first glance. In fact, it would afford him less protection than the presently existing notice clause system. While card issuers would be initially forced to absorb the entire amount of fraud loss, the greater portion of this figure would undoubtedly be passed back to the consumer in the form of higher retail prices.<sup>80</sup> In all probability, under such a disguised form of loss redistribution, cardholders would bear more of the loss than they do presently. This system would also impose an unnecessary hardship on those consumers who choose not to use credit cards. They would be forced to pay higher retail prices while deriving no benefits from the use of credit cards, nor in any way contributing to the losses generated by fraudulent use.

It has also been suggested that credit card fraud loss could be best allocated by imposing a maximum amount of cardholder liability for unauthorized use. This proposal has gained widespread recognition in the form of both state and federal legislation.<sup>81</sup> While it must be recognized as a progressive step toward an effective system of loss apportionment, it is still nothing more than a compromise to the traditional system of distribution. Under this type of arrangement the basic form of the liability-until-notice clause is allowed to remain untouched. Those problems heretofore discussed which are inherent within the clause itself are therefore in no way resolved by this proposal. Perhaps it can best be described as merely camouflaging the inequities of the notice clause by affording the cardholder the security of knowing that his liability will not be unlimited.

Any proposal which impartially allocates credit card fraud loss must by necessity abolish the use of the liability-until-notice clause in all credit card arrangements.<sup>82</sup> This objective can best be accom-

<sup>80</sup>This plan does represent a form of uniform loss spreading. However, it is inequitable in that losses would be spread almost entirely among cardholders. A truly uniform system of apportionment will be achieved only when fraud losses are spread evenly between cardholders and card issuers.

<sup>81</sup>Illinois; 12½ ILL. ANNO. ST. § 382 (Supp. 1970). Maine; 17 MAINE REV. STATS. ANNO. § 1635 (Supp. 1970-1971). Massachusetts; 42 M.G.L.A. ch. 255, § 12E (Supp. 1971). Minnesota; M.S.A. ch. 325, § 325.932 (Supp. 1971). New York; N.Y. GEN. BUS. LAW § 512 (McKinney Supp. 1970-1971), *formerly* L. 1967, ch. 753 (1967). North Dakota; 51 N.D.C.C. ch. 51-14.1-02 (Supp. 1969). Tennessee; 47 T.C.A. ch. 15, § 47-15-117 (Supp. 1970). Vermont; 9 V.S.A. § 4042 (Supp. 1970). Federal Law; Consumer Credit Protection Act, 15 U.S.C.A. § 1642 (Supp. 1971). *See also* South, *Legal Steps and Pitfalls In Bank Credit Cards*, 87 BANKING L. J. 222, 227 (1970) for a suggestion that card issuers regard this approach as a form of negative advertising and will not adopt it voluntarily.

<sup>82</sup>Use of the notice clause forces cardholders to bear a greater quantity of fraud losses than should reasonably be expected of them. In addition, the notice clause does

plished by the enactment of legislation designed to eliminate such one-sided contractual arrangements between holders and issuers. Courts will then be able to construe the respective rights of each party in accordance with a uniform set of statutory rules. As a basic premise, the most equitable methods of distributing fraud loss is to spread it as evenly as possible among those parties who derive benefits from the credit card system. Since both card issuers and cardholders enjoy reciprocal benefits from the use of credit cards, it would seem reasonable for them to equally absorb losses generated by their misuse.

Such a plan of loss apportionment could best be effected through legislation compelling the card issuer to initially assume liability for all fraud losses. Fifty per cent of this total amount would then be redistributed to all cardholders in the form of periodic service charges.<sup>83</sup> The amount of these charges would naturally be governed by the total amount of loss resulting from the unauthorized use of credit cards. The primary benefit of this proposal is that one half of the entire loss is evenly spread among all cardholders. This prevents the inequity of a few cardholders being saddled with an unreasonable amount of liability.

At first glance there would appear to be two major objections to this system of loss allocation. Further analysis, however, reveals that neither objection is valid. The most obvious problem would seem to be that many faultless cardholders would be forced to pay for the negligence of less prudent cardholders. This argument is weakened when the periodic assessments are looked upon as an inexpensive form of insurance based upon the same principle as automobile insurance. Thus, although a given cardholder may have never incurred unauthorized charges on his account in the past, he is guaranteed that his loss will not be excessive should he incur such charges in the future. A second possible objection is that people would no longer exercise due care in using their cards if the notice clause were abolished. This objection is likewise without merit. Since the amount of the assessments would directly correspond to the total amount of fraud loss, cardholders would be induced to exercise care in an attempt to minimize this loss. As an additional measure to control cardholder negligence issuers would be privileged to revoke credit cards that were too often misused.<sup>84</sup>

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not act to minimize the total amount of fraud loss which holders and issuers must absorb. *See* pgs. 393-397 *supra*.

<sup>83</sup>If a specific legislative plan was adopted compelling cardholders to bear one half of the total fraud loss through periodic service charges, it is unlikely that issuers would attempt to recoup the other fifty per cent in the form of higher retail costs.

<sup>84</sup>This would also serve to check the possibility of cardholders reporting false claims for unauthorized charges.

If card issuers were consistently forced to bear one half of the loss attributable to credit card fraud, they would be induced to take steps aimed at minimizing risk of misuse. Legislation compelling them to employ improved systems of cardholder identification would therefore be unnecessary. In their present form, most credit cards have printed upon them only the name and account number of the authorized holder. The majority of bank credit cards also contain a signature panel. These cards quite obviously do not sufficiently identify the rightful holder, and can therefore be successfully used by almost anyone. While the risk of misuse could be reduced through the use of more personalized identification systems, issuers are currently unwilling to bear the additional expense which this would involve. As long as they can recover the majority of unauthorized charges from cardholders, there is little reason for them to improve their present identification system in an attempt to minimize loss.<sup>85</sup>

The new addition to the Federal Truth In Lending Act<sup>86</sup> does stiffen the requirements somewhat by requiring card issuers to provide a method of identifying the authorized user of a card. Issuers could probably satisfy this general requirement merely by placing signature panels on all credit cards. Such a practice, however, would be of little value in solving the problem since a credit card thief can normally forge the authorized holder's signature well enough to successfully present the card. Signature panels are likewise ineffective when credit cards are made transferable.<sup>87</sup>

Aside from signature panels, there are other procedures which could be employed effectively to minimize loss. One such procedure would be to incorporate a photograph of the authorized holder on the credit card itself. This would allow store clerks to easily ascertain the authority of anyone presenting such a card.<sup>88</sup> Although card issuers recognize the validity of this system, most have refused to adopt it on the basis of the expense it would involve.<sup>89</sup>

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<sup>85</sup>H.R. REP. NO. 91-1500, *supra* note 1 at 7 estimates the total amount of credit card fraud loss to be approximately \$200 million per year. Gallese, *Buy Now Pay Never*, Wall Street Journal, Nov. 18, 1970, at 1, col. 6, states that a survey of 15 major oil concerns revealed that stolen credit cards cost them nearly \$23 million in 1969. These figures clearly indicate that cardholders are currently bearing the major portion of the loss occasioned by the unauthorized use of credit cards.

<sup>86</sup>Consumer Credit Protection Act, 15 U.S.C.A. § 1642 (Supp. 1971).

<sup>87</sup>H.R. REP. NO. 91-1500, *supra* note 1 at 16.

<sup>88</sup>These cards cost issuers approximately 53 cents each when completed, and can be manufactured at the rate of one per minute. H.R. REP. NO. 91-1500 *supra* note 1 at 8, 9.

<sup>89</sup>Although there are approximately 50 million bank credit cards in existence, only 4% of them contain pictures. H.R. REP. NO. 91-1500 *supra* note 1 at 9.



An additional identification procedure that could be of value in minimizing fraud loss involves placing the personal description of all cardholders on their individual credit cards.<sup>90</sup> While this system would not be as effective as the use of photographs it could more easily be put into operation.<sup>91</sup> The pertinent information could be printed upon the card by the same process that is currently used to print names and account numbers.<sup>92</sup>

Thus there are several means by which card issuers could improve upon their present system of identification. The application of these procedures would undoubtedly deter the unlawful use of credit cards and thereby reduce the amount of fraud loss. However, because issuers are still allowed to employ the so-called liability-until-notice contract provision, it is unlikely that they will personalize their credit cards beyond the minimum requirements of the new federal law. It is only when the cost of incorporating better identification systems becomes less than the amount of the total fraud loss issuers are forced to assume, that they will take steps to minimize the loss. Therefore, if legislation forced issuers to bear one half of the losses attributable to fraud, they would then employ better identification procedures to minimize this loss.

## VI. CONCLUSION

It is a recognized fact that credit cards are currently occupying a role of growing importance in the American economy. However, though they afford substantial benefits to both card issuers and cardholders, their increase in popularity has greatly amplified the risk of credit card fraud. For the credit card system to operate effectively, losses attributable to the unauthorized use of credit cards must be

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<sup>90</sup>A.B. 856, California Legislature (1970).

<sup>91</sup>The time and effort involved in photographing each individual cardholder would be eliminated by this identification process.

<sup>92</sup>While not technically an identification system, some card issuers are considering the use of a procedure designed to control fraud by supervising the use of credit cards at the point of sale. A computer system is employed whereby information is fed into a computer at the time of the sale. This data is then monitored to a central computer station. If the card is not to be honored for any reason, the sale is stopped and a potential loss is averted. The fallacy of this system, however, is that it is predicated upon liability-until-notice. That is, cardholders must report a loss or theft of their cards before the relevant information can be computerized. H.R. REP. NO. 91-1500 *supra* note 1, at 11-13.

minimized and equitably distributed among card issuers and holders. However, as long as card issuers are allowed to employ the liability-until-notice system of loss allocation, fraud loss will neither be minimized nor fairly distributed.

Thus far, neither the courts nor the legislature has taken a position which would require card issuing companies to substantially modify the conventional structure of the liability-until-notice form of loss distribution. Some courts have adopted a strict approach in consistently holding for card issuers by merely enforcing the credit card contract as written. Although other courts have adhered to a more liberal approach in uniformly ruling for cardholders, none have gone so far as to hold the liability-until-notice clause void, as being contrary to public policy. Instead, they have evaded the issue by basing their decisions on a liberal interpretation of the contract.

Unlike the courts, state and federal legislatures have acted with some degree of consistency in the area of loss apportionment. Current legislation generally serves to limit liability by fixing maximum amounts for which cardholders can be held liable for the misuse of their credit cards. However, because such legislation allows the basic format of the liability-until-notice system to remain untouched, it provides only a poor compromise to the traditional method of loss distribution, and is therefore unacceptable.

An effective legislative system of fraud loss allocation must prohibit the use of the liability-until-notice clause in order to spread losses as evenly as possible among card issuers and cardholders. The ideal arrangement would provide that issuers and holders must each absorb one half of the total annual loss generated by the unauthorized use of credit cards. Once this is accomplished, issuers themselves will voluntarily take steps to minimize the amount of fraud loss through the use of more personalized cardholder identification systems.

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