

## DUTY ISSUES IN THE EVER-CHANGING WORLD OF PAYMENTS PROCESSING: IS IT TIME FOR NEW RULES?

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### INTRODUCTION

Recent developments in payments law generally—such as “electronic check conversion” and Check 21<sup>1</sup>—have changed the operational and legal landscape of payments. Since the last time that all retail payments law was subjected to a “global” review, in the “Uniform Payments Code” project roughly twenty-five years ago, so many things have changed that it is time to think about catching the law up with the marketplace again.

The marketplace in this case is larger and less intermediated than it was. Payments products, payments systems, and means of committing payments frauds have proliferated in the past twenty-five years. Check 21, recent amendments to the scope of Regulation E,<sup>2</sup> and expansion of the National Automated Clearing House Association Operating Rules (NACHA Rules)<sup>3</sup> and Electronic Check Clearing House Organization Operating Rules (ECCHO Rules)<sup>4</sup> to cover new products, all signal the types of product changes we have seen. Payment systems rules have arisen with the new products. New means of fraud include

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1. Check Clearing for the 21st Century (Check 21) Act, 12 U.S.C. §§ 5001–5018 (Supp. V 2005).

2. Electronic Fund Transfers, 71 Fed. Reg. 51,437 (Aug. 30, 2006) (to be codified at 12 C.F.R. pt. 205).

3. *E.g.*, NAT'L AUTOMATED CLEARING HOUSE ASS'N, 2007 ACH RULES: A COMPLETE GUIDE TO RULES AND REGULATIONS GOVERNING THE ACH NETWORK, at R 1–19 (2007) [hereinafter 2007 NACHA RULES].

4. ECCHO Home Page, <http://www.eccho.org> (last visited Mar. 3, 2008) (select “ECCHO RULES” hyperlink on the top right part of the page, then request a password to obtain a copy of the Rules) [hereinafter ECCHO Rules].

intentional duplicate presentments of the same obligation as well as new age alterations and counterfeit instruments.

The marketplace has been adjusting faster than “laws” can. System rules have changed frequently.<sup>5</sup> Uniform Commercial Code (U.C.C.) Articles 3 and 4—those elegantly conceived and drafted backbones of check collection that have stood for decades—have decreased in importance as system rules and Federal Reserve System regulations and operating circulars have increasingly occupied the field.<sup>6</sup> Regardless of how dedicated the law is to preventing and redressing injury, it cannot reform itself fast enough to keep pace with the imaginations of individuals who are intent on committing fraud or with the types of errors that may be introduced as payments move from paper to electronics.

One of the bigger challenges in this era where system rules are forming a larger part of the “law” governing payments is to ensure that payment system participants fulfill basic duties to the obligors and payees whose payments they are handling. Those classic duty concepts such as “good faith” and “ordinary care” from U.C.C. Articles 3 and 4 play smaller roles in the newer system rules. Instead, there is a trend to make brighter lines in system rules, including, for example, specific rules on eligibility for treatment under certain of the NACHA provisions,<sup>7</sup> or bilateral agreements. In addition, the obligation that starts with the issuance of a paper check often becomes subject to NACHA Rules and Regulation E if it is a consumer transaction<sup>8</sup> or NACHA Rules and Article 4A if it is a commercial transaction.<sup>9</sup> This shift of legal regime alters the scope of duties that payments processors have vis-à-vis the obligor or payee, and does so in a manner that may be very difficult for consumers and smaller businesses to understand.

Another challenge is reallocating duties among system participants so that the participants in the best position to prevent loss carry their correct shares of the costs of prevention and loss. Although this

5. See, e.g., *id.* § 2.9.2, at OR 11, § 2.9.3.3, at OR 11.

6. For a more comprehensive discussion of this trend, see Stephanie Heller, *An Endangered Species: The Increasing Irrelevance of Article 4 of the UCC in An Electronics-Based Payments System*, 40 *LOY. L.A. L. REV.* 513 (2006).

7. See, e.g., 2007 NACHA RULES, *supra* note 3, § 2.10.1, at OR 11–12.

8. See Electronic Fund Transfers, 71 Fed. Reg. 69,430 (Dec. 1, 2006) (to be codified at 12 C.F.R. pt. 205); Electronic Fund Transfers, 71 Fed. Reg. 1638 (Jan. 10, 2006) (to be codified at 12 C.F.R. pt. 205).

9. See Fed. Reserve Bank, Operating Circular No. 4: Automated Clearing House Items §§ 1.1, 1.3, 2.1(j)–(k) (May 18, 2003) [hereinafter Operating Circular No. 4], available at [http://www.ffiec.gov/ffiecinfobase/resources/retail/frb\\_op\\_circ\\_no\\_4.pdf](http://www.ffiec.gov/ffiecinfobase/resources/retail/frb_op_circ_no_4.pdf). The term “credit item” is defined in subsections 2.1(j)–(k).

“least-cost-snafu-avoider” principle is not new in commercial law,<sup>10</sup> the issue of which players carry the loss-prevention duties has been undergoing changes in the past decade. In particular, both the new U.C.C. duties for depository banks taking “remotely created” checks for collection<sup>11</sup> and the corresponding provisions in Regulation CC<sup>12</sup> suggest even more duties for depository banks in loss prevention through exercise of their traditional “gatekeeper” roles. Moving duties to depository banks ultimately alters the loss allocations that have been in place for long periods, such as the doctrine of *Price v. Neal*,<sup>13</sup> a step already taken in the new U.C.C. and Regulation CC “remotely created check” rules.

This article looks at duty issues in check processing: what those duties have been, how they might be adjusting to new processing methods, how one demonstrates compliance or noncompliance with duty-related standards, and what barriers prevent some participants in the payment from benefiting from those duties. In considering whether the new complex of rules is appropriate to provide obligors and payees with remedies if someone else mishandles the payment, we should consider four organizing principles drawn from former payments law:

1. *Transparency*: the obligor should understand how its payment obligation will be processed and, if something goes wrong, how to determine whether entities processing the payment fulfilled whatever duties they had to the obligor or payee;
2. *Consistency*: the choice of collection method by the payee or depository bank should not disadvantage the issuer;
3. *Privity*: the person who is injured by a failure to exercise ordinary care, good faith, or another duty supplied by one of the sets of rules should be allowed to recover her loss even in the absence of a preexisting relationship with the person who caused the loss

10. For discussion of this principle in this context, see *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, 457 F.3d 619, 623 (7th Cir. 2006).

11. U.C.C. §§ 3-416, 3-417, 4-207, 4-208 (2005).

12. 12 C.F.R. § 229.34(d) (2007).

13. (1762) 3 Burr. 1354, 97 Eng. Rep. 871, 872 (K.B.). For more explanation of the rule, see official comment 3 to U.C.C. section 3-417 (“drawee takes the risk that the drawer’s signature is unauthorized unless the person presenting the draft has knowledge that the drawer’s signature is unauthorized”).

or any other connection that would normally cause us *to recognize a duty*;<sup>14</sup> and,

4. *Proof*: the injured person should get the benefit of a presumption because she may have difficulty proving *who caused the "error"* in processing or payment among many payments intermediaries involved in processing that payment and under the different duties imposed by different payment rules.

This article does not suggest ways to answer all of the questions it raises. Rather, it uses a few hypothetical cases to showcase the types of problems that arise under the current complex of laws and rules, particularly those for which there is no clear answer at present. Part I looks briefly at existing duty standards.<sup>15</sup> Part II presents the hypothetical cases. Part III states the case for expanding the duties of depository banks over Automated Clearing House (ACH) systems processing obligations that started life as "checks," and for the retention of both the duties of "good faith" and "ordinary care" from U.C.C. Articles 3 and 4 and the bright-line duties of the NACHA rules. Part IV states some preliminary conclusions.

## I. PAYMENT SYSTEM DUTIES—ARTICLES 3 AND 4 AND THE NACHA RULES

### A. U.C.C. Article 3, 4 and 4A Duties

1. The U.C.C. Article 3 and 4 Duties of "Ordinary Care" and "Good Faith" and Comparable Duties in Regulation CC

#### a. "Ordinary Care"

The duty to exercise "ordinary care" has been around since the 1962 version of the U.C.C. However, there was no "ordinary care" defi-

14. See *Conder v. Union Planters Bank, N.A.*, 384 F.3d 397, 399–400 (7th Cir. 2004) (holding that drawer had no cause of action against depository bank for its failure to deposit checks into accounts bearing names similar to those of the named payee); *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 955–58 (7th Cir. 1982) (analysis of failure of plaintiff's claim for failure to execute a fund transfer on time for lack of privity with defendant).

15. This article does not cover timing standards such as the "midnight deadline" rules in Article 4, U.C.C. sections 4-301 and 4-302.

dition in the 1962 U.C.C.<sup>16</sup> so that the scope of the duty was left to the courts to flesh out. Beginning with the 1990 version of Articles 3 and 4, the U.C.C. defined “ordinary care” as follows:

“Ordinary care” in the case of a person engaged in business means observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged. In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank’s prescribed procedures and the bank’s procedures do not vary unreasonably from general banking usage not disapproved by [Articles 3 or] 4.<sup>17</sup>

At the risk of boring the expert readers of this article, the duty of “ordinary care” factors into loss allocation cases governed by Articles 3 and 4 in determining the allocation of loss under the “comparative negligence” rules in the 1990 version of Articles 3 and 4,<sup>18</sup> whether collecting banks properly handled items in Article 4,<sup>19</sup> and in loss allocation in breach of warranty cases under both articles.<sup>20</sup> For example, under the general negligence rule in Article 3, the burden of proving failure to exercise ordinary care—such as an issuer’s or holder’s failure to protect the instrument from alteration or a forgery—is on the person asserting the preclusion (a payor bank who pays it or a depository bank who took it for collection or a person who took it for value).<sup>21</sup> If the person asserting the preclusion establishes the counter-party’s failure to exercise ordinary care, then the counter-party has an opportunity (and carries the burden) to establish that the person asserting the preclusion also failed to exercise ordinary care.<sup>22</sup>

16. The 1962 text of section 3-406 (the general “negligence” rule) used the phrase “in accordance with the reasonable commercial standards of the drawee’s or payor’s business.” U.C.C. § 3-406 (1962). Comment 6 to that section explained, “The section protects parties who act not only in good faith, (Section 1-201) but also in observance of the reasonable standards of their business. Thus any bank which takes or pays an altered check which ordinary banking standards would require it to refuse cannot take advantage of the estoppel [against the issuer or other party].” In addition, the 1962 version of section 4-406(3) readjusted the allocation from the payor bank’s customer back to the bank “if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).” *Id.* § 4-406(3). Of course, the concept of the respective duties to prevent risk is much older than the U.C.C. *E.g.*, *Palsgraf v. Long Island R.R. Co.*, 169 N.E. 99, 100 (N.Y. 1928) (Cardozo, C.J., observing that “[t]he risk reasonably to be perceived defines the duty to be obeyed”).

17. U.C.C. § 3-103(a)(9) (2005).

18. *Id.* §§ 3-404(d), 3-405(b), 3-406(b), 4-406(e).

19. *Id.* § 4-202.

20. *Id.* §§ 3-416, 3-417, 4-207, 4-208.

21. *Id.* § 3-406(c).

22. *See id.* § 3-406(b).

Since the effective date of Check 21 and the introduction of “electronic check conversion,”<sup>23</sup> it is less likely that the original check will survive as evidence of whether the issuer was sloppy or used pencil or some other easily alterable method of giving the instruction to pay. In some cases, it may be possible to see or detect the alteration from the original check or to detect it on a check image preserved by the payee, depository bank, or payor bank. In other cases, it may not. In Part II of this article, I discuss three decisions in which the ability or inability to detect an alleged alteration was presented.<sup>24</sup> If the payee or its depository bank transfers checks to images and destroys the originals according to system rule or corporate policy, and the error may have been introduced at that point, the lack of the original check will make for similar difficulties in allocating loss. At the moment, the allocation in such cases depends on which federal circuit the aggrieved party is in.<sup>25</sup>

“Ordinary care” is defined only in general terms.<sup>26</sup> So, to understand what “ordinary care” means requires an analysis of (1) the nature of the business of the person whose conduct is to be measured with reference to “ordinary care,” (2) the geographic area(s) in which the person does business, (3) what standards of conduct are used in the area(s) in which the person does business and whether they are “reasonable commercial standards,” and (4) whether the person’s conduct was commensurate with those standards.<sup>27</sup> Examples of an issuer’s failure to exercise “ordinary care” include leaving blanks on the check and check-writing practices that “facilitate” alterations such as using pencil or erasable ink, allowing rubber signature stamps to be used and not guarding them properly,<sup>28</sup> or using a computerized check-writing machine and not keeping it secured.<sup>29</sup> Examples of depository bank failures to exercise ordinary care include inadequate procedures in opening accounts<sup>30</sup> and the receipt of a very large item for deposit in a newly-opened account.<sup>31</sup> Article 4’s references cover

23. For a worthwhile discussion of “electronic check conversion,” see Heller, *supra* note 6, at 518–20.

24. *Infra* text accompanying notes 75–92.

25. Compare Wachovia Bank, N.A. v. Foster Bancshares, Inc., 457 F.3d 619, 622–23 (7th Cir. 2006) (destruction of original check no bar to recovery for alleged alteration), with Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A., 208 F. App’x 232, 235 (4th Cir. 2006) (destruction of original check bars recovery, but see Judge Niemeyer’s well-reasoned dissent).

26. U.C.C. § 3-406 cmt. 1 (citing *id.* § 3-103(a)(9)).

27. See *id.* § 3-103(a)(9).

28. *Id.* § 3-406 cmt. 3 (Case # 1).

29. See Perini Corp. v. First Nat’l Bank, 553 F.2d 398, 400–01, 412–14 (5th Cir. 1977).

30. U.C.C. § 3-405 cmt. 4.

31. *Id.* § 3-406 cmt. 4.

the collecting bank's responsibility for collection or return<sup>32</sup> and banks' actions in paying a check that is altered or contains a forged drawer's signature.<sup>33</sup>

This article assumes that the law will not move quickly to a system of strict liability in warranty form such as the NACHA Rules provide, and that some standard such as "ordinary care" will continue to be relevant in resolving disputed payment transactions when it appears the error occurred while the instrument was in the hands of the issuer, payee, depository bank, or payor bank. Part III presents some issues that any harmonization of the law of check collection should address.

*b. "Good Faith"*

The 1962 version of the U.C.C. defined the term "good faith" from a strictly subjective standard; behaving in "good faith" required only "honesty in fact" in the transaction—and that generally did not take much.<sup>34</sup> The 1990 version of Articles 3 and 4 added an objective standard of "the observance of reasonable commercial standards of fair dealing"<sup>35</sup> to the definition.

The terms "ordinary care" and "good faith" are not coextensive<sup>36</sup> and Articles 3 and 4 take pains to invoke the duties they create in different environments. For example, to shift loss back onto an employer

32. *Id.* § 4-202.

33. *Id.* § 4-406(d)–(e).

34. See U.C.C. § 1-201(19) (1962). Commentators described the subjective "honesty in fact" standard as the functional equivalent of the "hear no evil, see no evil, do no evil" trio. See Emma C. Jordan, *Holder in Due Course*, in BASIC UCC SKILLS 1988: ARTICLE 3 AND ARTICLE 4, at 51–52 (PLI Commercial Law & Practice, Course Handbook Series No. 462, 1988) (explaining that "this test [allows an intermediary to] literally 'hear no evil, and see no evil' [by] carefully looking the other way to avoid obtaining the subjective knowledge that would deprive them of the HDC status"). But there was no requirement that someone do something constructively useful to satisfy this standard. Courts did manage to find that some holders did not take instruments in "good faith" and thus were ineligible to be "holders in due course" because they knew too much about the underlying transaction or they directed its form. *E.g.*, *Unico v. Owen*, 232 A.2d 405, 411–17 (N.J. 1967) (articulating the "close connectedness" standard, under which the more the taker knows about the underlying transaction or controls or participates in the underlying transaction, the less the taker should be free of the defects that may have arisen in the underlying transaction); *Am. Plan Corp. v. Woods*, 240 N.E.2d 886, 887, 889 (Ohio Ct. App. 1968) (adopting "close connectedness" doctrine in case in which taker had "pervasive knowledge" of terms of sale). *Cf.* *Universal C.I.T. Credit Corp. v. Ingel*, 196 N.E.2d 847, 852 (Mass. 1964) (bad faith cannot be proved simply by showing of taker's knowledge of a pattern of questionable dealing by payee).

35. U.C.C. §§ 3-103(a)(6) (2005).

36. For a wonderful discussion of "good faith" issues, see SECTION OF BUS. LAW, AM. BAR ASS'N, WHO PUT THE "GOOD" IN "GOOD FAITH"? (2004), available at <http://www.abanet.org/buslaw/library/ann04.shtml> (scroll down to "Program: Who Put the Good in Good Faith" and select "Program Materials" hyperlink).

under the comparative negligence rules in the 1990 version of section 3-405, the party trying to avoid loss—the depositary bank, payor bank, or other taker for value—must establish first that they took or paid the instrument “in good faith.”<sup>37</sup> If the bank or taker can meet its good faith burden, it shifts all of the loss back to the employer who hired a defalcating employee. If the employer (who, for the moment, bears all of the loss caused by the faithless employee’s behavior) wishes to share the loss with the taker for collection or value or the payor, she needs to show that the taker or payor “fail[ed] to exercise ordinary care in paying or taking the instrument” and that the failure “substantially contribute[d]” to the loss.<sup>38</sup>

To prove that the taker or payor acted in “good faith” in this context, they must show that (1) they have procedures and policies in place to protect *someone* (e.g., the issuer or the payee), (2) the procedures are adequate to protect the interests of their counter-party, and (3) they followed the procedures and policies in fact.<sup>39</sup> Failure to follow the bank’s own established procedures and policies is proof of a lack of good faith.<sup>40</sup> Similarly, failure to have sufficient procedures and policies in place to protect the interest of the counter-party is proof of a lack of good faith. Under the 1990 definition, “good faith” inquiries focus on assessments of internal risks (bank employee and agent problems and systems risks); assessments of risks posed by customers in connection with opening accounts, deciding whether to advance funds against uncollected deposits, and determining which customers to trust to encode or image checks or to truncate checks; and assessments of risks associated with bank correspondents and their processing agents.<sup>41</sup>

Going forward, in part because of the “good faith” inquiry’s pivotal role in determining eligibility for “holder in due course” status,<sup>42</sup> and in part because it is necessary if we retain the concept for comparative negligence or other purposes, we need to provide standards for these

37. U.C.C. § 3-405(b).

38. *Id.*

39. *See* Me. Family Fed. Credit Union v. Sun Life Assurance Co., 727 A.2d 335, 343 (Me. 1999).

40. *Id.* at 344 (depositary bank that failed to place a hold on large deposits that Regulation CC authorized failed the “objective” prong of Article 3’s “good faith” standard of reasonable commercial standards of fair dealing).

41. *See e.g.*, U.C.C. §§ 3-405, 4-209 (2005). For a case holding the early release of uncollected funds to a depositor violated the “good faith” requirement, *see* Me. Family Fed. Credit Union, 727 A.2d at 344 (citing Regulation CC’s deposit availability rules as the underlying basis for its determination).

42. U.C.C. §§ 3-302(a), 4-211.

“good faith” inquiries that are suitable to the current and future automated processing and check-imaging environments. In contrast to the “ordinary care” issues discussed above and below in Part III, these “good faith” analyses require introspection (e.g., what should we do in our bank) as well as some objective understanding of the duty to the counter-party (e.g., reasonable standards of fair dealing). Part III presents the types of concerns we should consider in measuring “good faith” in these new environments.

### *c. Duties Under Regulation CC*

Regulation CC imposes duties to exercise ordinary care and to act in good faith in complying with its requirements.<sup>43</sup> Beyond the duty imposed by the U.C.C. on the depository and collecting banks to serve as the agent of the depositor, Regulation CC extends potential liability of banks in the collection to “the depository bank, the depository bank’s customer, the owner of the check, or another party to the check.”<sup>44</sup> Subpart C (“Collection of Checks”) also imposes different damages for failures to exercise “ordinary care” and to act in “good faith”—with potential consequential damages available in the latter cases.<sup>45</sup> Somewhat apart from the U.C.C.’s split of loss allocation between “ordinary care” and “good faith,” Subpart C applies “comparative negligence” standards to the failure to meet the requirements of either test.<sup>46</sup> The express reservation of rights under the U.C.C. and other law in section 229.38(a) is instructive that the U.C.C. and Regulation CC should operate in tandem to produce a whole result.

## 2. Duties Under U.C.C. Article 4A

The National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted Article 4A after some large-scale execution errors occurred; the Seventh Circuit’s holding in *Evra Corp. v. Swiss Bank*

43. 12 C.F.R. § 229.38(a) (2007).

44. *Id.*

45. *Id.* This subsection expressly preserves a paying bank’s liability to its customer under the U.C.C. or other law. *Id.*

46. *Id.* § 229.38(c). This subsection provides:

If a person, including a bank, fails to exercise ordinary care or act in good faith under this subpart in indorsing a check (§ 229.35), accepting a returned check or notice of nonpayment (§§ 229.32(a) and 229.33(c)), or otherwise, the damages incurred by that person under § 229.38(a) shall be diminished in proportion to the amount of negligence or bad faith attributable to that person.

*Corp.*<sup>47</sup> also spurred its approval. Prior to Article 4A, funds transfers had operated under a combination of system rules, operating circulars, and bilateral contracts that were considered by many to be insufficient for resolving the types and magnitudes of errors that can arise in wholesale funds transfers. The prefatory note gives three reasons for Article 4A: (1) existing wire transfer system rules applied to “only limited aspects” of these transfers,<sup>48</sup> (2) the absence of applicable law caused “a great deal of uncertainty,”<sup>49</sup> and (3) there was “no consensus about the juridical nature of a wire transfer and consequently of the rights and obligations that are created.”<sup>50</sup> Privity problems also contributed to the difficulty of resolving errors because each party only had privity with some parties in these often many-stage transfers.

Article 4A is a uniform state law that contains bright-line articulations of who owes duties to whom (e.g., when a bank “accept[ed] a payment order” and the consequence of acceptance<sup>51</sup>), and what damages might flow from breach of a duty that are comparable to those in Articles 3 and 4. Article 4A uses the same standard for “good faith” as Articles 3 and 4, that is, “honesty in fact and the observance of reasonable commercial standards of fair dealing.”<sup>52</sup> It also relies on use of “commercially reasonable” security procedures and compliance with any written agreement or instructions of the bank’s customers.<sup>53</sup>

The most significant differences between the duties in Articles 3 and 4 for check processing and those for funds transfers come in the form of bright-line standards for errors in funds transfers<sup>54</sup> and the role of contracted-for “security procedures” in the loss allocation for unauthorized payments,<sup>55</sup> both of which were deemed more suitable in light of the highly automated nature of funds transfers at the time Article 4A was approved. In possible future harmonization of the vari-

47. 673 F.2d 951, 955–60 (7th Cir. 1982) (citing *Hadley v. Baxendale*, (1854) 9 Exch. Div. 341, 354–55, 156 Eng. Rep. 145, 151 (applying the common law rule that no consequential damages may be awarded unless the defendant had special notice giving rise to liability for consequential damages)).

48. U.C.C. art. 4A prefatory note (2005) (“Why is Article 4A needed?”).

49. *Id.*

50. *Id.*

51. *Id.* art. 4A prefatory note (“Concept of acceptance and effect of acceptance by the beneficiary’s bank”), § 4A-209.

52. *Id.* § 1-201(b)(20) (prior to 2001, appearing at § 4A-105(a)(6)).

53. *Id.* §§ 4A-202(b), 4A-203 cmts. 1, 4.

54. *Id.* §§ 4A-205, 4A-207, 4A-303, 4A-305.

55. *Id.* §§ 4A-201, 4A-202(b)–(c), 4A-203.

ous laws and rules applicable to aspects of “check collection,” these Article 4A standards may be helpful.

*B. Duties Under the NACHA Rules*

Reflecting the direction that may be required as payments are ever more automated, the NACHA Rules provide bright-line duties and detailed warranties with indemnification. For purposes of this article, I use only a limited set of the NACHA Rules. For example, operating rule section 2.7 specifies that an originating depository financial institution (ODFI) may initiate “destroyed check entries” if the following conditions are met: the item must be (1) “eligible”—a term defined in subsection 2.7.2 (this requires that there be an “item” as Article 4 defines that term<sup>56</sup>), “(2) a negotiable demand draft drawn on or payable through or at an office of a Participating DFI, other than a Federal Reserve Bank or Federal Home Loan Bank, (3) in an amount less than \$2,500,” and (4) lost or destroyed or “otherwise unavailable while in transit for presentment to a paying bank.”<sup>57</sup> Items ineligible include “items that are rejected during processing by the ODFI.”<sup>58</sup> Each ODFI initiating a “destroyed check entry”—which the NACHA Rules refer to as an “XCK” entry—makes seven warranties to each Receiving Depository Financial Institution (RDFI), ACH Operator, and Association<sup>59</sup>:

1. The ODFI has good title to the destroyed check, entitlement to enforce it, or authority to obtain payment on behalf of someone entitled to enforce the item,<sup>60</sup>
2. signatures are genuine,<sup>61</sup>
3. the item to which the destroyed check entry pertains has not been altered,<sup>62</sup>
4. the item is not subject to defenses or claims in recoupment that can be asserted against the ODFI,<sup>63</sup>
5. the ODFI has no knowledge of insolvency of the maker, acceptor, or drawer of the item,<sup>64</sup>

56. *Id.* § 4-104(a)(9).

57. 2007 NACHA RULES, *supra* note 3, § 2.7, at OR 8.

58. *Id.*

59. This refers to regional payment associations.

60. 2007 NACHA RULES, *supra* note 3, § 2.7.3.1, at OR 8–9.

61. *Id.* § 2.7.3.2, at OR 9.

62. *Id.* § 2.7.3.3, at OR 9.

63. *Id.* § 2.7.3.4, at OR 9.

64. *Id.* § 2.7.3.5, at OR 9.

6. the destroyed check entry accurately reflects the item,<sup>65</sup> and
7. the ODFI has not presented and will not present the item to which the destroyed check entry pertains or a copy of that item.<sup>66</sup>

The NACHA Rules provide similarly bright-line eligibility standards, warranties, and indemnification for other cases, including re-presented check entries (RCKs),<sup>67</sup> accounts receivable entries (ARCs),<sup>68</sup> back office conversion entries (BOCs),<sup>69</sup> and Internet-initiated entries (WEBs),<sup>70</sup> among others. Damages for breach of warranty run to indemnification of RDFIs, ACH Operators, Associations, and “any other party covered by the warranty” for “any and all resulting claim, demand, loss, liability, or expense, including attorneys’ fees and costs, resulting directly or indirectly from the breach of these warranties.”<sup>71</sup> Of course, with broad indemnification potentially at stake, the ODFI has many incentives to act with appropriate attention.

## II. HYPOTHETICAL CASES WHERE EXERCISE OF CURRENT DUTIES MATTERS

This part of the article presents several examples drawn from my imagination as well as from real transactions. Each is designed to illustrate different aspects of transactions that test our understanding of what standards should govern, which players should have responsibilities, and which players should benefit from whatever care standards apply or may apply. The U.C.C. provides that the item is chargeable against the drawer’s account if it is properly payable.<sup>72</sup> However, the U.C.C.’s loss allocation rules preclude the person whose failure to exercise ordinary care substantially contributed to the making of an alteration (or forged signature) from asserting the alteration by U.C.C. section 3-406(a). The person precluded (e.g., the drawer) may persuade a court to allocate some of the loss to another person, such as

65. *Id.* § 2.7.3.6, at OR 9.

66. *Id.* § 2.7.3.7, at OR 9.

67. *Id.* § 2.8, at OR 9. This section provides for nine warranties, including a correct encoding warranty for post-issuance encoding and an agreement by the originator that a restrictive endorsement by it or its agent is void or ineffective upon initiation of the RCK entry. *Id.* § 2.8.3.8–9, at OR 10.

68. *Id.* § 2.9, at OR 10.

69. *Id.* § 2.10, at OR 11.

70. *Id.* § 2.11, at OR 13.

71. *E.g.*, *id.* § 2.9.3.6, at OR 11 (Accounts Receivable Entries).

72. U.C.C. § 4-401 (2005).

the depository bank, if the person precluded can show that the other also failed to exercise ordinary care so that its actions also substantially contributed to the loss under section 3-406(b).<sup>73</sup> These provisions handle the problem if the error starts with the issuer or payee, and not as clearly if the issue arose during the encoding process or subsequent translation of the file to an image or electronic file. Article 4's encoding warranties handle the encoding errors.<sup>74</sup> If the error is introduced in the imaging, stripping, or transfer to an electronic file, something beyond what a layperson would consider "encoding" is the cause of the error.

A. *"Garden-Variety" Check Fraud Cases—Destruction or Other Unavailability of Valuable Evidence to Determine Whether Someone Took for Collection or Value in Good Faith and in Observance of Ordinary Care*

Let's look at variations on one fraud hypothetical—something that might be an alteration per *Young v. Grote*,<sup>75</sup> and another transaction that might be a "counterfeit" check, such as the check that the parties litigated in *Wachovia Bank, N.A. v. Foster Bancshares, Inc.* or *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*—both cases in which the obligations at issue were in the six figures.<sup>76</sup>

The classic early decision in *Young v. Grote* involved a drawer, a woman who the court had lots of fun mocking on the ground that no fool would let a woman handle matters such as drawing negotiable instruments, and who, the court concluded, drew an instrument in so sloppy a fashion as to facilitate its material alteration.<sup>77</sup> The risk of the alteration fell on the drawer whose actions made the alteration possible, not on the drawee.

Contemporary alterations can occur at many points in the forward collection process. For example, an employee of the issuer or a payee might alter the check. Or, an error may be introduced as the check is encoded or imaged or when it is converted into an electronic file. Assume that the alteration is not readily visible in the image or ascertainable from the electronic file and that the item is processed through an electronic presentment agreement.

73. *Id.* § 3-406(a)-(b).

74. *Id.* § 4-209.

75. (1827) 4 Bing. 253, 130 Eng. Rep. 764 (C.P.).

76. *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*, 208 F. App'x 232, 233 (4th Cir. 2006); *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, 457 F.3d 619, 620 (7th Cir. 2006).

77. 130 Eng. Rep. at 765.

In *Foster Bancshares* and *Chevy Chase Bank*, because the “original checks” in both matters were imaged and destroyed by the payor banks, the checks were not available to help the district courts determine if the original check was forged or altered.<sup>78</sup> This expert audience knows that U.C.C. Articles 3 and 4 provide different loss allocations for disputes involving “altered” and “counterfeit” obligations. For example, payor banks that pay “altered” items in good faith may assert a breach of the presentment warranty of “no alteration” against the presenting bank or any transferor of the item.<sup>79</sup> This loss allocation rule places the risk of presenting an altered check on the presenting bank, which in turn is able to return that loss to the depository bank or to another transferee whose actions enabled the altered check to enter the collection stream.<sup>80</sup> In both of these cases, the presenting bank argued that the payor bank should bear the risk if the check was counterfeit instead of altered, on the basis that payor banks were to bear the risk of paying “forged checks” while presenting banks bore the risk of “altered checks.”<sup>81</sup>

In *Foster Bancshares*, the payor bank could not produce the original check because it destroyed the check after imaging it pursuant to its ordinary internal procedures.<sup>82</sup> Nevertheless, the payor bank still prevailed over the depository bank in its breach of presentment warranty action for an altered check.<sup>83</sup> Judge Posner explained that in the case of a check bearing a different payee name from that of the original check, *Foster Bancshares*, as a depository bank, was in a better position to detect a change in the name of a payee than was the payor bank, which generally has no idea who the payee is.<sup>84</sup> Judge Posner explained that the depository bank “might have reason to suspect that the person who deposited the check with it was not the intended payee.”<sup>85</sup> And, he reasoned, the depository bank “would be in as good a position as Wachovia [the payor bank] to spot an alteration on the

78. *Chevy Chase Bank*, 208 F. App'x at 233; *Foster Bancshares*, 457 F.3d at 620.

79. U.C.C. § 4-208(a).

80. *See id.*

81. *Foster Bancshares*, 457 F.3d at 622 (citing U.C.C. § 3-418(c) & cmt. 1; HENRY J. BAILEY & RICHARD B. HAGEDORN, BRADY ON BANK CHECKS § 28.11[1] (2006)); *Chevy Chase Bank*, 208 F. App'x at 234 (citing Nat'l Title Ins. Corp. Agency v. First Union Nat'l Bank, 559 S.E.2d 668, 669 (Va. 2002) (holding that a party seeking payment warrants that he has no knowledge that a check is counterfeit)).

82. 457 F.3d at 620.

83. *Id.* at 620, 623 (citing U.C.C. § 4-208(a)).

84. *Id.* at 622.

85. *Id.*

check.”<sup>86</sup> Finally, he observed, it is a question of whether the court should assume that forgery or alteration occurred.<sup>87</sup> He concluded that alteration of the payee’s name—the “classic alteration”—should be assumed especially where the presenting bank does no more than “assert the possibility of [forgery/counterfeit]” on its own behalf.<sup>88</sup>

In *Chevy Chase Bank*, the payor bank failed to carry its burden to show that the check at issue was altered, in part because the payor bank had destroyed the check following payment.<sup>89</sup> The court reasoned that the original check “may have shed light on whether the check was altered” and whether it “may have contained smudges, erasures, chemical bleach marks, broken fibers, or other signs of alteration.”<sup>90</sup> Judge Niemeyer’s spirited dissent described nine indicia that the check at issue had been altered, including a number of pieces of direct evidence and circumstantial evidence.<sup>91</sup> These included the identity of the “front-to-back alignment as other checks in the same batch as the check issued by” the drawer, the difference in the font used in the payee’s name from the font on the rest of the check, and the fact that it was consistent with alteration by typewriter.<sup>92</sup>

The *Foster Bancshares* and *Chevy Chase Bank* decisions comprise a cautionary tale for all who litigate: the absence of the original check vastly complicates the required determination of whether the taker took the check according to the U.C.C. formula “in good faith” and with “ordinary care,” particularly where the difference between alterations and counterfeit or “forged checks” are at issue.

*B. Another Real Life Example of the “Counterfeit” Check or “Alteration” Problem?*

Assume that X, before the effective date of Check 21, bought a cashier’s check for \$25 at a local bank. X then went to a national office supply store and bought check stock comparable to that used by the bank for cashiers’ checks.<sup>93</sup> X scans information from the cashier’s

86. *Id.*

87. *Id.*

88. *Id.*

89. 208 F. App’x 232, 235 (4th Cir. 2006).

90. *Id.*

91. *Id.* at 235–36 (Niemeyer, J., dissenting).

92. *Id.*

93. Some banks use check stock for official checks that laypersons can buy in retail outlets such as Staples. In the desktop publishing era, using commercially available check stock strikes

check such as the check number, bank's name and routing number, as well as the issuer's signature block onto the blank check stock. X uses a specialized machine to fill in the \$159,630.00 amount to be paid—a machine of a type no longer in regular use by banks to issue bank checks, and also not in regular use in the area in which the check issued. X also supplies a different payee's name to the face of the instrument. So far, we have a check that facially is like the cashier's check actually issued by the drawee bank, but that differs both in terms of the named payee and in the face amount from the "real" cashier's check that the payor bank believes may have been the source document for the check in dispute.

To add some spice to this hypothetical, please assume that

- the check does not use MICR ink, and
- the resulting check uses five different typefaces and two different background styles for the amount in numerals and the signature block.

In other words, the check is highly unusual in its appearance. Its unusual appearance should be obvious to trained bank service employees, and the dollar amount should call for more than casual care in deciding whether to advance funds against it. Is the fact that the payor bank's own records show the issuance of the actual \$25 check with the same check number sufficient for the court to deem this one an "alteration" instead of a "counterfeit"? Or should recovery turn on circumstances surrounding the deposit and advances against the deposit so that there are several types of "good faith" and "ordinary care" arguments that disputants might raise?

X deposits the check to an ATM in a nearby town on a Friday after the bank has closed. Just after his bank opens the following morning, X is able to obtain as advances against this deposit two cashier's checks and cash totaling more than \$140,000. Assume further that X's account at the depository bank has been overdrawn multiple times in the past ninety days and that the overdrafts range up to the high five figures. Under these circumstances, Regulation CC would allow the depository bank to delay availability under the special anti-fraud provisions in

me as a lack of care in the issuance of the instrument, which might qualify under U.C.C. section 3-406 to preclude the issuer from recovery.

section 229.13.<sup>94</sup> Failure to take advantage of the delayed availability has been held to be a lack of good faith.<sup>95</sup>

Assume that the depository bank has not opened the ATM deposit at the time of the advances to X. In fact, the bank does not open the ATM deposits until the following Monday morning. Finally, assume that the depository bank uses a third-party processor whose automated processing machine rejects the item more than once (because it lacks MICR ink?) and that the processing center eventually “strips” the check (that is, adds a workable MICR line to the check) and forwards it for collection despite its facial problems.

Now, if the payor bank mistakenly pays this check, who should bear this loss? Should we allow one outcome if the check is extant and another if it has been destroyed? In *Foster Bancshares*, the payor bank destroyed the check after paying it and before the basis for its later warranty action arose.<sup>96</sup> What happens if the check is truncated and destroyed by the depository bank in its normal course of business before anyone states an objection to its payments? Or, should we require the payor banks to seek different remedies—a breach of presentment warranty action for “altered” checks and a restitution action under U.C.C. section 3-418 for the “forged check” mistakenly paid by the payor bank?

*C. Depository Bank Takes for Collection Items Scanned and Sent by Its Customers*

Now consider the case of a depository bank with a base of depositors across the country or some depositors with many store locations around the country. An individual customer is the payee of a check and is not close to a branch of its bank. The bank provides the customer with the option of making deposits by scan via a specially protected Internet site.<sup>97</sup> The bank also promises availability of deposits made by this route in no more than two days, which makes it likely that collection will be based on the image and not the actual check.

94. 12 C.F.R. § 229.13(b) (Large deposits), 229.13(d) (Repeated overdrafts) (2007). Section 229.13(e) on “[r]easonable cause to doubt collectibility” would not yet apply, because the depository bank has not seen the thing. *See id.* § 229.13(e)(1).

95. *See Me. Fed. Family Credit Union v. Sun Life Assurance Co.*, 727 A.2d 335, 344 (Me. 1999).

96. 457 F.3d 619, 620 (7th Cir. 2006).

97. Fifth Third Bank is introducing a specialty web vault that may facilitate processing under similar circumstances. Steve Bills, *Fifth Third Cash Management Line Expands and Modernizes*, AM. BANKER, Sept. 4, 2007, at 11.

Assume the depositor skillfully raises the face value of the check that it then scans and deposits, or that it creates a “counterfeit” check from the original check. Either way, the depository bank has no idea what the original check looked like, but it captures and forwards for collection the MICR information from this deposit. Pursuant to the agreement between the depository bank and the payor bank, the depository bank does not forward either original checks or images of checks to the payor bank. Also assume that the customer who scans the check does not encode it, so that the depository bank is the only participant that makes an encoding warranty under Article 4.<sup>98</sup>

Here, it seems clear to me that the depository bank should bear any loss that ensues. Its actions in allowing its customer to manage the deposit process in this manner are the primary causes of the loss that someone will suffer. By allowing scanned items to be transferred to it without a backup means of checking the original checks, the depository bank has opened itself up to a loss, but its better knowledge of its customer and its ability to protect itself through contract with its customer helps it manage this risk.

#### *D. Other Check Problems Resulting from Electronic Processing*

Somewhat different problems may arise because of electronic processing errors. Where applicable, Check 21’s “substitute check” warranty<sup>99</sup> imposes strict liability. But Check 21 only comes into play if a bank has (1) transferred, presented, or returned a “substitute check” and (2) received “consideration” for the check.<sup>100</sup> This warranty arises regardless of whether the warranty beneficiary received the substitute check or another paper or electronic copy of the substitute check or original check.<sup>101</sup> The scope of the warranty reaches only to the substitute check’s qualification for “legal equivalence” with the original check, and to a warranty against “double debits,” that is, against paying more than once for the same obligation.<sup>102</sup>

98. See U.C.C. § 4-209(a) (2005) (whoever “encodes information *on or with respect to* an item after issue”) (emphasis added); cf. 12 C.F.R. § 229.34(c)(3) (“Each bank that presents or transfers a check or returned check warrants to any bank that subsequently handles it that, at the time of presentment or transfer, the information encoded *after issue in magnetic ink on the check or returned check* is correct.”) (emphasis added). Thus, the U.C.C. and Regulation CC employ different standards; the Regulation CC standard is narrower in my opinion.

99. 12 U.S.C. § 5004 (Supp. V 2005).

100. *Id.*

101. *Id.*

102. *Id.*

### E. Presentment in Triplicate

A payor bank received three presentments of the same obligation by electronic means. Assume that (1) there was a paper check at the outset of the transaction, so that Articles 3 and 4 applied to this transaction, and that the transaction was eligible for Check 21 treatment, and (2) no “substitute check” was created by any bank in the forward collection or return route. (We also should assume that no “positive pay” agreement governed the account on which this check was drawn.) Check 21’s warranty offers no help to the customer whose obligation has been replicated because of the absence of any “substitute check” in the forward collection route.<sup>103</sup>

We also could assume that the depository bank has a system to detect duplicates, but that system has failed on the day the triplicates occur, so that the depository bank does not suspect that it is forwarding the same obligation three times. No intermediary bank catches the triplication.<sup>104</sup> Without reaching the question yet of what the payor bank did with the triplicate presentment, should the outcome depend on where the replication occurred or by what means and intentions it came about? Does it matter if the payee’s equipment mistakenly created three “copies” of the single payment, or if the payee purposefully created three copies of the single payment?

We come to the conclusion that two of these replicas should not be “properly payable” by the payor bank under Article 4’s rules.<sup>105</sup> We also know that one or more depository banks might have obtained a “security interest” in each of the replicates so that some banks may make “holder-in-due-course” noises about them.<sup>106</sup> Are they holders in due course of separate obligations? Or of no obligation?

This fact pattern raises a host of duty-related questions:

- Did the depository bank breach a duty of “ordinary care”? Did it breach a “good faith” duty?
- If the depository bank has equipment designed to catch duplicates, does the failure of that equipment constitute a violation of its “ordinary care” duty or of its “good faith” duty? Or both? Or neither? Because this payment started life as a

103. *See id.*

104. An interesting question arises whether any intermediary would have a duty to catch the triplicates.

105. U.C.C. § 4-401(a) (2005).

106. *Id.* §§ 4-210, 4-211.

“check” and it is being processed electronically, the duty of “ordinary care” from section 3-103(a)(9) requires that the bank not violate its own procedures and that those procedures do not vary unreasonably from general banking usage not disapproved of by Articles 3 and 4.<sup>107</sup> Accordingly, because the bank has equipment to catch problems such as duplicates, it would seem that it violated its “ordinary care” duty.

- Did it act in “good faith”? One can argue that this bank violated “good faith” as well: it had a system and it violated its own system intended for the protection of someone who is a party to the payment transaction, e.g., the issuer of the check and other banks.
- What if the depository bank does not have this equipment? To what extent do depository banks check the deposits they are receiving electronically for duplicates? Is there any expectation that banks will check for duplicates? Does the depository bank have any duty to “test” the electronic deposit?
- When does the availability of such equipment, working properly, become a measure of “ordinary care” or of “good faith”?

*Changing the hypothetical slightly*, what should be the result if the payee sends the three replicas to different depository banks? Here, it is unlikely that any of the depository or intermediary banks will catch this error in the forward collection route, and the payor bank cannot catch it until the second iteration is presented for payment to the payor bank.<sup>108</sup> Assuming the payee has had accounts with the depository banks for a while, has not had problems in those accounts, and that the face values are in line with previous deposits, it is unlikely that the depository banks will question the deposits or place availability holds on them. It also may take some time before the payee learns it has received more than one payment for the same obligation.

107. *Id.* § 3-103(a)(9).

108. Of course, we have no idea which iteration is the one, true obligation that should be paid. The first to arrive? What if it is not the iteration that was deposited into the payee’s bank account? In this case, the doctrine of merger and suspension presents a new problem: if the payee’s copy is one of the dishonored copies, the suspension of the underlying obligation under section 3-310(b)(1) ends and under section 3-310(b)(3) the payee may enforce either the “instrument” or the underlying obligation. In this scenario, the obligor gets its account at its payor bank debited and also ends up as a defendant in a suit on the original check (assuming it is extant) or on a photocopy of the original check that does not qualify as a “substitute check” and create Check 21 warranties against double debits. What rights does the obligor have? A suit for wrongful dishonor? A right to a recredit of the sum paid to the “wrong” person?

*Changing the hypothetical once more*, what if the payee's employee creates the replicas and sends one to the employer's bank for the employer's account and one each to different depositary banks in which the employee has opened accounts?

If the payor bank does not recognize the triplicate presentments as such and pays all three "items," the payor bank's customer has a right to credit of two of the debits to her account under the ordinary U.C.C. section 4-401 rule, subject to any restriction that section 4-406 places on the recredit rights.<sup>109</sup> How does the liability get assigned between the depositary bank and the payor bank?

*F. No Original Check and No Remotely Created Draft*

A telemarketer sells widgets to an elderly person. The customer provides sufficient account information to the telemarketer to enable the latter to process the payment, and the telemarketer or a service provider creates a file on an X9.37 format and sends the file to the telemarketer's bank for collection. No one created a paper check or remotely created draft representing this obligation.

What law and what standards of care apply to the handling of this payment? It cannot be a "check" or an Article 4 "item" because there was no written obligation.<sup>110</sup> Unless communicated directly to a bank by the customer, the instruction is not governed by Article 4A.<sup>111</sup> Thus, if one of the current schemes applies, it must be an ACH transfer subject to the NACHA Rules and, because it is a consumer transaction, it is an "electronic fund transfer" subject to the Electronic Fund Transfer Act (EFTA) and Regulation E.<sup>112</sup> Processed as a "Telephone-Initiated Entry" under NACHA Rule section 2.13 ("Telephone-Initiated Entries," or TELs), the consumer gets no direct NACHA rights (because those rights benefit only RDFIs, ACH Operators, and NACHA<sup>113</sup>), but does get the EFTA's error resolution rights so long as the consumer starts the

109. *See id.* §§ 4-401, 4-406.

110. *See id.* §§ 3-103(a)(8), (12), 3-104(f), 4-104(a), (c).

111. *See id.* § 4A-104 cmt. 1.

112. *See* Electronic Fund Transfer Act (EFTA), 15 U.S.C. § 1693-1693r (2000); Electronic Fund Transfers (Regulation E), 12 C.F.R. pt. 205 (2007).

113. *See* 2007 NACHA RULES, *supra* note 3, § 2.13.2.3, at OR 15 (Liability for Breach of Warranty). Section 2.13.2.3 also provides that its indemnification includes claims, etc., based on the RDFI's failure to comply with these Rules resulting in the RDFI's violation of the EFTA or of Regulation E. *Id.*

dispute process within sixty days after receiving documentation of the transfer under EFTA section 908.<sup>114</sup>

What if the payment is processed more than once?<sup>115</sup> Do the error resolution rules of the EFTA apply? First, one must be certain that the alleged “error” falls within the definition of “errors” in EFTA section 908(f), which covers both “unauthorized electronic fund transfer[s]” and “incorrect electronic fund transfer[s]” from the consumer’s account.<sup>116</sup> But the consumer must overcome two obstacles to recovery: she must meet the same sixty-day limit on notifying her bank, and she must persuade her bank that the transfers were “unauthorized” or “incorrect,”<sup>117</sup> which seems likely. The EFTA timing limitations are stricter than the U.C.C.’s.<sup>118</sup> The proof of what is “unauthorized” or “incorrect” may be similar to the U.C.C.’s “properly payable” rule in fact.<sup>119</sup> The consumer has to recognize that the Article 4 check rules are not directly applicable to these transactions and that the NACHA Rules and EFTA are; further, she must realize that she may lose her right to her remedy if she chooses Article 4’s rules over the EFTA’s rules.

### III. SOME PRELIMINARY CONCLUSIONS

#### A. *Organizing Principles*

Earlier in this article, I presented four basic principles of payments law that we need to consider in framing rules for the present

114. EFTA § 908, 15 U.S.C. § 1693f.

115. Allegations of multiple debits for the same payments arise in connection with consumer uses of credit cards, remotely created drafts, and payments like this authorized by telephone that are not recorded in paper form. The Federal Trade Commission sought injunctive relief against numerous vendors offering “free travel” packages to consumers beginning in the 1980s. *See, e.g.*, *FTC v. Amy Travel Serv., Inc.*, 875 F.2d 564, 566, 570 (7th Cir. 1989); *FTC v. World Travel Vacation Brokers, Inc.*, 861 F.2d 1020, 1022 (7th Cir. 1988); *Citicorp Credit Servs., Inc.*; Proposed Consent Agreement with Analysis to Aid Public Comment, 57 Fed. Reg. 55,534, 55,537 (Nov. 25, 1992) (citing related 1987 filing against Credit Card Travel Services, Inc., doing business as Bank-Card Travel Club). Further, the Department of Justice is prosecuting a payments processor who is alleged to handle remotely created drafts on behalf of telemarketers. For opinions in the companion civil action, see *United States v. Payment Processing Ctr., LLC*, 461 F. Supp. 2d 319 (E.D. Pa. 2006), and *United States v. Payment Processing Ctr., LLC*, No. 06-0725, 2006 U.S. Dist. LEXIS 75715 (E.D. Pa. Oct. 18, 2006).

116. 15 U.S.C. § 1693f(f).

117. *See id.*

118. *Compare* 15 U.S.C. § 1693f(a), *with* U.C.C. §§ 4-401, 4-406(f) (2005) (imposing a one year notice requirement for most cases of alterations and forged checks in addition to the U.C.C. statute of limitations).

119. U.C.C. § 4-401(a).

and future “check” processing disputes. These included: transparency, consistency, privity/eligibility for relief, and proof. They favor a staunch combination of harmonization and education.

1. *Transparency*: Obligors should be informed of how their payment obligations will be processed. If something goes wrong under the current mix of rules, consumers must be prepared to invest a great deal of energy trying to determine what standards of care those processing the payment should have followed, as well as whether someone breached those standards during the processing, and the procedures for obtaining redress. We also have multiple sources of “law” for different stages of the same transaction, a factor that can overwhelm the average consumer. To complicate the task of identifying the standards and securing their benefits, we are in an environment in which system rules such as those from the Electronic Check Clearing House Organization (ECCHO) and NACHA, which are not readily available to obligors/issuers, are replacing more widely available sets of rules such as the Uniform Commercial Code and Federal Reserve Board regulations. To add to this complexity, we also have embedded “security procedures” that are confidential out of necessity, such as those referenced in Rule 4.0 (“Security Procedures”) in Federal Reserve Bank Operating Circular Number 4 (“Automated Clearing House Items”).<sup>120</sup>
2. *Consistency*: One payment may be processed by different intermediaries using different rules (from U.C.C. Articles 3 and 4 to Check 21 or to the NACHA rules and the Electronic Fund Transfer Act<sup>121</sup>) under which different standards and different warranties govern the duties of the different intermediaries. The reversibility rules in these sets of rules differ considerably; remedies depend on following special timing rules, etc. Choice of the collection method by the payee or depository bank should not disadvantage the issuer.
3. *Privity*: The person who is injured by a failure to exercise ordinary care or good faith or another duty supplied by one of the

120. Operating Circular No. 4, *supra* note 9, § 4.0.

121. 15 U.S.C. §§ 1693–1693r.

sets of rules may not have any preexisting relationship with the person who caused the loss or any other connection that would normally cause us *to recognize a duty*. Courts have refused to grant remedies in these cases under the U.C.C.<sup>122</sup> The NACHA Rules are specific about which participants may benefit from NACHA warranties.<sup>123</sup> And,

4. *Proof*: the issuer of the check may have difficulty proving *who caused the "error"* in processing or payment among many payments intermediaries involved in processing that payment, and under the different duties imposed by different payment rules.

We also have to deal with the growing reality of "electronic checks" (instructions that are never in paper form) and "Internet-Initiated Entries" under the NACHA Rules. Consumers are unlikely to appreciate that these are different payment processing regimes. These payments are governed in the former case by whatever "agreement" is in place and in the latter by the NACHA Rules and the EFTA for consumer transactions.<sup>124</sup> Consumers could choose the "wrong" remedy—and be left without a remedy if they fail to follow rules for the "right" legal regime.

## B. Future Rules

### 1. Future "Ordinary Care" Rules

If we reformed the law to cover electronic imaging and processing in one more global law, we would need to provide standards to hold the place of "ordinary care." The types of questions we would need to answer in fashioning those standards would include:

- Will one baseline standard suffice for handling of payments in retail payments (checks) that will travel to the payor bank by legally divergent forms and routes? Should there be sepa-

122. See *Conder v. Union Planters Bank, N.A.*, 384 F.3d 397, 399–400 (7th Cir. 2004) (affirming district court holding that drawer had no cause of action under U.C.C. section 3-420(a) for conversion against depository bank for its failure to deposit checks into accounts bearing names similar to those of the named payee, and affirming dismissal of drawer's claim in general negligence against depository bank); *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 955–58 (7th Cir. 1982) (holding plaintiff's claim against defendant for failure to execute a wire transfer on time failed for lack of privity with defendant).

123. *E.g.*, 2007 NACHA RULES, *supra* note 3, § 2.11.2.6, at OR 13.

124. *See id.* § 2.11, at OR 13.

rate baselines for different processing routes? What are the costs of having different baselines? Are these costs different in terms of the four organizing principles mentioned above—transparency, consistency, privity, and proof?

- How will depository banks deal with depositors that truncate checks on their premises and send information to their depository banks for collection? Will evolving legal standards follow the approaches in Article 4 for encoding warranties and Check 21 so that the rules place all of the burdens inside the banking system? Or, will the standard allocate some of the loss to the truncators?
- What will depository banks do to prevent the replication of information so that only one instruction to pay is sent forward for collection? To the extent that they use software to detect duplicates, will that software be governed by the ordinary care standard? Will a warranty such as the “no-double-debit” warranty in Check 21 resolve this issue?
- In transactions not subject to the NACHA Rules, when and under what circumstances will depository banks destroy original checks? Will the NACHA rules on destruction become the standard?
- When will depository banks allow their *depositors* to destroy original checks? And to what extent should destruction rules depend on the method (electronic presentment of checks under section 4-110 agreements, ACH, or electronic check conversion) used to collect the particular obligation?
- To what extent will payment systems compete to make their rules available and favorable to consumers? To what extent will persons be hindered in obtaining recourse by difficulty in obtaining information about the scope of care in cases governed by proprietary system rules (as the ECCHO rules have been until recently)?

## 2. Future “Good Faith” Rules

Questions pertaining to “good faith” that we might try to resolve in the new payments environment include:

- Should the standard of “good faith” depend on the degree of automation involved? In other words, does the standard of

“good faith” differ if processing is automated after the payment arrives at the payee?<sup>125</sup> Should we expect takers for value, collecting banks, or payor banks to adopt special procedures to protect issuers and owners in highly automated environments? Or should we impose new warranty obligations on those who do not adopt procedures when subsequent losses occur?

- What processing procedures should be instituted if the payment fails to pass muster under the automated process?<sup>126</sup>
- Should payments that fail the automated processing equipment be eligible for stripping and later automated processing?<sup>127</sup>
- Should we increase the warranties made to the payor bank and the drawer if the depository bank strips a check?
- Should the processing standards depend on the face value of the instrument (higher standards for larger-value obligations, such as the exposure-limit rules in the NACHA Rules<sup>128</sup>) or the nature of the payment (low-value consumer payment generated from desktop publishing versus a higher-value item that lacks MICR ink and purports to be a cashier’s check)?
- Under what situations should the payment obligation be required to pass some human scrutiny at the depository bank before forwarding to the payor bank for payment?
- Under what situations (e.g., when an item is rejected by processing equipment once or more than once) should manual review (not a traditional signature comparison) be performed at the payor bank before payment?

125. NACHA Rules require that in “electronic check conversion” the source document be read by a specialized reader rather than having the account information keyed in manually. *E.g., id.* § 2.9.2, at OR 11 (applying to “Accounts Receivable Entries”), § 2.10.2, at OR 12 (applying to “Back Office Conversion Entries”). Other eligibility rules apply in both cases. *Id.* § 2.9.1, at OR 10, § 2.10.1, at OR 11.

126. NACHA Rule subsection 2.7.2 renders ineligible for “destroyed check entries” items rejected during processing by the Originating Depository Financial Institution, i.e., checks that do not pass muster in the check reader. This would resolve cases in which processors might strip a check that lacked MICR ink and, for that reason, could not be processed through the ordinary reader, then later turns out to be a counterfeit check.

127. *See id.*

128. *Id.* at pt. I, Quick Find 9 (explaining ODFI exposure limits).

### C. To Whom Do Banks Owe Duties?

One of the recent problems in check processing is related to privity. *Evra* and *Conder* put some remedy possibilities off the table because of a lack of privity.<sup>129</sup> But in other cases, the rules are written to provide more potential beneficiaries with rights. Check 21's warranty provision is such a rule,<sup>130</sup> even if the circumstances under which the warranty applies are relatively limited. Article 4A also imposes on the originating and intermediary banks duties that flow back to the originator of the funds transfer.<sup>131</sup>

As described above, the NACHA Rules also impose bright-line standards through eligibility provisions and related warranties. If an item was converted through a Back Office Conversion Entry (BOC), the NACHA Rules render ineligible as a source document any check that, among other things, was not encoded in magnetic ink, is for amounts greater than \$25,000, is a third-party check, or is a demand draft that does not contain the signature of the Receiver.<sup>132</sup> Participants who process ineligible documents are vulnerable to warranty liability.<sup>133</sup>

The future solution seems to require an amalgam of rules using the current U.C.C. "good faith" and "ordinary care" standards, and the brighter-line rules of Articles 4A, NACHA, and Check 21. Retention of the U.C.C. standards will assist in the resolution of disputes between issuers, payees, and depository and payor banks so long as the U.C.C. standards continue to have substance. The likelihood is that bright-line standards in rule sets such as the NACHA Rules will define the future scope of the "good faith" and "ordinary care" duties that should be retained to assist in the resolution of disputes.<sup>134</sup>

129. See *Conder v. Union Planters Bank, N.A.*, 384 F.3d 397, 399–400 (7th Cir. 2004); *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 955–58 (7th Cir. 1982).

130. 12 U.S.C. § 5004 (Supp. V 2005).

131. U.C.C. art. 4A prefatory note ("Bank error in funds transfers"), §§ 4A-207, 4A-302, 4A-303, 4A-305 (2005).

132. 2007 NACHA RULES, *supra* note 3, § 2.10.1, at OR 11–12. A "Receiver" is a "natural person or an organization that has authorized an Originator to initiate an ACH entry to the Receiver's account with" the Receiving Depository Financial Institution (RDFI). *Id.* pt. I, at ACH Primer 2.

133. *Id.* § 2.10.3, at OR 12.

134. *E.g., id.* § 2.10.1, at OR 11–12 para. 2 (rendering ineligible for BOC entries "checks or sharedrafts that have not been encoded in magnetic ink," which would have placed more duties to check the six-figure "item" deposited into the ATM and taken for value by the depository bank before it was ever subjected to mechanical or manual inspection in the hypothetical case above).

## CONCLUSION

The duties formerly assigned to depository, intermediary, and payor banks are undergoing stresses because of basic automated processing, the post-Check 21 surge in electronic processing, and the rise in ACH transfers. The ability of parties that are not themselves depository institutions or higher-level system participants to locate the sources of errors in check processing, and to understand which rules actually govern their transactions, is decreasing. Multiple routes for the collection of payments starting life in the same form contribute to a decline in transparency and an increase in the burden on the average consumer or small business to obtain remedies. The lack of privity between the issuer or owner of the check and the person who caused the problem also may be a factor preventing a remedy for the issuer or owner.

Because paper checks—formerly single, unique embodiments of payment obligations—have been transformed into images or streams of electronic information, with the originals often destroyed before the theft or error is discovered, the loss of physical evidence for participants in disputes about payments will be an increasing problem. Thus, paper stock, ink quality, handwriting, handwriting/implement pressure, fingerprints, endorsements (hand- or spray-applied), chemical washing, fiber disruption, and the like will continue to decline as means to help assign liability based on the statutory “ordinary care” and “good faith” tests. In this new era, it may be harder to predict results and to create systems to prevent losses than has been possible in the more than forty years since the U.C.C. first went into effect.

To continue with the careful allocation of risks that has characterized loss allocation under the U.C.C. and to handle new issues that inevitably will arise as technology continues to change, new parameters for duties in payments processing are required. This may mean creating standards more on the order of Article 4A’s “security procedures” or brighter-line new warranties such as the Check 21 or NACHA warranties, or it may involve an entirely new solution.

Check processing has moved from a one-option, move-the-paper-from-the-payee-to-depository-bank-to-the-payor-bank world, with the original check as the best evidence, to one in which several viable options exist for getting the drawer’s order to pay to the payor bank and in which the check may have been destroyed. Check processing options include electronic presentment using the provisions of Article 4 and system rules and check conversion under the NACHA Rules (together

with Regulation E if the drawer was a consumer). In addition, the proliferation of check processing options means the payee or its agent or bank—rather than the drawer/obligor—chooses the type of processing the payment obligation will receive. This choice, to a great extent, also determines the duty standards, if any, to which the check processing will be subject.

This range of choice is not all bad news: the NACHA Rules and Regulation E provide different, but not weaker, protections to consumer drawers than the scheme that the Uniform Commercial Code gave them. The lack of drawers' control over how a check gets collected complicates their ability to get relief in payment disputes and creates new discovery problems. The issue is how drawers and others determine whether participants in the check collection process have fulfilled the duties assigned to them, as *Foster Bancshares* and *Chevy Chase Bank* demonstrate.<sup>135</sup> Proving fulfillment or non-fulfillment under these circumstances introduces new costs to payments participants.

It is costly to leave the resolution of these important liability issues to litigants, as Judge Posner observed in *Foster Bancshares*.<sup>136</sup> The additional standard-setting and risk reallocation work should be accomplished by someone—whether by NCCUSL and state legislatures, by Congress or the Board of Governors, or by payments systems such as NACHA and ECCHO.

Finally, because the issuer no longer controls the choice of collection method, it may be time to have uniform rules across all retail payments methods by which we measure compliance with duties. With larger numbers of consumer checks being processed under the NACHA Rules and Regulation E, consumers may not object to convergence of the “reversibility” or error-resolution rules as vigorously as they did when the Uniform Payments Code (UPC) was proposed in the 1980s, when consumer concerns defeated its adoption by the states.<sup>137</sup> On the other hand, consumers may be satisfied with the shift from standards in U.C.C. Articles 3 and 4 to the NACHA Rules and Regulation E substi-

135. See *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*, 208 F. App'x 232, 234–35 (4th Cir. 2006); *Wachovia Bank, N.A. v. Foster Bancshares, Inc.*, 457 F.3d 619, 622 (7th Cir. 2006).

136. See *id.* at 623. Judge Posner was referring to the National Conference of Commissioners on Uniform State Laws (NCCUSL), the organization that partners with the American Law Institute in drafting the Uniform Commercial Code.

137. See Fred H. Miller, *Report on the New Payments Code*, 41 BUS. LAW. 1007, 1008 (1986); Fred H. Miller, *Report on the New Payments Code*, 39 BUS. LAW. 1215, 1220 (1984).

tutes, in a manner similar to the compromise rules that the New Payments Code suggested a quarter century ago.<sup>138</sup>

Creating new rules with greater transparency, consistency, and cleaner evidentiary standards will not be an easy task. In early 2003, when I proposed a more global, UPC-like solution for Check 21's original draft to Professor Fred Miller, then President of NCCUSL, his response was the functional equivalent of "are you insane?" And the responses of the states and others to the proposals in the UPC and to more recent revisions of the U.C.C.<sup>139</sup> suggest that stakeholders other than consumers will have to be persuaded of the merit of the proposals. Given the costs of uncertainty and demands of the law reform process, the harmonization process may be easier than it was previously and it should start now.

138. See Fred H. Miller, *U.C.C. Articles 3, 4 and 4A: A Study in Process and Scope*, 42 ALA. L. REV. 405, 409 n.6 (1991).

139. No state has enacted the 2003 revisions to U.C.C. Article 2. See Uniform Law Commissioners, *A Few Facts About the... Amendments to UCC Articles 2 and 2A*, [http://www.nccusl.org/nccusl/uniformact\\_factsheets/uniformacts-fs-ucc22A03.asp](http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ucc22A03.asp) (last visited Feb. 22, 2008). Only Arkansas, Kentucky, Minnesota, Nevada, and Texas have enacted the 2002 revisions to Articles 3 and 4; Oklahoma introduced but did not enact them in 2007. See Uniform Law Commissioners, *A Few Facts About the... Amendments to Articles 3 and 4 of the UCC*, [http://www.nccusl.org/nccusl/uniformact\\_fact\\_sheets/uniformacts-fs-ucca3.asp](http://www.nccusl.org/nccusl/uniformact_fact_sheets/uniformacts-fs-ucca3.asp) (last visited Feb. 22, 2008).