

# ELECTRONIC FUNDS TRANSFER IN THE BANK CARD INDUSTRY

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## I. DESCRIPTION OF THE CREDIT CARD INDUSTRY

Electronic Funds Transfer (EFT) promises to be an extremely important development in the bank card industry.<sup>1</sup> The bank or credit card industry is a system whereby banks issue cards that extend an open credit line to customers for the purchase of goods and services from participating merchants. Credit Systems, Inc. (CSI), to which I am counsel, is a not-for-profit regional bank card association of over 700 midwestern banks. It is a member of Interbank Card Association which licenses the Master Charge trade name and trademark to banks. The regional associations and larger banks of the Interbank Card Association act as clearing-houses for Master Charge transactions among member banks. CSI also operates a regional association containing over 300 member banks in connection with the VISA system. Most regional associations, including CSI, are subject to the provisions of Section 5 of the Bank Service Corporation Act<sup>2</sup> and are

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1. For an extremely helpful introduction to the legal ramifications of EFT as it affects the bank card industry, see PRACTICING LAW INSTITUTE, ELECTRONIC FUNDS TRANSFER (Pub. A 4-2079 1977).

2. 12 U.S.C. § 1865 (1970) provides:

(a) No bank subject to examination by a Federal supervisory agency may cause to be performed, by contract or otherwise, any bank services for itself, whether on or off its premises, unless assurances satisfactory to the agency prescribed in subsection (b) of this section are furnished to such agency by both the bank and the party performing such services that the performance thereof will be subject to regulation and examination by such agency to the same extent as if such services were being performed by the bank itself on its own premises.

(b) The assurances required by subsection (a) of this section shall be given, in the case of—

(1) a national banking association or a bank operating under the code of laws for the District of Columbia, to the Comptroller of the Currency;

(2) a bank (other than a bank described in paragraph (1)) which is a member of the Federal Reserve System, to the Board of Governors of the Federal Reserve System; and

(3) a bank (other than a bank described in paragraph (1) or (2))

regulated and subject to examination by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Bank, and state bank regulatory authorities.

Credit card transactions occur at the retail level, between the bank's card holders and participating merchants, "and sales slips generated by cardholders from banks from other regions are interchanged (*i.e.*, settled) through regional associations and larger member banks." Banks on the merchant side record retail transactions by collecting merchandise sales slips, and forwarding them to the regional association where EFT is used to effect an interchange of transactions with the cardholder's bank in a different region. CSI accomplishes this interchange by accumulating daily the sales slips from its member banks and processing them through a computer which automatically scans, separates, and records them on electronic tape. These tapes are then transmitted to the Interbank national network for interchange. Interbank's National EFT System ("INET") settles and clears each association's sales slips and the regional association and larger banks exchange settlement drafts which enable member banks to immediately charge their cardholder's account.

## II. APPLICATION OF EFT TO BANKS— IN DEVELOPING RETAIL DEBIT CARD SYSTEM

The ultimate goal of debit card transactions is direct remote electronic debiting and crediting of demand deposit and savings accounts, thereby eliminating the need for checks or money. By 1980, without EFT, banks will be inundated with forty billion checks a year which would cost six billion dollars to process; EFT, however, will eliminate many paper transactions and increase the flow of money. Retail establishments throughout the country contain twelve billion dollars of idle cash, and additional billions of float—"money in transit"—exist at all times. Debit cards could greatly reduce both and offer consumers the ability to secure cash, make deposits, transfer funds, and make utility payments electronically. A national EFT system, like the credit card system, would enable a consumer to secure cash throughout the United States. Banks would also benefit from such a system: competing banks can share an EFT terminal and expensive brick and mortar branches

can be eliminated. Money thus saved on construction would be available for loans.

In 1972, CSI began investigating methods by which the bank card industry could expand its credit card system and participate in the development of a retail EFT system. The study culminated in the formation by bank members of CSI of Financial Communications Services, Inc. (FCS) to develop a retail EFT system for the bank card industry. FCS had several advantages: it utilized CSIs experience in managing credit cards in developing control of debit cards. In addition, it sought to establish a common trade name for use by all member banks to ensure public acceptance in the market place. Finally, it was planned to use the same electronic network for both debit and credit cards. Eventually, this network could be joined with other regional associations to form a national EFT system. VISA and Interbank are already preparing models for these networks.

FCS was to be a five-state regional association capable of providing a full line of EFT retail services. Any institutions capable of accepting demand deposits could have issued debit cards and been "on line" for those cards. The system would have provided daily settlement of accounts among all participating banks and truncated all paper items at the originating bank, thereby eliminating the flow of paper. Although it was unclear whether banks would have been required to share the system with other financial institutions, by combining credit and debit card communications networks, FCS would have achieved substantial economies.

In spite of these advantages, the FCS system was aborted because the legal and economic environment was too uncertain. In 1976, the Missouri legislature failed by seven votes to enact a bill favorable to FCS. The bill provided that neither point of sale terminals nor automatic unmanned free standing remote service units were branch banks.<sup>3</sup> Many federal courts, on the other hand, have held that EFT terminals used by nationally chartered banks are subject to state branch banking laws as interpreted under federal banking statutes.<sup>4</sup> Federal

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3. Mo. H. Bill No. 1236, 78th Gen. Ass., 2d Sess. (1976) (Senate Substitute for Senate Committee Substitute).

4. See, e.g., *Missouri ex rel. Kostman v. First Nat'l Bank*, 538 F.2d 219 (8th Cir. 1976), *cert. denied*, 97 S. Ct. 357 (1977); *Illinois ex rel. Lignoul v. Continental Ill. Nat'l Bank*, 536 F.2d 176 (7th Cir. 1976), *cert. denied*, 429 U.S. 871 (1976); *Independent Bankers Ass'n of America v. Smith*, 534 F.2d 921 (D.C. Cir.), *cert. denied*, 429 U.S. 862 (1976).

laws require banks to commit capital and surplus to each terminal,<sup>5</sup> thereby greatly increasing the cost. After assessing the continuing uncertainties and increased costs, the banks concluded that the system was at present unfeasible.

### III. ADDITIONAL IMPEDIMENTS TO DEBIT CARD DEVELOPMENT

Development of EFT in the bank card industry is impeded by several factors. The definition of the EFT terminal is especially important. Initially, the Comptroller of the Currency indicated that a terminal was essentially an electronic mail box.<sup>6</sup> Subsequent cases, however, led by *Independent Bankers Association of America v. Smith*,<sup>7</sup> have held that any machine which does the equivalent of lending money, paying checks, or accepting deposits is a branch.

The Eighth Circuit Court of Appeals considered this issue recently and handed down a rather disturbing opinion in *St. Louis County National Bank v. Mercantile Trust Co.*<sup>8</sup> The court held that a trust office was a branch even though it did not pay checks, lend money, or accept deposits.<sup>9</sup> Because the office was not located in the city in which Mercantile Bank's headquarters were located, the court affirmed the district court's order closing the trust office.<sup>10</sup> To define branch, the court referred to Senator McFadden's explanatory remarks made in the Congressional Record *after* the McFadden Act was passed. Senator McFadden stated that if any business carried on at the remote office was also performed in the main banking house, that office was a branch.<sup>11</sup> If this case is not reversed, the entire loan production office system operated by many large banks throughout the country is in jeopardy. Notwithstanding these cases, a recently published ruling of the Comptroller of the Currency suggests that if a third party purveyor of bank card services owns or leases a terminal and subsequently allows a bank to use it on a transaction fee basis, it may not be subject to branching laws.<sup>12</sup> Realistically, however, until there is federal legisla-

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5. *E.g.*, 12 U.S.C. § 36(d) (1970).

6. 12 C.F.R. § 7.7491 (1976) (removed 41 Fed. Reg. 36,198 (1976)).

7. 534 F.2d 921 (D.C. Cir.), *cert. denied*, 429 U.S. 862 (1976).

8. 548 F.2d 716 (8th Cir. 1976), *cert. denied*, 97 S. Ct. 2975 (1977).

9. *Id.* at 719.

10. *Id.* at 720.

11. *Id.* at 719.

12. 41 Fed. Reg. 48,333 (1976). The Comptroller adopts the ruling by the Court

tion or new court decisions, there will be no further development of multistate retail bank-related EFT systems.

The antitrust laws may also hinder development of EFT systems. Operators of an EFT system cannot share with some competitors and exclude others; if the system is the only one available and provides an essential service, it must be shared with all potential users.<sup>13</sup> The Bank Service Corporation Act<sup>14</sup> of 1962 recognized the importance of sharing and allowed banks to form corporations to share certain services. However, the Justice Department recently advised in a business review letter that the proposed Nebraska Electronic Transfer System ("NETS") may be a monopoly.<sup>15</sup> NETS is an organization which represents eighty percent of the deposits in the state of Nebraska, and proposes to operate an EFT system under a state law that requires sharing. The Justice Department refused to assure the Nebraska organization that it would not be sued for violation of the antitrust laws—probably under section 7 of the Clayton Act.<sup>16</sup>

Finally, there are a number of Uniform Commercial Code problems with EFT. Articles 3 and 4 of the UCC<sup>17</sup> were designed primarily for paper transactions. FCS relies on UCC section 4-103,<sup>18</sup> which allows a bank and its customers to vary the terms of the Code by agreement to solve these inadequacies. Presently, the 348 Committee and its reporter, Professor Hal Scott, are developing amendments to Articles

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of Appeals for the District of Columbia that "a CBCT is a branch only when it is 'established (*i.e.*, owned or rented) by the national bank.' Consequently, . . . any CBCT which is not established by a national bank (*i.e.*, owned or rented by the bank) is not a branch of a national bank and not subject to the provisions of 12 U.S.C. § 36." See also Peck & McMahon, *Recent Federal Litigation Relating to Customer-Bank Communications Terminals ("CBCTs") and the McFadden Act*, 32 Bus. Law. 1657, 1681-82 (1977).

13. *Associated Press v. United States*, 326 U.S. 1 (1945) (a combination of competitors for the good of all but to the exclusion of all other competitors violates the Sherman Act); *United States v. Terminal R.R. Ass'n*, 226 U.S. 383 (1912) (control of the only available railroad routes to St. Louis by a combination of railroad companies violated Sherman Act when competitors were denied use).

14. 12 U.S.C. §§ 1861-1865 (1970).

15. Antitrust Division, U.S. Dep't of Justice Press Release, March 7, 1977 (business review letter to W. Brandt from D. Baker). See *Electronic Funds Transfer and Banking Regulations*, 1977 WASH. U.L.Q. 519.

16. Clayton Act, ch. 323, § 7, 38 Stat. 730 (1914) (current version at 15 U.S.C. § 18 (1970)).

17. U.C.C. §§ 3-101 to 4-504.

18. U.C.C. § 4-103.

3, 4 & 8 which it is hoped will infuse the Code with sufficient flexibility to accommodate a paperless society.<sup>19</sup>

Unfortunately, many states have enacted restrictive EFT laws. Many of these laws, which are essentially exceptions to antibranching statutes, prohibit out-of-state banks from sharing EFT terminals within the state. By erecting EFT trade barriers, these laws will partition multi-state market areas in which consumers want to utilize their credit or debit cards for the purchase of goods and services. These artificial barriers defeat the efficiency advantages of EFT.

In sum, EFT is an excellent replacement for the check. Six billion dollars of float could be eliminated by creating a more efficient payment system. EFT is faster, more efficient, easier to use, and less susceptible to fraud and theft. In many areas of the country the check is useless to obtain cash. The law must now demonstrate that it is flexible enough to cope with electronic checks. If it does not allow banks to develop EFT systems, others, particularly retailers,<sup>20</sup> will dominate the payments system by controlling EFT throughout the United States.

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19. 41 ALI PROCEEDING 592-94 (1975); The committee was expected to issue its final amendments for Article 8 for review before the Commissioners on Uniform State Laws by summer of 1977. Amendments of Articles 3 and 4 are continuing. 42 ALI PROCEEDING 706-07 (1976).

20. San Francisco Chronicle, Mar. 29, 1977, at 49, col. 1.