

THE EXPEDITED FUNDS AVAILABILITY ACT OF 1987: BEYOND TOASTERS AND TOTALLY FREE CHECKING

In 1987 Congress enacted the Expedited Funds Availability Act¹ (E.F.A.A.) in response to public concern that banks held customers' deposits for unduly long periods before crediting their accounts.² In May 1988 the Board of Governors of the Federal Reserve System (the Board) promulgated the final rules for implementing the E.F.A.A., known collectively as "Regulation CC."³ These rules, effective September 1988, limit fund holding periods for all U.S. banks.⁴ Regulation CC also provides for enhanced check return procedures⁵ to reduce bank losses, and takes steps to eliminate a specific check-kiting scheme, MICR fraud,⁶ for large dollar items. Finally, to encourage faster return of unpaid checks, the rules change the law of deposits and collections embodied in Article 4 of the Uniform Commercial Code.

This Note explores the Expedited Funds Availability Act in depth, and its current and future impact on the check collection process. Part I examines the law and procedures of the modern check collection system. Part II describes check-kiting schemes that take advantage of inefficient check return and the measures banks employ to limit such fraud. Part III analyzes the provisions of the E.F.A.A. in detail, and how the Act alters the flow of checks and attendant bank duties in collection and return systems. In addition, Part III examines the risks of fraud losses banks will face under the new availability rules. Finally, Part IV examines the Board's measures to limit fraud, and future technologies for greater efficiency.

This Note concludes that although in the short run banks may face higher costs and heightened risk of fraud, consumers will benefit with prompter access to funds. In the long run, however, both banks and customers will profit from the advanced and lower-cost banking technologies that the new regulations promote.

1. Title VI of the Competitive Equality Banking Act, Pub. L. No. 100-86, 101 Stat. 635 (1987) (codified at 12 U.S.C. §§ 4001-4010, 248a (1987)).

2. 133 CONG. REC. H3073 (1987) (statement of Rep. St. Germain).

3. 12 C.F.R. § 229 (1988).

4. See *infra* notes 51-74 and accompanying text.

5. See *infra* notes 75-81 and accompanying text.

6. MICR fraud is a costly form of check-kiting. See *infra* Part II. In an MICR fraud scheme the perpetrator manipulates the magnetic characters across the bottom of a check, known as the MICR. See *infra* notes 31-32 and accompanying text.

I. DEVELOPMENT OF MODERN COLLECTION SYSTEMS

Banks and other financial entities process approximately 35 billion checks annually.⁷ To accommodate this load, banks have of necessity abandoned slow, manual check handling for rapid and accurate automated systems. Currently, banks use the Magnetic Ink Character Recognition (MICR) system.⁸

The MICR is a series of numbers printed across the bottom of a check with special ink. This ink contains iron particles that can be magnetized and read by computer. The characters are divided into three fields: the "transit number" field, the "on us" field and the "amount field."⁹ The "transit number" field contains the necessary routing information that banks use for modern automated presentment.¹⁰ The "on us" field tells the payor bank¹¹ from which account to draw the funds. Finally, the "amount field" encodes the amount of the check.

Only the transit number and on us fields are preprinted on the checks.¹² The depository bank,¹³ or the first collecting bank¹⁴ that has the necessary equipment for encoding, prints the amount of the check in the amount field. Once the amount is printed, the rest of the presentment process is automated. Checks pass through a machine called a

7. See generally GENERAL ACCOUNTING OFFICE, COMPTROLLER GENERAL'S REPORT TO THE CONGRESS: THE FEDERAL RESERVE SHOULD MOVE FASTER TO ELIMINATE SUBSIDY OF CHECK CLEARING OPERATIONS (May 7, 1982); Jordan, *Ending the Floating Check Game: The Policy Arguments For Delayed Availability Reform*, 36 HASTINGS L.J. 515, 521 (1985) (hereinafter *Jordan*).

The number may be even larger. Some commentators have calculated that approximately 40 billion checks passed through banking channels in 1983. Because the known growth rate is seven percent, the 1987 figure could be as high as 52 billion. See F. LEARY, B. MCCULLOUGH & P. WINSHIP, MATERIALS ON THE LAW OF CREDIT AND PAYMENT SYSTEMS (COMMERCIAL PAPER) 298 (1983) (statistics on post-World War II growth of check use in United States).

8. For a discussion of the history of check systems development see S. YAVITZ, AUTOMATION IN COMMERCIAL BANKING (1967).

9. See N. PENNEY & D. BAKER, THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS (1980) at ¶ 1.02[2].

10. Note, *The Allocation of Risk of Loss Due to "MICR Fraud": Is Northpark a Steadfast Solution or an Evanescent Effort*, 9 DEL. J. CORP. L. 347, 351 (1984).

11. The "payor" (or "drawee") bank is "a bank by which an item is payable as drawn or accepted," U.C.C. § 4-105(b) (1985), in other words, the bank whose name and address appear on the check.

12. PENNEY & BAKER, *supra* note 9 at ¶ 1.02[2].

13. The depository bank is "the first bank to which an item is transferred for collection even though it is also the payor bank." U.C.C. § 4-105(a) (1985).

14. A "collecting bank" is "any bank handling the item for collection except the payor bank." U.C.C. § 4-105(d) (1985).

“reader-sorter,” which electronically sorts checks by destination.¹⁵ When the checks arrive at the next bank in the collection chain, the process is repeated until the individual check reaches its payor bank.¹⁶

Checks usually pass through several intermediary banks¹⁷ or Federal Reserve Bank branches on the way to the payor bank.¹⁸ Each bank extends provisional credit in the amount of the check to its immediate transferor.¹⁹ The credit becomes final upon payment by the payor bank.²⁰ If the payor bank dishonors the item, notice of nonpayment usually proceeds back up the collection chain to the depository bank.²¹

The collection chain works on the presumption that “no news is good news.” The U.C.C. does not require notice that the instrument has been paid, only that it has not.²² If the bank’s holding period expires with no notice, the provisional credit automatically becomes final.²³

Most banks can obtain credit for an instrument in as little as forty-eight hours, even for large dollar items that are still in the process of

15. See Wechsler, *Delayed Funds Availability*, 35 SYRACUSE L. REV. 1117, 1129 (1984).

16. This process is known as “fine sorting.” See generally PENNEY & BAKER, *supra* note 9, at ¶ 1.02[4].

17. An intermediary bank is “any bank to which an item is transferred in the course of collection except the depository or payor bank.” U.C.C. § 4-105(c) (1985). Thus, a depository bank can be a collecting bank, or the payor, but not an intermediary. A payor bank may be neither a collecting bank nor an intermediary. *Id.*

18. Normally, if the depository bank is not a member of the Federal Reserve system, it must transfer the check to a “correspondent” bank that is a member. The correspondent bank then forwards the check to the local branch of the Federal Reserve Bank of that district. If the payor is in another district, the check is transferred to that district’s Federal Reserve, which will then present the check to the payor. If the payor is in the same district, the check will be presented directly to the payor by the first Federal Reserve Bank. See Note, *Computerized Check Processing and a Bank’s Duty to Use Ordinary Care*, 65 TEX. L. REV. 1173, 1177-78 (1987).

19. See U.C.C. § 4-104 official comment 6 (1985).

20. U.C.C. § 4-213(1),(2) (1985).

21. U.C.C. § 4-212(1) (1985). If the instrument is dishonored, then the immediate transferor will “charge back” the credit it extended to its transferor, and so on up the line, to the original depository’s customer.

The Federal Reserve and several commentators attempted to instate “direct return” of dishonored items to the depository, then optional under U.C.C. § 4-212(2). Their efforts were unsuccessful, however, largely because not every jurisdiction enacted that provision. See Miller & Ballen, *U.C.C. Survey, Commercial Paper*, 41 BUS. LAW 1399, 1402 (1986).

The regulations implementing the E.F.A.A. that explicitly allow direct return have rendered this discrepancy in jurisdictions moot.

22. See U.C.C. § 4-202(1)(b) (1985). This is reasonable because 99.3% of all checks are paid on presentment. U.C.C. § 4-212 comment 1 (1985).

23. U.C.C. § 4-213(1) (1985). For an in-depth description of the modern check clearing system, see Jordan, *supra* note 7, at 521-31.

clearing.²⁴ On the other hand, banks traditionally prohibit customers from both withdrawing funds and writing checks against their deposits for a much longer period, sometimes as much as twenty-one banking days.²⁵ One 1982 estimate determined that banks' ability to use these uncredited funds may net them over \$400 million annually.²⁶

Banks impose long holding periods on consumer funds²⁷ as a result of the "no news is good news" collection system. Although depositaries and collecting banks present checks for payment at astonishing speed, once dishonored, the pace slows to a crawl. Despite technological advances in the collection process the procedures for returning checks are unautomated. Most banks return these items to their immediate transferor in the next day's mail.²⁸ Because the check can take days to go back up the collection chain, banks impose long holding periods to assure notice of dishonor arrives before the customer withdraws the funds.²⁹

II. CHECK-KITING SCHEMES

A check-kiting fraud turns the banks' "no-news-is-good-news" assumption against itself. The classic kite involves depositing one worthless check, drawn on a distant payor bank, in a depositary bank. The perpetrator then deposits a second worthless check, drawn on a third institution, in the payor bank to cover the first check. After the hold period expires at the depositary bank, he withdraws the funds and covers

24. See *Jordan*, *supra* note 7, at 531.

25. *Jordan*, *supra* note 7, at 516. A "banking day" is a day on which a bank is open to the public for carrying on substantially all of its banking functions. U.C.C. § 4-104(1)(c) (1985).

26. The Federal Reserve routinely extends credit to depositary institutions for checks presented for payment. This amounts to an interest-free advance on the check, at least until the Federal Reserve can present it in turn. The Comptroller General estimated that the loss in potential interest on these "loans" to the U.S. Treasury was "up to about \$400 million." Comptroller General's Report, *supra* note 7.

27. Banks' commercial clients are usually able to negotiate much shorter hold periods, and in some cases immediate availability. *Delayed Funds Availability: Hearing before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 4, 8 (1982) (testimony of Theodore E. Allison, Staff Director for Federal Reserve Bank Activities).

28. Because only 0.67% of all checks are dishonored, the volume of returns is apparently not great enough to merit more expeditious treatment than that of the U.S. Postal Service. See J.D. Caneker and Associates, Inc., Return Items Study, Final Report, 53 Fed. Reg. 19382 (1988) [hereinafter BAI Study] (prepared for the Bank Administration Institute). Another banking industry study found that 5% of all dollar losses by participating banks were caused by returned cash letters and items lost in the mail on their way to the prior indorser. See *Jordan*, *supra* note 7, at 532 n.88.

29. A study prepared for the Bank Administration Institute found that the forward collection process takes an average of 1.6 days to complete, while the return time clocked in at 5.2. See *BAI Study*, *supra* note 28.

the second check, keeping the interest made on the first check. This scheme continues until one of the checks is dishonored.³⁰

In a MICR fraud scheme, the perpetrator of the fraud deposits a sizeable check that has either a fictitious or existing drawee bank printed on its face. In addition, another existing drawee in a location distant from the first is encoded numerically in the MICR line.³¹ The check makes its way through normal banking channels to the MICR encoded payor. When that institution determines that no such account exists, it sends the check back to its immediate transferor. At that bank, a clerk examines the check manually and notices the discrepancy. That bank then forwards the instrument to the Federal Reserve branch of the payor bank whose name appears on the check. At this point, the Federal Reserve either transfers the check to the named payor, or discovers that no such bank exists. In either case, when the instrument finally makes its way back to the depository the holding period has expired, and the malefactor has absconded with a large sum of the depository's funds.³²

30. This is the same check-kiting scheme that E.F. Hutton employed for years in bilking several large commercial banks of millions of dollars in interest. See N.Y. Times, May 17, 1985 at D1, col. 4. See also *Town & Country State Bank of Newport v. First State Bank of St. Paul*, 358 N.W.2d 387 (Minn. 1984) (description of "classic" kite); B. CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS*, ¶ 4.12 (1981) (discussing results of cases involving large check-kiting schemes).

31. This fraud is impossible to decipher without visual scrutiny and a knowledge of individual banks' codes. The only way to discern a bank's identity from the MICR line is to use the *KEY TO ROUTING NUMBERS* (Rand McNally 1988), which lists the American Banker's Association assigned bank transit numbers and check routing numbers to individual payor banks. See Miller, Ballen, Davenport & Vergari, *U.C.C. Survey: Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers*, 42 BUS. LAW. 1269, at 1282 (1987) [hereinafter *1987 U.C.C. Survey*] (suggesting that quick review of *Key to Routing Numbers* could avoid a MICR fraud problem.).

32. MICR fraud already has cost banks several million dollars. See *1987 U.C.C. Survey*, *supra* note 31.

Only two cases regarding MICR fraud have been decided in the federal courts. The first is *Northpark National Bank v. Banker's Trust Company*, 572 F. Supp. 524 (S.D.N.Y. 1983). In that case, a customer of Northpark deposited a check for \$62,500 that bore the name of a fictitious bank, but the MICR code for an existing bank. The check took a circuitous route through collection channels and eventually was returned unpaid to the depository, by which time the perpetrator of the fraud had withdrawn all but \$3,000.

The court held that U.C.C. §§ 4-202(1)(a) and (b) provided the only legally viable cause of action for the depository. The court demonstrated a willingness to hold a collecting bank liable if the inconsistencies on the face of the check were "usually an indication of fraud." *Id.* at 531. If those same inconsistencies were frequently the result of simple error, however, and a reasonable bank employee would find no cause for alarm, then no liability would attach. Because the inconsistencies of the check in *Northpark* were not obvious, the depository had to bear the loss. *Id.*

In the second case, *United States Fidelity and Guarantee Co. v. Federal Reserve Bank of New*

One device that can help prevent MICR fraud is "wire advice of nonpayment."³³ Regulation J³⁴ requires paying banks using the Federal Reserve system for check collection to wire notice of nonpayment of "large-dollar items" (\$2500 or more).³⁵ The regulation's purpose is to avoid the problems MICR fraud perpetrators take advantage of: hold periods expiring before notice of nonpayment reaches the depository.³⁶ Currently, the regulation requires a payor bank that does not intend to pay an item to notify the depository promptly, usually within three banking days.³⁷

The problem with reliance on this provision as a means of allocating

York, 620 F. Supp. 361 (S.D.N.Y. 1985) (*USF&G*), the plaintiff depository bank accepted an \$880,000 check for deposit. The depository later allowed the customer to withdraw the funds under extremely suspicious circumstances. When the check eventually arrived, the depository sued the local Federal Reserve Bank branch for breach of its duty of ordinary care under § 4-202. *Id.* at 363-68. It also sued one of the "paying banks" for failing to comply with its midnight deadline under § 4-302. *Id.* at 373.

The court analogized the contributory negligence component of § 3-406 to cases of MICR fraud brought under § 4-202. Section 3-406 precludes a party from avoiding payment on an altered instrument if the party's negligence contributed to its alteration. The court reasoned that because § 3-406 incorporates negligence concepts in requiring ordinary care of collecting banks, the same duty of care should apply to depository banks that benefit from the protection the provision provides. *Id.* at 371-72. The court further noted that because the depository is in the unique position to examine both the customer and the instrument, it has a duty of due care to observe before holding the collecting bank to its own duty. Otherwise, the entity in the best position to prevent the fraud could avoid liability for its own inaction. Under the court's analysis, plaintiff's gross negligence prevented it from recovering. *Id.* at 372.

The court also absolved the payor bank of liability for missing its midnight deadline under U.C.C. § 4-302. *Id.* U.C.C. § 3-511(2)(b) excuses delay in notice of dishonor when the presenting party has no "reason to expect or right to require that the instrument be accepted or paid." On the plaintiff depository's inquiry before the funds were withdrawn, the payor bank had informed plaintiff that there was no account in that customer's name at their bank. The court held that because of this notice, plaintiff had no "right to expect payment" on the instrument. *Id.*

33. This is proposed as a solution in Note, *Assessing Liability for MICR Fraud*, 37 ALA. L. REV. 145 (1985). The author suggests that the bank named on the check wire advice of nonpayment, even if it does not hold an account in that name. If, as in *Northpark*, 572 F. Supp. 524 (S.D.N.Y. 1983), *supra* note 32, the named drawee does not exist, the first bank to realize this should wire advice. Failure to do so would result in liability on the instrument. *Id.* at 157-59.

The problem with this solution is that the first bank to receive the check will not be the bank "named" on the check, but the MICR-encoded institution. A long delay will be inevitable after the automated system rejects the check, which then must be handled manually down the chain to the named payor. The E.F.A.A. incorporates a better solution; *see infra* notes 100-101 and accompanying text.

34. 12 C.F.R. § 210 (1987).

35. 12 C.F.R. § 210.12(c) (1987).

36. *See generally* CLARK, *supra* note 30, ¶ 4.6[4] (Supp. 1987).

37. The payor bank must notify the depository so that notice is received no later than two banking days following its normal midnight deadline for returning the item. 12 C.F.R. § 210.12(c) (2) (1987).

liability among several banks is the potential lack of a "paying bank" to give notice of nonpayment.³⁸ The bank encoded in the MICR line will assume the code is misprinted and forward the check for payment to the bank named on the check without giving notice to the depository. If that bank is fictitious, then the notice will never be triggered.³⁹ Thus if a court can find no "paying bank" to hold responsible, a depository bank may be left with the losses, even absent any negligence on its part.⁴⁰

III. THE EXPEDITED FUNDS AVAILABILITY ACT OF 1987

In 1987, Congress enacted the Expedited Funds Availability Act in

38. See Note, *Assessing Liability for MICR Fraud*, *supra* note 33, at 158. In addition, this provision applies only to banks using the Federal Reserve Bank in collection; only 40% of checks are currently collected in this manner.

39. This is precisely what occurred in the *Northpark* case, *supra* note 32. The bank returned the check through normal channels, but notice was never given because neither bank considered itself the payor. See Note, *Assessing Liability for MICR Fraud*, *supra* note 33, at 158.

40. See *Citizens State Bank v. Martin*, 227 Kan. 580, 609 P.2d 670 (1980) (bank to which a check mistakenly sent owed no duty of ordinary care to depository under U.C.C. § 4-202 because not a "collecting bank" under that section). But see *Northpark*, 572 F. Supp. 524 (Federal Reserve a collecting bank for purposes of U.C.C. § 4-202).

The necessary conclusion after *Northpark* and *USF&G*, 620 F. Supp. 361, discussed *supra* note 32, is that a depository must not only show a lack of negligence on its own part, *USF&G*, 620 F. Supp. at 373, but negligence on the part of a collecting bank, *Northpark*, 572 F. Supp. at 534-35. For example, if an altered check used in a MICR fraud scheme is indistinguishable from a normal check, then a collecting bank will not be put on notice of fraud under *Northpark*. Thus, even if the depository is not negligent in dealing with the malefactor, it must absorb the loss, absent a showing of negligence by a collecting bank.

Furthermore, under U.C.C. §§ 3-418, 3-417(1)(b) and 4-207(1)(b), the payor bank is liable for paying over a forged drawer's check because the payer is in the best position to verify the customer's indorsement.

In the MICR fraud cases, the depository is assumed to be in the best position to prevent the fraud, see *Northpark*, 572 F. Supp. at 535 n.27; *USF&G*, 620 F. Supp. at 372, perhaps because it has the ability to determine the customer's trustworthiness in a face-to-face context. On the other hand, in a situation in which the instrument is well fabricated, the depository is in no better position to avoid the fraud than a paying bank that realizes that its MICR number does not correspond to the named bank on the check. Unless the paying bank promptly gives notice of nonpayment under U.C.C. § 4-301 (or will advice of nonpayment under Regulation J, if required), the paying bank will be liable for the item. If the paying bank does give notice, however, and because of nonnegligent delays, the notice does not arrive until after the funds have been released, the depository must bear the loss. This is simple risk allocation, and has nothing to do with ordinary care or comparative negligence. There may be valid reasons for strictly allocating the risk of loss to the depository. Both the *Northpark* and the *USF&G* courts declined to do this, however, preferring to employ comparative negligence analyses to reach the same result.

Regulation CC has largely obviated this problem, however, by defining the "payor bank" to be the MICR-encoded institution. This places the responsibility for notice of nonpayment squarely on the bank that will first receive the check. See *infra* notes 100-101 and accompanying text.

response to consumer demands for shorter check hold periods.⁴¹ Congress found that while banks used state of the art technology to speed the process of check collection for their own benefit, they did not attempt to improve the return systems to reduce the necessary hold time. In addition, banks placed holds on all instruments even though less than one percent of all checks are unpaid.⁴²

The E.F.A.A. gives the Board of Governors of the Federal Reserve System broad authority to implement the Act in three general areas.⁴³ First, the E.F.A.A. creates specific time frames for making funds available.⁴⁴ Second, the Act requires banks to pay interest when they give provisional credit, not when the check "clears."⁴⁵ Finally, the E.F.A.A. obligates banks to disclose the new funds availability policies to their customers.⁴⁶

Under its broad authority, the Board promulgated rules collectively known as "Regulation CC."⁴⁷ Both the E.F.A.A. and the rules substantially affect the law of bank collections and deposits.

41. Title VI of the Competitive Equality Banking Act, Pub. L. 100-86, 101 Stat. 635 (August 10, 1987) codified at 12 U.S.C. §§ 4001-4010, 248a (1987).

Several states already had similar legislation in place. Any state law in effect as of September 1, 1989 that requires greater funds availability will supplant the E.F.A.A. and Subpart B of Regulation CC (regarding funds availability schedules). 12 C.F.R. § 229.20. No further amendments by the states will be allowed after that date, however. *Id.* Other inconsistencies, whether in effect before or after September 1, 1988, will also be superseded. *Id.*

In addition, the E.F.A.A. will supplant state laws regarding check collection, to the extent that they conflict with subpart C of Regulation CC. 12 C.F.R. § 229.40.

42. See 133 CONG. REC. H3073 (daily ed. May 5, 1987) (remarks of Rep. St. Germain, Chairman, House Banking Comm.).

43. The final rules amend Regulation J, codified at 12 C.F.R. § 210, and add a new section, § 229, which the Board refers to as "Regulation CC."

44. See *infra* notes 51-74 and accompanying text.

45. 12 C.F.R. § 229.14. For a helpful discussion of interest policies see, Jordan, *supra* note 7, at 560-62.

46. Disclosure must be made: (1) when a new account is opened, 12 C.F.R. § 229.17(a); (2) in a bank's first scheduled mailing after Sept. 1, 1988, 12 C.F.R. § 229.17(b).

Disclosure must be posted: (1) where consumer deposits are accepted, 12 C.F.R. § 229.18(b); (2) at Automated Teller Machines (ATMs), 12 C.F.R. § 229.18(c).

Disclosure must be given: (1) on all preprinted deposit slips, 12 C.F.R. § 229.18(a); (2) upon customer request, 12 C.F.R. § 229.18(d); (3) when bank policy changes are made; 12 C.F.R. § 229.18(e).

The disclosure should include a complete exposition of the bank's funds availability policy, especially hold periods for different items and how to tell them apart, 12 C.F.R. § 229.16(b)(2); exceptions that the bank may invoke to delay availability, 12 C.F.R. § 229.16(b)(3), (4); general notice policy and timing, 12 C.F.R. § 229.16(c)(2); and overdraft and returned check fees, 12 C.F.R. § 229.16(c)(3).

47. 12 C.F.R. § 229 (1988).

In passing the E.F.A.A., Congress feared that shortened collection times would increase banks' fraud losses.⁴⁸ To avoid this result, the E.F.A.A. gives the Board broad authority to develop systems to speed the return of unpaid items. In response, the Board has defined new duties for banks in the collection chain,⁴⁹ and proposed several new technological advances to expedite return procedures.⁵⁰

A. Enhanced Funds Availability Under the E.F.A.A.

The most important provisions in the E.F.A.A. for consumers are those that create new time limits for funds availability. These provisions are in two parts: a temporary schedule, effective September 1, 1988, and a permanent schedule that takes effect on September 1, 1990.⁵¹ For purposes of permitted "hold time," a check is divided into one of three classifications: (1) local checks; (2) nonlocal checks; or (3) certain instruments more likely to be honored, i.e., cash, Treasury checks, and cashiers' checks.⁵²

48. Under the E.F.A.A., notice of nonpayment will often not reach the depository before it is required to release the funds. See *infra* notes 158-65 and accompanying text.

49. See *infra* notes 82-123 and accompanying text.

50. See *infra* notes 171-79 and accompanying text.

51. 12 C.F.R. § 229.12(a).

52. Current law generally requires next-day availability for cash. See U.C.C. § 4-213(5) (1985). The E.F.A.A. requires the following items to be available on the next banking day:

(1) cash, 12 C.F.R. § 229.10(a); (2) wire transfers, 12 C.F.R. § 229.10(b); (3) checks drawn on the U.S. Treasury, when indorsed by the payee and deposited into account, 12 C.F.R. § 229.10(c)(1)(i); (4) U.S. Postal money orders when deposited in the payee's account and in person to an employee of the depository bank, 12 C.F.R. § 229.10(c)(1)(ii); (5) checks drawn on a Federal Reserve Bank or Federal Home Loan Bank when deposited in the payee's account and in person to an employee of the depository bank, 12 C.F.R. § 229.10(c)(1)(iii); (6) checks drawn on a State or unit of local government when deposited in the payee's account and in person to an employee of the depository bank which is located in the same state that issued the check, or in which the locality is located, with a special deposit slip, 12 C.F.R. § 229.10(c)(1)(iv); (7) cashiers, certified, tellers or depository checks when deposited in the payee's account and in person to an employee of the depository, with a special deposit slip, 12 C.F.R. § 229.10(c)(1)(v); (8) a check drawn on the same or another branch of the depository bank (if the branch is in the same state or check processing region), 12 C.F.R. § 229.10(c)(1)(vi); and (9) the first \$100 of all checks deposited on any one business day, 12 C.F.R. § 229.10(c)(1)(vii).

In addition, funds from checks that fall under the categories in (c)(1) (ii), (iii), (iv) and (v) above are to be made available one business day later if they are not deposited in person at the depository bank, for example, deposits to ATMs. 12 C.F.R. § 229.10(c)(2). Operational difficulties in collecting and verifying these unstaffed deposits caused the Board to add this regulation. This exception does *not* include Treasury checks or "on us" checks (checks drawn on the depository). Under the E.F.A.A., these are subject to the next-day availability requirements no matter where deposited. See 53 Fed. Reg. 19,395 (1988) (operational difficulties inapplicable with regard to U.S. Treasury checks).

Checks under the third category are subject to next day availability if the customer deposits the instrument in person at a depository bank branch.⁵³ Treatment of the former two classes under the Act is more complex. First, \$100 of any deposit, local or nonlocal, is subject to next day availability.⁵⁴ In addition, banks must allow customers to write checks drawn against funds from local checks⁵⁵ on the second business day⁵⁶ after the banking day⁵⁷ the item was received for deposit. Banks must also make \$400 of the total deposit available for cash withdrawal on that date.⁵⁸ The following business day, all funds may be withdrawn.⁵⁹ Funds from nonlocal checks must be available for check writing purposes on the fifth business day following deposit. As with local checks, \$400 must be available for cash withdrawal on the fifth business day, and all funds may be withdrawn the next business day.⁶⁰ Cash availability of the total amount in both cases may be further delayed by one business day.⁶¹

The temporary schedule in effect until September 1990 is slightly less stringent. Banks must make the proceeds of a local check available on the third business day following the banking day of deposit for both cash withdrawal and check writing.⁶² A nonlocal check must clear by the

53. More specifically, "A depository bank shall make funds deposited in an account by check available for withdrawal not later than the business day after the banking day on which the items are deposited." 12 C.F.R. § 229.10(c)(1). For the difference between a "banking day" and a "business day" see *infra* notes 56-57.

54. 12 C.F.R. § 229.10(c)(1)(vii).

55. A "local check" is one that is drawn on or payable through or at a "local paying bank," i.e., a bank located in the same Federal Reserve check processing region as the depository. 12 C.F.R. §§ 229-2(r),(s),(m).

56. A "business day" is defined as a calendar day other than a Saturday, a Sunday, or a national holiday. 12 C.F.R. § 229.2(g).

57. A "banking day" is that part of a business day on which an office of the bank is open to the public for carrying on substantially all of its banking functions. 12 C.F.R. § 229.2(f).

58. 12 C.F.R. §§ 229.12(b), (d).

59. *Id.*

60. *Id.*

61. Branches of depository banks located outside the contiguous United States have one further business day to credit their customers' accounts if the payor bank is located in another state. 12 C.F.R. § 229.12(e).

62. 12 C.F.R. § 229.11(b)(1)(i). If, however, a bank must process the local check outside a local clearinghouse association, then the funds may be made available one day later. 12 C.F.R. § 229.2(l). Nonetheless, the bank must make \$400 available for cash withdrawal as of 5:00 p.m. on the day the funds would have been available had the banks belonged to the same association. This limitation also applies to other irrevocable transactions, such as wire transfers and issuance of cashiers checks. 12 C.F.R. § 229.11(2). This limitation protects the banks who typically post their returns in the evening of the day of receipt. For such banks, even if the check were returned on the day the funds were released, the bank would not be aware of it after closing hours. Meanwhile, the

seventh business day, as must all checks deposited in "nonproprietary" automated teller machines.⁶³

There are, however, several exceptions to these time limits. For example, the limits described above do not apply to items deposited within thirty days of opening a new account.⁶⁴ Nor do the regulations apply to large deposits,⁶⁵ redeposited checks,⁶⁶ or accounts with a history of overdrafts.⁶⁷ A "good faith" exception also exists under which a depository can extend the hold placed on a check if there is "reasonable cause" to believe that the item will be uncollectible.⁶⁸ Emergency conditions can

customer could withdraw the entire amount in cash during the day. To limit the potential loss to the depository, a customer may withdraw a maximum of \$400.

63. 12 C.F.R. § 229.11(d). A nonproprietary ATM is an ATM that is not owned or operated by, or located on the premises of, a particular bank. *Id.* See also 12 C.F.R. §§ 229.2(x), (aa). In addition, branches of depository banks located outside the forty-eight contiguous states have one extra day if the payor bank is located in another state. 12 C.F.R. § 229.11(e).

64. 12 C.F.R. § 229.13(a). An account is considered "new" during the first thirty days following the initial opening deposit unless the customer had a previous account relationship with that institution. For examples of new accounts see 53 Fed. Reg. 402, 403 (1988).

This exception does not apply if the deposited items are certified checks, cash, or government checks. In that case, the bank must make the funds available on the business day following the banking day of deposit. If those items, aggregated or alone, exceed \$5000, then the rule applies only to the first \$5000. The bank must make the balance available no later than eight business days after deposit. This latter provision does not apply to cash or electronic payments which must be made available in their entirety. 12 C.F.R. § 229.13(a)(ii).

Unlike the other exceptions discussed below, the Board has established no maximum time limit for holding new account funds. In theory then, banks are free to hold their customers' funds up to the thirty day new account period, after which the regular schedule in effect at that time would apply. Presumably, banks are still held to their obligation of good faith under U.C.C. § 1-203, which is also not disclaimable under U.C.C. § 4-103(1).

65. A "large deposit" is one that exceeds \$5000 in the aggregate, i.e., deposited in any or all of a customer's accounts on any banking day. 12 C.F.R. § 229.13(b). This does not apply to deposits subject to next-day availability under 12 C.F.R. § 229.10. The bank may also extend the hold pursuant to 12 C.F.R. § 229.13(h), see *infra* text accompanying note 72.

66. This exception does not apply to checks that are redeposited due to either postdating or failure to indorse. 12 C.F.R. § 229.13(c).

67. The account must be "repeatedly overdrawn," defined as a negative account balance, or a balance that would have been negative if checks or other charges had been paid, for a total of six days in the past six months (or only two days, if the overdraft is \$5000 or greater). 12 C.F.R. § 229.13(d).

68. "[R]easonable cause to believe [that the check is uncollectible] requires the existence of facts which would cause a well-grounded belief in the mind of a reasonable person." 12 U.S.C. § 604(c)(1) (Supp. VI 1988). The regulations adopt this definition. 12 C.F.R. § 229.13(e)(1). The bank must include its reason for its belief of uncollectability in the notice of delay. If the belief is based on confidential information, for example a reasonable belief that the customer is engaged in kiting activity, it may so state in lieu of full disclosure. Banks should, however, file an internal memo

also suspend the normal availability schedules.⁶⁹

If a bank invokes any of these exceptions, it must give the customer notice,⁷⁰ stating the reason for the delay and the date upon which the funds shall be available.⁷¹ The bank may only hold the funds for a "reasonable period" of time. The rules consider four days after the funds would have been available under the applicable schedule to be *prima facie* reasonable; longer delays may also be reasonable, but the bank has the burden of establishing reasonableness.⁷²

The penalty for violating these provisions is the actual damage sustained.⁷³ A bank may be excused, however, if the violation is the result of a *bona fide* error.⁷⁴

B. *The New Collection System*

Compliance with the availability schedules under the E.F.A.A. often will require depository banks to release funds well in advance of receipt of notice of dishonor. This creates the potential of exposing banks to

stating the actual reasons for the delay. 12 C.F.R. § 229.13(g)(3). See *supra* note 46 for a more detailed discussion of funds availability disclosure requirements.

The statute also forbids banks to make this determination based on any particular class of checks. Even if the depository knows the check is drawn on a rural bank, and notice of nonpayment cannot reach the bank before the funds must be made available, it cannot extend the hold. Nor can it do so based on the race or national origin of the depositor.

69. 12 U.S.C. § 604(c)(1) (Supp. VI 1988); 12 C.F.R. § 229.13(f).

70. The depository bank must give this notice at the time of deposit, unless the deposit is not made in person or the facts giving rise to the exception become known to the depository after the deposit. In these cases, notice must be given as soon as practicable, but not later than the first business day following knowledge of the facts leading to the exception. 12 C.F.R. § 229.13(g)(2)(i). This notice should include sufficient information for the customer to identify both the deposit and the relevant account, the reason for the delay, and the date upon which the funds will become available. 12 C.F.R. §§ 229.13(g)(1)(i)-(v).

71. 12 C.F.R. § 229.13(g).

72. 12 C.F.R. § 229.13(h).

73. In individual actions, a court may allow additional exemplary damages, not less than \$100 nor more than \$1000. In class action suits, the limit of those damages is the lower of \$500,000 or one percent of the bank's net worth. In addition, reasonable attorneys' fees and costs may also be awarded in enforcing the bank's liability. 12 C.F.R. § 229.21(a).

74. The bank, to be charged, must demonstrate a *bona fide* error by a preponderance of the evidence. 12 C.F.R. § 229.21(c)(1). Examples of a *bona fide* error include, but are not limited to: (1) clerical error; (2) calculation error; (3) computer malfunction; and (4) printing error. An error of legal judgment with respect to the depository's obligations is not, however, a *bona fide* error. 12 C.F.R. § 229.21(c)(2). This section does not apply to actions arising from alleged breaches of statutory duties under subpart C of Regulation CC, nor actions for wrongful dishonor under U.C.C. § 4-402, 12 C.F.R. § 229.21(f).

substantial losses.⁷⁵ The Board addressed these concerns in subpart C of Regulation CC.⁷⁶ These rules attempt to speed the return process by defining new duties for paying banks, returning banks, and depositories.⁷⁷ Their overall effect is to make the return process mirror the collection chain and to encourage the kind of technological advances that have previously been the exclusive domain of the presentment process. In doing so, the rules alter both warranty liability under U.C.C. section 4-207⁷⁸ and contract liability under U.C.C. section 3-414,⁷⁹ and modify Regulation J regarding wire notice of nonpayment.⁸⁰ Finally, the provisions make changes to check-presentment procedures and establish guidelines for determining interbank liability.⁸¹

*1. Paying Bank's Responsibility for Check Return:
12 C.F.R. Section 229.30*

Under Regulation CC section 229.30, a payor bank⁸² must return a check to the depository as if it were presenting the item for collection. A paying bank may satisfy this requirement in one of two ways. First, it may return the check in the same manner as a similarly situated bank would handle a check for forward collection drawn on the depository.⁸³ Second, a payor bank can also return a check expeditiously if the check arrives at the depository by 4:00 p.m. on the second business day following the banking day of deposit in the case of a local check, or four days later if the check is nonlocal.⁸⁴ Any means of return is acceptable, in-

75. See *infra* notes 158-70 and accompanying text.

76. 12 C.F.R. §§ 229.30-.38.

77. 12 C.F.R. §§ 229.30-.32; see *infra* notes 82-123 and accompanying text.

78. 12 C.F.R. § 229.34; see *infra* notes 129-33 and accompanying text.

79. 12 C.F.R. § 229.35; see *infra* notes 134-38 and accompanying text.

80. 12 C.F.R. § 229.33; see *infra* notes 124-28 and accompanying text.

81. 12 C.F.R. §§ 229.36-.38; see *infra* notes 143-57 and accompanying text.

Many of these rules come from proposed amendments to Article 4 of the U.C.C. made by the National Conference of Commissioners on Uniform State Laws, the organization responsible for U.C.C. revisions. See generally 52 Fed. Reg. 47,139 (1987).

82. A payor bank is defined at 12 C.F.R. § 229.2(z) as the bank whose routing number appears on the check in magnetic characters or in fractional form, and to which the check is sent for payment or collection.

83. 12 C.F.R. § 229.30(a)(2).

84. 12 C.F.R. § 229.30(a)(1). Originally, the Board proposed only the "forward collection" test as a means of determining expeditious return. Commentators thought this standard too uncertain, especially in light of the current "midnight deadline" requirement. The Board responded by adding the second "two-day/four-day" standard, based on average presentment times.

Most checks presented for collection do arrive at the payor bank within the limits of the new standard, and its advantage lies in the certainty of its measure. In some cases, however, it may take

cluding sending the check to a returning bank that agrees to handle it for return,⁸⁵ or returning the item directly to the depository.⁸⁶ This provision reinforces U.C.C. section 4-212(2), as that subsection was previously optional, and not all jurisdictions had enacted it. The regulation now explicitly permits direct return.⁸⁷ In addition, Federal Reserve bank branches have agreed to accept all items for expeditious return.⁸⁸

The payor bank, however, is still required to meet its midnight deadline⁸⁹ under U.C.C. sections 4-301 and 4-302.⁹⁰ The regulations, however, now allow the payor bank to extend that deadline in a good faith

longer than either two or four days to present a check. In that case, the check still would be considered to have been returned expeditiously if it arrived no later than if it had been presented for payment. 53 Fed. Reg. 19,379 (1988).

The payor bank's only duty is to *send* the check so that it should arrive on time; risks of unforeseeable transportation delays, etcetra, are borne by the depository. *Id.* at 19,478. In addition, delays caused by the depository or returning banks are not attributable to the payor. This is analogous to the responsibility of returning banks under U.C.C. § 4-202(3). *Id.*

85. The Board initially proposed allowing the payor bank to return the item to any bank that had handled it for collection, even if that bank did not agree to handle it for return. Because commentators thought it unfair to force expeditious return requirements on a bank that did not hold itself out as a returning bank, the final regulation limits the option to those cases in which the payor or returning bank cannot identify the depository. It must then advise its transferee that it cannot identify the depository. The check is not subject to expeditious return requirements. 53 Fed. Reg. 19,379 (1988).

86. The commentary to 12 C.F.R. § 229.30 notes several methods: (1) it may return the check directly to the depository, bypassing all intermediaries; or (2) the payor may send the check to any returning bank willing to handle it under 12 C.F.R. § 229.31(a), whether or not that bank handled it for forward collection. 53 Fed. Reg. 19,478-80 (1988).

The payor may also send the check to the presenting bank or clearinghouse through which the item was presented as currently required under U.C.C. § 4-301(4). In addition, it may send the item to any Federal Reserve Bank, whether or not the check was handled by that Bank during the collection process.

If the depository cannot be identified, then the payor bank is free to return the check to any bank that handled the check for forward collection. This is so whether or not that bank agrees to return it expeditiously under 12 C.F.R. § 229.31(a), if the payor advises this bank that the depository is unidentifiable. 12 C.F.R. § 229.30(b). The risk of less than expeditious return will fall on the depository if it did not follow the indorsement standards of 12 C.F.R. § 229.35(a), or the collecting bank if it did not adhere to its indorsement standards under the same provision. In this situation, if the payor bank bears the loss, it may still have a claim against the prior collecting bank under U.C.C. § 4-207.

87. 12 C.F.R. § 229.30(a)(2). *See supra* note 21 and accompanying text.

88. This new process is known as "universal returns." Previously, Federal Reserve branches would accept for return only items they had handled for collection. This new process will likely have a profound effect on the competitive market for returns. *See generally* 53 Fed. Reg. 19,495 (1988).

89. The "midnight deadline" with respect to a bank is midnight on its next banking day following the banking day on which it received the item or notice, or from which the time for taking action commences, whichever is later. U.C.C. § 4-104(h) (1985). This deadline is significant in allocating

effort to expedite delivery. If the payor bank does so, the item must be received by the recipient bank on the next banking day following the midnight deadline.⁹¹

a. Regulation CC's Effect on Former Practice

Prior to September 1, 1988, a payor bank's primary duty in the collection chain was to pay or dishonor the item in a timely manner. The new rules will no longer permit a payor bank simply to drop the dishonored item in the mail by its midnight deadline under U.C.C. section 4-301. The payor bank must now dispatch the item as if the bank were presenting it for payment.⁹²

This provision will have several ramifications. First, payor banks will have to insure that notice of dishonor under Regulation J arrives one day earlier than previously required. This requirement applies to all checks, not just those processed for forward collection by a Federal Reserve bank.⁹³ Second, because direct return and direct notice are explicitly permitted under this section, banks that previously had not established account relationships with certain depositaries now may be compelled to do so.⁹⁴ Third, banks that previously paid no fee for items returned through the Federal Reserve will face higher return costs, though collection fees will be commensurately lower.⁹⁵

Other provisions of the U.C.C. have also been altered as applied to paying banks. A paying bank may now extend the time for return beyond its section 4-301 midnight deadline. If a bank does extend its midnight deadline, however, the check must arrive on the recipient bank's next banking day.⁹⁶ Further, a paying bank now warrants that it is au-

liability under Article Four, and has been altered somewhat by the E.F.A.A. *See infra* note 91 and accompanying text.

90. Failure to meet the midnight deadline renders the payor bank accountable for the item under U.C.C. § 4-302 (1985). Keeping this requirement should encourage payor banks to expedite the process as much as possible. Under the liability standards of 12 C.F.R. § 229.38, a payor bank can be liable for the item under either § 4-302, or this provision, but not both.

91. This provision allows banks to return checks, for example, by a jet leaving after midnight. In addition, the item may arrive after the recipient's next banking day if the payor bank uses a "highly expeditious means of return," such as air courier. 12 C.F.R. § 229.30(c). This extension also applies to notice of nonpayment under Regulation J, 12 C.F.R. 210.12; *see infra*, notes 124-28.

92. 12 C.F.R. § 229.30(a)(2).

93. *See supra* note 88 and accompanying text.

94. *See supra* note 21 and accompanying text.

95. *See infra* note 173 and accompanying text.

96. *See supra* note 91 and accompanying text.

thorized to return the item, that it has met the applicable deadline, and that the returned check has not been materially altered.⁹⁷ In addition, a payor bank is now subject to an indorser's contract liability under U.C.C. section 3-414. The regulation has expanded this liability beyond indorsers in the collection chain, (i.e., payee to presenting bank), to the payor bank, and back down the return path to the depository.⁹⁸ Finally, a paying bank must now accept check presentment at certain locations, whether or not it did so previously.⁹⁹ The Board's intent behind these provisions is to encourage banks to expedite returns by making that process the legal equivalent of the more lucrative collection route.

b. The Timely Demise of MICR Fraud

The regulation, by its definition of payor bank, also makes MICR fraud essentially impossible for items over \$2,500. Regulation CC section 229.2(z)(3) defines a payor bank as the bank whose routing number appears on the check in magnetic or fractional form, and to whom the check is sent for collection. This definition renders the printed name on the check entirely irrelevant to the determination of which bank is the payor bank in a MICR fraud scheme.¹⁰⁰ The MICR encoded bank will receive the item first, and even though the name of another bank may be printed on the check, the encoded bank will be considered the paying bank. Thus, that bank will be required to expeditiously return the item, or send notice of dishonor. Further, the bank will not forward the check to another bank in an attempt to collect it.¹⁰¹ Any delay in notice of dishonor sought by the MICR criminal is thus eliminated. In addition, the provision resolves any dispute over which bank is the "paying bank" for purposes of fixing liability.

97. 12 C.F.R. § 229.34. See *infra* notes 129-33 and accompanying text.

98. See 12 C.F.R. § 229.35, discussed *infra* notes 134-38 and accompanying text.

99. See *infra* notes 143-48 and accompanying text.

100. See *supra* notes 31-32 and accompanying text.

101. See 12 C.F.R. §§ 229.2(z) and 229.33(a). If the MICR criminal uses a fictitious MICR number, the depository may find the discrepancy itself when encoding the check with the amount field. See *supra* note 31 and accompanying text. If not, then the first bank to notice the fictitious MICR number should notify the depository. Under the *Northpark* reasoning, *supra* note 32, this would constitute enough of a discrepancy to trigger a duty to notify the depository. 572 F. Supp. at 534-35.

2. *Returning Bank's Responsibility for Check Return:*
 12 C.F.R. Section 229.31

The responsibilities of a returning bank¹⁰² are similar to those of a paying bank under Regulation CC section 229.30. A bank that agrees to handle an item for return¹⁰³ must do so as expeditiously as it would for collection, or within the "two-day/four-day" standard.¹⁰⁴ This standard is more stringent than the U.C.C. section 4-202 requirement to act "seasonably" in returning a check.

The returning bank also has the same routing options as does a paying bank.¹⁰⁵ Because the returning bank may now route the item to a bank that did not handle it for forward collection, a bank that accepts an item for return must settle with its transferor as it would an item for payment, and not by charge-back under U.C.C. section 4-212(1).¹⁰⁶ The returning bank may also charge its transferor a fee for the check's return.¹⁰⁷

Prior to Regulation CC, a bank returning items was subject to a duty similar to that of payor banks: to dispatch the dishonored check before its midnight deadline. In addition, such a bank generally received an item from the bank to which it had sent the item for collection, and re-

102. A "returning bank" is a bank, other than the depository or the payor bank, that handles a returned check or notice in lieu of return. A returning bank is also a collecting bank for purposes of U.C.C. §§ 4-202(1)(e) and (2). 12 C.F.R. § 229.2(cc).

103. 12 C.F.R. § 229.31(a). The commentary to the regulation notes:

A returning bank agrees to return checks expeditiously if it:

- (1) publishes or distributes availability schedules for the return of returned checks and accepts the returned check for return;
- (2) handles a returned check for return that it did not handle for forward collection; or
- (3) otherwise agrees to handle a returned check for expeditious return.

53 Fed. Reg. 19,481 (1988).

104. 12 C.F.R. § 229.31(a). A returning bank is also given an extension of the midnight deadline (or the deadline for notice of dishonor) if it decides to convert the check into a "qualified return check". This process usually involves attaching a strip of paper containing MICR coding to the bottom of a check, using the depository's code as if it were the payor. The check then rapidly moves up normal collection channels. This extension does not apply if the returning bank is sending the check directly to the depository, however. 12 C.F.R. § 229.31(a)(2).

105. *See supra* notes 85-88 and accompanying text. The returning bank and the paying bank may return the item to the same banks, i.e., the depository, the prior indorser, etcetra. *See supra* note 86. This provision modifies U.C.C. § 4-212(2) in that it now authorizes direct return. *Id.*

106. 12 C.F.R. § 229.31(c). This provision reflects the philosophy behind all of subpart C: to make the return process mirror the collection process, thus harnessing its economic motivations and technological developments. This philosophy also requires providing availability for returned checks according to the same schedules as for forward collection, even if the bank previously handled the item for collection. Under 12 C.F.R. § 229.32(b), the provisional credits for forward collection become final upon expiration of the time for payment for a returned check by the depository bank.

107. 12 C.F.R. § 229.31(d).

turned it only to its immediate prior indorser. Thus once it met its own deadline, the bank had no real interest in expeditious return.

Regulation CC characterizes these banks as "returning banks." This terminology does not exist in the U.C.C. Flowing from the new title are significantly increased duties, which have the combined effect of rendering the returning bank the legal equivalent of a collecting bank.¹⁰⁸ One aspect of this duty is the elimination of charge-back under U.C.C. section 4-212(1). Because a returning bank may not have handled the item for collection, it must receive provisional credit instead of merely charging back the credit it had previously extended.¹⁰⁹

In addition, returning banks have an expeditious return standard similar to the standard for payor banks.¹¹⁰ Regulation CC measures potential liability from the time the item arrives at the depository, not when it leaves the returning bank. The new regulation further authorizes returning banks to send items directly to the depository, not to the immediate prior indorser. These provisions will require returning banks to apply advanced collection techniques to the return process. Further, the Federal Reserve will now accept all return items, whether or not it handled them for collection.¹¹¹ The combined effect of these changes will make the Federal Reserve a major competitive force in the new and burgeoning market of cost-effective check returns.¹¹²

Finally, returning banks, like paying banks, are now subject to both contract and warranty liability on dishonored checks. This is akin to current liability schemes for collecting banks under U.C.C. sections 3-414 and 4-207.¹¹³

108. *See supra* notes 102-07 and accompanying text.

109. *See supra* notes 17-21 and accompanying text.

110. *See supra* notes 83-84 and accompanying text.

111. This development is referred to as "universal returns." Previously, the Federal Reserve only returned checks it handled for collection. *See* note 88 and accompanying text.

112. In addition, the Board estimates that because of its new direct return policy, 43% of checks that currently go to a non-Federal Reserve bank for return will now proceed directly to the depository. 53 Fed. Reg. 19,383 (1988). In addition to easing the potential burden on returning banks, this new policy will also insure that a large volume of checks go to the Federal Reserve for return, not to other institutions (at least initially). While those institutions may welcome this routing now, the Federal Reserve may end up monopolizing a large share of the market before competitive return services begin. *See infra* note 172 and accompanying text.

113. *See supra* notes 97-98 and *infra* notes 129-38 and accompanying text.

3. *Depository Bank's Responsibility for Check Return:*
 12 C.F.R. Section 229.32

Prior to passage of the E.F.A.A., direct returns by paying and returning banks were difficult because many paying banks did not have a preexisting return arrangement with a depository.¹¹⁴ Regulation CC section 229.32 remedies this problem by specifying several locations at which a depository must accept these returns.¹¹⁵

Once the return check arrives, the depository¹¹⁶ must pay the returning bank for the item as if it were presented for payment. Further, the depository bank is accountable for the amount of the item at the close of the banking day on which the item arrives.¹¹⁷ A depository may not impose a charge for accepting and paying checks returned to it.¹¹⁸

If a check is presented to the wrong depository, that bank simply becomes another returning bank in the chain. It may either return the item directly to the correct depository, or through another returning bank that must then return it to the correct depository. The depository may also

114. 53 Fed. Reg. 19,482 (1988).

115. These locations are derived from U.C.C. § 3-504(2), which provides that presentment for payment on an instrument may be made at the place specified therein, or if one is not specified, at the place of business of the maker. The commentary states:

The four locations at which a depository must accept items for return are:

- (1) at any location where presentment of checks for forward collection is requested by the depository;
- (2) At any branch or head office consistent with the name and address of the bank in its indorsement on the check;
- (3) If no address appears in the indorsement, at any branch or head office associated with the routing number of the bank in its indorsement on the check;
- (4) If no routing number or address appears in the indorsement on the check, at any branch or head office of the bank;

A depository may require that return checks be separated from checks presented for payment.

12 C.F.R. § 229.32(a).

116. A "depository bank" is defined at 12 C.F.R. § 229.2(o) as the first bank to which an item is transferred even though it is the paying bank or the payee.

117. 12 C.F.R. § 229.32(b)(1) reads:

Payment may be made in any of the following forms:

- (1) debit to an account of the depository bank on the books of the returning or paying bank,
- (2) cash,
- (3) wire transfer,
- (4) any other form of payment acceptable to the returning or paying bank.

As previously noted, a returning or paying bank will no longer receive credit by charge back under U.C.C. § 4-212. See *supra* note 106 and accompanying text. A return is just another payment, except that the depository may not return its own returned check.

118. 12 C.F.R. § 229.32(d).

return the check to the bank from which it received the check.¹¹⁹

The main change in depositary bank practice will be the new indorsement requirements under Regulation CC section 229.35.¹²⁰ Failure of the depositary bank—or its customer—to adhere to the new standards may result in the depositary's liability on the item for its late return. Banks must quickly make new deposit agreements if depositaries do not wish to bear the risk of their customers' improper indorsements.¹²¹ In addition, banks must develop new indorsement plates and techniques to ease meeting these new standards.

The second major change for depositaries will be organizational. They will receive checks directly from payor banks and Federal Reserve banks. In all likelihood, the depositaries have no existing account relationship with the Federal Reserve. Because the regulations specify locations at which returns must be accepted, these "foreign" banks may also return items to departments that are not normally prepared to handle them.¹²² Finally, even though checks and notice of dishonor will arrive earlier, depositary banks will have to streamline their own internal procedures to assure that these returns are processed as quickly as possible. Even the more lenient temporary schedule can allow notice to arrive on or near the same day that banks must make the funds available. Failure to promptly charge back the account could still result in substantial losses, especially in cases of fraud.¹²³

4. *Notice of Nonpayment: 12 C.F.R. Section 229.33*

Regulation J requires paying banks to give depositaries notice of dishonor on checks larger than \$2500.¹²⁴ This provision only applies, however, to checks processed for collection by a Federal Reserve Bank.¹²⁵ In contrast, Regulation CC section 229.33 requires that the paying bank give this notice for *any* check larger than \$2500, irrespective of which banks processed the item for collection. The depositary must receive the notice of dishonor no later than 4:00 p.m. on the second business day following the banking day the check was presented for payment.¹²⁶ The

119. *Id.* § 229.32(c).

120. *See infra* notes 139-42 and accompanying text.

121. *See infra* note 141 and accompanying text.

122. *See supra* note 21 and accompanying text.

123. *See infra* notes 158-70 and accompanying text.

124. 12 C.F.R. § 210.12(c).

125. *Id.* § 210.12(c)(1).

126. *Id.* § 229.33(a). This is one business day fewer than is currently required. *See id.* § 12(c)(2).

notice must be by reasonable means¹²⁷ and must contain specific information to aid the depository in processing the return.¹²⁸

5. *Return Transfer Warranties and Indorsement Contracts:*
12 C.F.R. Sections 229.34 and 229.35

Regulation CC section 229.34(a) incorporates the timely return warranty provision of Regulation J.¹²⁹ In addition, the regulations require the returning or paying bank to warrant to its transferee, or any subsequent returning bank, to the depository, and to the owner of the item, that the bank is authorized to return the check, has met its applicable

127. *Id.* § 229.33(a). These include the original check itself, a writing (including a photocopy of the check), telephone, Fedwire, telex, or other form of telegraph.

128. *Id.* § 229.33(b). This follows the content requirements currently specified by Regulation J, *id.* § 210.12.

The item itself must be returned and the notice alone carries no value.

Section 229.33 also contains a consumer-oriented provision. A depository, upon receiving a returned check or notice of nonpayment, must provide the check or notice to its customer under U.C.C. § 4-212(1) by its midnight deadline or other reasonable time after it learns the facts. If the depository fails to do so, within the time period it may still charge back the item, but it will be held liable to its customer for any loss resulting from the delay if the depository had sufficient information to allow it to chargeback. 12 C.F.R. § 229.33(d).

This approach appears to codify the common law. A bank that fails to comply with § 4-212(1) is not *prima facie* liable on the instrument; it may recover the funds in restitution. Section 4-212 merely prevents it from exercising an automatic right of chargeback. *See* R. SPEIDEL, R. SUMMERS & J. WHITE, *COMMERCIAL AND CONSUMER LAW* (3d ed. 1981). The commentary to 12 C.F.R. § 229.33 states that this provision follows *Appliance Buyers Credit Corp. v. Prospect National Bank*, 708 F.2d 290 (7th Cir. 1983). In *Appliance Buyers* the court held that timely sending a returned check or notice of nonpayment by the depository was not a condition precedent to chargeback of its customer's account. *Id.* at 293-94. *See* 53 Fed. Reg. 19,484 (1988).

In addition, the provision also requires the depository to accept notice at certain locations. 12 C.F.R. § 229.33(c).

The payor bank should not send an item before it is certain it will not be paid. This is because by sending the notice, the bank warrants under 12 C.F.R. § 229.34(b) that it has or will return the check. It may be able to mitigate this liability by informing the depository that it is returning the item.

129. *Id.* § 210.12(b). That section provides:

(b) *Paying bank's warranties and agreement.* A paying bank that obtains a credit or refund for the amount of a payment it has made for a cash item:

(1) Warrants to the Reserve Bank (and to a subsequent collecting bank, and to the sender and all prior parties) that it took all action necessary to entitle it to recover its payment within the time limits of: (i) this subpart; (ii) State law, unless a longer time is afforded by this subpart; (iii) the rules or practices of any clearing house through which the item was presented; and (iv) any special collection agreement under which the item was presented; and

(2) Agrees to indemnify the Reserve Bank for any loss or expense sustained (including attorney's fees and expenses of litigation) resulting from the Reserve Bank's giving the credit or refund to the paying bank, or charging, or obtaining a refund from, the sender.

deadline for doing so,¹³⁰ and that the returned check has not been materially altered.¹³¹ In addition, the provisions include new warranties for notice of nonpayment of large-dollar items.¹³² Damages for breach of these warranties may not exceed the consideration received by the paying bank, plus any finance charges or related expenses.¹³³

The proposed rules also substantially extend an indorser's contract liability under U.C.C. section 3-414. Section 3-414 provides that upon dishonor, an indorser will pay any subsequent holder of the instrument.¹³⁴ In check collections, this creates a chain of indorsement from the depository bank through the collecting banks¹³⁵ to the payor, each promising to pay its subsequent transferee(s).

Regulation CC section 229.35(b) extends this chain through the payor bank, and back up the chain to the depository, allowing each bank to recover from prior indorsers.¹³⁶ If the depository is insolvent, the loss

130. Those deadlines would be either the midnight deadline under the U.C.C.; the deadline contained in Regulation J, 12 C.F.R. § 210; or the new extension of the above two, in 12 C.F.R. § 229.30(c). *See supra* notes 89-91 and accompanying text.

131. 12 C.F.R. § 229.34(a). These provisions do not apply to Treasury checks, or checks from state and local government. *Id.* The payor bank or returning bank does not warrant, however, that it has met the expeditious return requirements under 12 C.F.R. § 229.30(a) or 12 C.F.R. § 229.31(a), respectively. Only banks, not customers, may sue for breaches of those sections. *See infra* note 155 and accompanying text.

132. 12 C.F.R. § 229.34(b). This provision also imposes liability on a payor bank that subsequently decides to pay the check. *See supra* notes 83-91 and accompanying text.

133. 12 C.F.R. § 229.34(b). The consideration would be the settlement received pursuant to 12 C.F.R. § 229.31(d); *see supra* note 107. This language is adopted from the warranty damages section of U.C.C. § 4-207(3).

In addition, 12 C.F.R. § 229.33(c) adopts the vouching-in provisions of U.C.C. § 3-803 of the and § 210.5 of Regulation J, 12 C.F.R. § 210.5. Those sections provide that if a returning bank is sued for breach of warranty, it may give a prior returning bank or the paying bank written notice of the suit, and that bank may then give notice to a prior institution, and so on. A bank's failure to intervene and defend will bind that bank by the result of the litigation.

134. U.C.C. § 3-414 (1985).

135. *Id.*

136. This provision applies whether or not the bank's indorsement actually appears on the check. *See* 53 Fed. Reg. 19,484 (1988).

This new form of contract liability may be described as a "ring chain of indorsement," as the figure below illustrates. The prior chain of indorsement under U.C.C. 3-414 is in roman type, the 12 C.F.R. § 229.35 chain of indorsement in italics. 12 C.F.R. § 229.35 CHAIN OF INDORSEMENT:

Depository → Collecting Bank → Presenting Bank → Payor
 Returning bank — *Returning bank* — *Returning bank*

If the check is returned through the same banks through which it passed for collection, then the priorities established in the collection chain control in determining which banks are prior and subsequent indorsers. 12 C.F.R. § 229.35.

would fall upon the bank that first took the item for collection.¹³⁷ This provision alters U.C.C. section 4-212(2) because recovery is no longer had by prior settlement, and makes sections 3-502, 3-503(2) and 3-508 inapplicable between banks, or depository and customer.¹³⁸

Regulation CC section 229.35 also substantially changes current indorsement practices in an effort to expedite check return. Prior to this regulation, banks indorsed a check with little or no regard to legibility or location on the check.¹³⁹ The regulation now requires banks to adopt new standards of indorsement, and specifies ink color and location requirements for each indorsing institution.¹⁴⁰ Failure to adhere to these requirements would relieve a paying or returning bank from liability for delay in returning a check, if the delay was due to the improper indorsement.¹⁴¹

Similarly, the regulation requires the consumer to indorse the check only in a certain area on the back. The depository bears the risk of loss due to its customer's improper indorsement, but this provision may be altered by agreement.¹⁴²

6. *Check Presentment and Delivery: 12 C.F.R. Section 229.36*

Regulation CC section 229.36 contains three provisions. First, it imposes the same duties on "payable through" or "payable at" banks as are

137. This is the result under current law as well. See U.C.C. § 4-414.

138. A depository would still be permitted to recover a prior settlement from its customer, however. 53 Fed. Reg. 19,485 (1988).

139. 52 Fed. Reg. 47,144 (1987).

140. A depository's routing number must be contained in an area one-and-a-half inches from the "trailing" edge of the check (left side, as viewed face-front) to three inches from the "leading" edge. The payee's indorsement is to be placed in an area one-and-a-half inches from the trailing edge. The depository must place its indorsement next to the payee's, and returning banks must indorse between the depository's indorsement and the leading edge. See Appendix D, 53 Fed. Reg. 19,462 (1988).

In addition, the depository must use either purple or black ink (purple is preferred). Collecting banks cannot use purple. The indorsement must include the bank's name, location, nine-digit routing number and the date of indorsement. *Id.*

Finally, returning banks are precluded from using the depository and payee indorsement areas.

141. The depository is also responsible for unreadable indorsements resulting from damage or alteration of the check occurring between the time of issue and the time the depository accepts the check for payment. This would include its customer's indorsement. 12 C.F.R. § 229.38(d). The payor bank is responsible for unreadable indorsements resulting from the condition of the check at the time of issue, i.e., any marks, bands or other print on the back of a check. 12 C.F.R. § 229.38(d). These may be varied by agreement, shifting the risk of loss to the respective bank's customer. See 53 Fed. Reg. 19,486 (1988).

142. For a discussion of these "agreements," see M. BENFIELD & P. ALCES, *COMMERCIAL PAPER AND ALTERNATIVE PAYMENT SYSTEMS* 26-31 (1987).

imposed on paying banks.¹⁴³ Second, it specifies four locations at which paying banks must accept presentment of checks.¹⁴⁴ Finally, it allows for check truncation in certain cases.¹⁴⁵

Check truncation requires the depository bank to relay sufficient information for payment to the paying bank without sending the physical check.¹⁴⁶ This information transfer can facilitate the collection process tremendously. However, banks have not universally adopted this procedure because absent agreement by all parties, its legality under the U.C.C. is questionable.¹⁴⁷ The regulation allows truncation by agreement with the paying bank, but not if the rights of prior parties to the check are prejudiced.¹⁴⁸

7. *Variation by Agreement and Liability: 12 C.F.R. Sections 229.37 and 229.38*

Regulation CC section 229.37 permits variations from subpart C regulations by agreement. Regulation CC section 229.37 is similar to U.C.C. sections 1-203 and 4-103(1),¹⁴⁹ because a bank cannot contract out of its duties of ordinary care and good faith.¹⁵⁰ Unlike U.C.C. section 4-

143. 12 C.F.R. § 229.36(a). A check payable at or through a particular bank is deemed drawn on that institution for purposes of determining the time for return or notice of nonpayment under the UCC, Regulation J, and 12 C.F.R. § 229.36(a). *Id.*

144. These locations are similar to those found in 12 C.F.R. § 229.32(b). Their purpose is to enhance presentment efficiency and encourage rapid return or notice of dishonor by increasing the number of locations at which a check is deemed received by the payor bank. This has implications for meeting applicable deadlines for return. *See supra* note 99 and accompanying text. This provision affects U.C.C. § 3-504(2)(c) in that an instrument need not necessarily be returned to a location specified within.

145. 12 C.F.R. § 229.36(e).

146. For a more detailed description of check truncation see *infra* note 176.

147. *See* 53 Fed. Reg. 19,433, 19,445 (1988).

148. Such prejudice would arise, for example, by extending the paying bank's time for return while the depository is still required to make the funds available according to the schedule. 53 Fed. Reg. 19,846 (1988).

149. U.C.C. § 4-103(1) provides in pertinent part:

(1) The effect of the provisions of this Article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure; but the parties may by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable.

(3) Action or non-action approved by this Article or pursuant to Federal Reserve regulations or operating letters constitutes the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent with clearing house rules and the like or with a general banking usage not disapproved by this Article, *prima facie* constitutes the exercise of ordinary care.

150. 12 C.F.R. § 229.38(a).

103(2), however, variations by agreement permitted under Regulation CC section 229.37 do not apply to entities or individuals that have not specifically assented to them.¹⁵¹

If a bank does not meet its duty of ordinary care or does not act in good faith it will incur liability under Regulation CC section 229.38. The measure of damages is the amount of the loss incurred, up to the amount of the check, less any loss that could not have been avoided through the exercise of ordinary care.¹⁵² A bank is not liable, however, for the misconduct of others, or loss or destruction of the check while in the possession of others.¹⁵³ In addition, the section incorporates a "pure" comparative negligence standard, diminishing a party's damages by that proportion attributable to his negligence or lack of good faith.¹⁵⁴ Finally, the E.F.A.A. provisions that allow for civil liability, class action suits, and punitive damages do not apply to those regulations adopted to improve the return process.¹⁵⁵

151. The E.F.A.A. may finally address some of Professor Grant Gilmore's objections to U.C.C. Article 4. He considered it unacceptable that banks could conveniently contract out of any of the rules therein, save the requirements of good faith and ordinary care, and define the latter by "general banking usage." See Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 376-77 (1952).

It is clear that banks have improved the collection system in good faith. It is less clear, however, if "general banking usage" could be described as ordinary care with regard to returns. In fact, Congress' major reason for passing the E.F.A.A. was the perceived disparity between the two. See *supra* notes 41-42 and accompanying text.

152. 12 C.F.R. § 229.38(a). This measure of damage is derived from U.C.C. § 4-103(5). Failure to act in good faith, however, can result in other proximate damages. Nothing in this section limits or alters a payor bank's liability to its customer for wrongful dishonor under U.C.C. § 4-402. That section contains a different measure of damages. See 53 Fed. Reg. 19,487 (1988).

153. 12 C.F.R. § 229.38(a). In addition, if a bank is prevented from acting by forces beyond its control, such as war or natural disasters, its time for acting is extended by the time necessary to complete the action diligently. 12 C.F.R. § 229.38(e).

The proposed regulations incorporated a bona fide error defense, but the Board removed this provision because it felt that the negligence standard alone provided sufficient protection. 53 Fed. Reg. 19,430 (1988).

154. 12 C.F.R. § 229.38(c).

155. 12 C.F.R. § 229.38(e); see *supra* notes 73-74 and accompanying text. Those provisions in the E.F.A.A. are §§ 611(a) and 611(b), 12 U.S.C. §§ 4010(a) and (b). These provisions provide:

(a) *Civil Liability*. Except as otherwise provided in this section, any depository institution which fails to comply with any requirement imposed under this title or any regulation prescribed under this title with respect to any person other than another depository institution shall be liable to such person

Id.

The commentary to the final rules notes that "[a]llowing punitive damages for delays in the return of checks where no actual damages are incurred would only encourage litigation and provide little or no benefit to the check collection system." 53 Fed. Reg. 19,487 (1988). Thus, only banks may sue

This section, however, does not affect a paying bank's liability to its customer under the U.C.C.¹⁵⁶ In addition, a paying bank that fails to comply with the requirements for expeditious return of a check under Regulation CC section 229.30(a) may be liable under either that regulation, or U.C.C. section 4-302, but not both.¹⁵⁷

C. Potential Fraud Losses

The greatest danger to banks under the new availability rules is the \$100 next-day availability requirement.¹⁵⁸ Absent any applicable exceptions,¹⁵⁹ an individual may deposit a \$100 local or nonlocal check on Monday, and obtain the proceeds on Tuesday. While one hundred dollars may seem insignificant alone, in the aggregate these potential losses could prove substantial.

In addition, stolen government checks also pose a significant threat. Regulation CC specifically states that these checks are subject to next day availability in their entirety, as long as they are deposited in an account held by the payee of the check.¹⁶⁰ This last requirement might deter the casual thief who did not have the patience to open a new ac-

other banks for breaches of the check return requirements under subchapter C. The consumer is limited to breaches of the availability schedule provisions.

Banks are also shielded from liability if they rely on Board regulations and rulings, even if these are later rescinded, amended, or judicially held to be invalid. 12 C.F.R. § 229.38(h).

156. 12 C.F.R. § 229.38(a). The bank's potential liability to the customer is codified in Part 4 of Article 4 of the U.C.C.. For example, a paying bank may still be liable to its customer for wrongful dishonor under U.C.C. § 4-402; *see supra* note 152 and accompanying text.

157. 12 C.F.R. § 229.38(b). 12 C.F.R. § 229.30(a) leaves in place the time limits set by the UCC, i.e., the "midnight deadline." Regulation 229.38(b) also maintains the paying bank's "accountability" under U.C.C. § 4-302(a) for missing that deadline. The section makes clear that the paying bank may be liable only under either the UCC or the Regulations, but not both.

158. *See supra* note 52 and accompanying text.

159. *See supra* notes 64-69 and accompanying text.

160. Initially, the only requirement was that the check be indorsed only by the person to whom it was issued. This would include those checks "indorsed in blank," and deposited into an account other than that of the named payee. The Board felt that these types of checks posed even greater risks than a check deposited by the payee, because a stolen check could be fraudulently indorsed, deposited in a third party account, and the proceeds would be available the following business day. 53 Fed. Reg. 19,467 (1988). The regulations now eliminate this possibility.

In addition, U.S. Treasury checks, U.S. Postal Service money orders, and checks drawn on units of state and local government are not subject to the expeditious return provisions of 12 C.F.R. § 229.30(a), § 229.31(a) and notice of nonpayment under § 229.33. *See supra* note 52 and accompanying text. This makes them increasingly attractive as a fraud device, because not only must their funds be made available sooner than regular checks, the checks themselves need not be returned until later.

count in the name of his victim.¹⁶¹ However, it could easily be manipulated in the course of a more sophisticated fraud scheme.¹⁶²

In addition, even if a bank strictly complies with Regulation CC, it still lacks assurances that returned checks or notice of nonpayment will arrive before it releases the funds to the customer. For example, under the more stringent permanent schedule, banks must make funds from a non-local check available for cash withdrawal on the sixth business day following deposit. This means that if the check is deposited on a Monday, the funds must be available in cash on Tuesday of the following week. The presentment process usually requires at least two days for nonlocal checks, and one day for local items, under existing systems.¹⁶³ In practice, however, it can sometimes take as long as four days for nonlocal checks to be presented, and two days for local.¹⁶⁴ Thus the Monday check could not arrive at the payor until Friday. That bank will be required to either return the check within four business days, or as fast as it would an item for payment. The returned check, then, need not arrive until Thursday, allowing two or three days for the customer to withdraw

161. Even this is no guarantee: all Treasury checks are valid for five years following the date of issue. In contrast, banks are not required to pay items older than six months under U.C.C. § 4-404. The E.F.A.A. included a provision to shorten this time period for Treasury checks simultaneously with the effective date of the Act, but left the Treasury Secretary free to delay this provision. The Secretary has exercised this option, stating that it would impose a hardship on individuals accustomed to keeping their U.S. Treasury checks for periods up to five years, and that more time was needed to educate these people. Telephone interview with Robert Glover, Director Bank Supervision and Regulation, Federal Reserve Bank of Cleveland (August 16, 1988).

Whatever the merits of this argument, this allows the intrepid purse snatcher to use the stolen identification and cash to open an account in the name of his victim, wait the required thirty day period of the new accounts exception to the availability requirements, and get next day availability of the Treasury check. If he were successful in stealing more checks from the payee, these, too, would be available to him on a next-day basis.

162. Indeed, some banks are so concerned about the potential for government check fraud that they will not accept those instruments to open a new account. Telephone interview with Mr. Robert Glover, *supra* note 161.

163. See *BAI Study*, *supra* note 28. That study found the average collection time to be 1.6 days, combining local and nonlocal checks. The average return time, however, was 5.2 days, for a total round trip of 6.8 days. Under the permanent schedule, funds from nonlocal checks must be available only six days after deposit, long before the *average* time for return under current systems. In addition, the study found that 40% of all returns take seven days or longer, and 15% require fully 10 days or more. *Id.* Even the more relaxed temporary schedule would allow 40% of all returns to arrive late; funds must now be made available only seven days after deposit. If the average return now takes 6.8 days, banks may already be at some risk, despite the new return requirements.

164. This is the reason for the addition of the "two day/four day" expeditious return standard for paying and returning banks. See *supra* notes 83-84 and accompanying text.

the check's proceeds in cash.¹⁶⁵

Indeed, depository banks are now at risk under the temporary schedule. If a check deposited Monday takes a full four days for presentment, it will arrive at the payor bank on Friday, and must be returned within four days time, i.e., by Thursday. Currently, funds must be available for both check writing and cash withdrawal seven days after deposit, or in our case, Wednesday. It is therefore necessary to both expeditiously present and return the check to avoid the risk of loss to the depository.

In addition, check-kiting schemes would be more effective. Under the new rules, one can predict with accuracy exactly when the funds must be made available, and also when the returned check is likely to arrive. Further, the new regulation helps the check kiter because the depository bank must release the funds for check-writing purposes one business day earlier than for cash withdrawal.¹⁶⁶

Finally, the expanded regulations regarding notice of dishonor do not guarantee that notice of dishonor arrives before the bank releases the funds.¹⁶⁷ If the check in the hypothetical above is larger than \$2500, then the payor bank must send notice so that it arrives at the depository by midnight of the second business day following receipt of the item—one day earlier than previously required.¹⁶⁸ Assuming the check deposited Monday arrives on Friday, this notice must arrive by midnight on Tuesday. Because the bank must make funds available by 9:00 a.m.,¹⁶⁹ the thief could easily withdraw the cash a few hours before notice arrives, unless either the presented check or the notice of its dishonor is ahead of

165. Even if the check were to arrive as fast as possible (in this case, Tuesday), the payor bank is under no obligation to return it to the depository before four days elapse. If it did, however, the returned check would have to arrive before 4:00 p.m. on Tuesday. Under these circumstances, the funds would be released before the check arrived, because the depository must make them available at 9:00 a.m. 12 C.F.R. § 229.19(b). The same holds true for local checks, which must be available for cash withdrawal on the third day following deposit. These checks often take two days to be presented, and need not be returned until two days after presentment. In a worse-case scenario, a check deposited on Monday would be presented on Wednesday, and returned on Friday. Meanwhile, the funds would have been available since Thursday. See 12 C.F.R. §§ 229.12(b) and (d).

Under the proposed rules, however, the payor bank would have been obligated to return the check as fast as it would present an item for collection, drawn on the depository. This may have provided the depository with greater protection than the current regulations afford because most nonlocal checks do not take four days to present. See *supra* note 163 and accompanying text.

166. 12 C.F.R. § 229.12(c).

167. See *supra* notes 124-28 and accompanying text.

168. 12 C.F.R. § 229.33(a); see *supra* note 126 and accompanying text.

169. 12 C.F.R. § 229.19(b).

schedule.¹⁷⁰ To avoid this result, banks will have to develop rapidly the existing return technology.

IV. PROPOSED MODERNIZED CHECK RETURN PROCEDURES

The Expedited Funds Availability Act addresses these problems of potential bank fraud loss increases, requiring the Board to develop and implement systems for expediting the return of unpaid items.¹⁷¹ The Board began instituting these new systems on September 1, 1988. These procedures will help other banks comply with the immediate requirements of Subpart C. In addition, the Board has also instituted long-term improvements to the check collection system.

Effective September 1, 1988, the Federal Reserve began returning dishonored checks directly to the depository.¹⁷² In addition, the Federal Reserve has instituted "universal returns," i.e., it will now accept any check for return, whether or not it handled the check for collection.¹⁷³

The Federal Reserve also began accepting qualified return checks for return September 1, 1988, and will qualify raw returns itself if this will

170. If the item were local, notice would be no more expeditious, because both it and a returned check must arrive within two days after presentment. 12 C.F.R. § 229.30. However, banks' losses would in either case be limited to \$5000. Under 12 C.F.R. § 229.13(b), a bank may extend the availability requirements for a "reasonable time" if a deposit in the aggregate exceeds that sum in any one day. *See also* 12 C.F.R. § 229.13(h) (extension may only be for "reasonable" amount of time, and establishing four days as *prima facie* reasonable).

171. Congress specifically mandated development of modern return procedures. *See generally* 133 Cong. Rec. H3075 (1987) (statement of Rep. LaFave); Expedited Funds Availability Act, 12 U.S.C. § 609(b) (1987). For an analysis of the possible dangers that banks face under the strict permanent schedule, see *supra* notes 158-65 and accompanying text.

172. *See* 53 Fed. Reg. 19,491 (1988).

A pilot program at the Reserve Bank of Dallas indicates that the Federal Reserve's action will reduce the average return time by one half day, and more, when the item has multiple indorsers. *See* 52 Fed. Reg. 47,171 (1987) (proposed rules). In addition, a survey of over 18,000 return items showed that 43% of these items had more than one indorser. *Id.* at 47,172.

The guidelines for direct returns are found at Appendix A, 53 Fed. Reg. 19,446-48 (1988).

173. *See* 53 Fed. Reg. 19,491-92 (1988). Previously the Federal Reserve returned only those items that it had handled for forward collection. Deadlines and specific charges for these services are yet to be established. Formerly, banks paid only a collection charge; the return component was factored in, so no additional fee was assessed. Now, however, collection charges will be lowered as the return component is removed, and banks will only be charged for those checks that are actually returned.

A discussion of the competitive effects of the new Board universal returns policy is beyond the scope of this Note. Certainly, new services will appear as an alternative to the Federal Reserve, spurring cost reductions in return fees. For an overview of the potential ramifications of the E.F.A.A. in general, see 52 Fed. Reg. 47,175 (1987) (discussion of proposed rules).

speed up the return process.¹⁷⁴ Fees for returning qualified return checks would be the same as for collection items, as well as deposit deadlines.¹⁷⁵

In addition, the Federal Reserve has changed its notification services. The change supports the new notice of nonpayment amendment to Regulation J, thereby allowing same-day notification of the depository in most cases.¹⁷⁶

Finally, the Federal Reserve has begun to institute new check truncation¹⁷⁷ and extended MICR capture services.¹⁷⁸ These procedures along

174. To qualify returns, the dishonored check is placed in a carrier envelope, or has a strip of paper attached to the bottom of the check. These contain the nine-digit routing number of the depository, the amount of the check, and a returned check identifier. The check can then proceed through the same high-speed processing equipment used for collections.

The benefits of the qualified return check system are: (1) more timely return of dishonored items to the depository; (2) elimination of manual handling at intermediary banks; (3) using banks' already existing efficient technology to move returns as fast as collections, requiring a minimum of investment; (4) reduction in the use of the U.S. mail to return items.

Despite these advantages, numerous problems prevented the participating banks from permanently instituting the program at the end of the trial.

First, and perhaps most importantly, not every jurisdiction had enacted proposed U.C.C. § 4-212(2). However, 12 C.F.R. § 229.30(a) remedies the problem, and overrides any conflicting state provisions. *See supra* note 21. Second, many paying banks currently have difficulty in determining which indorsement on the check belongs to the depository, and on occasion, that bank is not a correspondent bank of the payor. Regulation CC 229.35 addresses this problem by requiring industry standards for indorsements. *See supra* notes 139-142. Finally, banks are concerned about difficulties in separating returned checks from those presented for forward collection. The most efficient way to process returns is to use existing collection paths, and mix them with forward items. The Board's discussions with depository banks have revealed a definite preference to keep these two separated, on account of "extra risks" associated with identical processing. Thus, the Board proposes to keep qualified check returns separate from normal checks, unless the depository agrees to accept them in its cash letter. *See* 53 Fed. Reg. 19,492 (1988).

175. For the most part, only nonlocal items will be qualified. In addition, qualifying items would be optional for paying and returning banks. The Board noted that qualifying items would not be the most efficient means of return in all cases, but that the earlier qualification could take place, the more quickly the items could be returned. In addition, the Board has requested comment on the likelihood of paying banks initiating the qualifying process. *Id.*

176. 12 C.F.R. § 210.12(c). *See supra* notes 124-128 and accompanying text.

The Federal Reserve will now guarantee same-day notification, if it is notified before certain deadlines. In addition, a new fee schedule is also proposed, ranging between \$1.75 and \$5.25, depending on the type of notification requested. 53 Fed. Reg. 19,493 (1988).

177. The Federal Reserve has implemented a truncation feasibility pilot at six Reserve banks. In the first phase of the pilot, the local Federal Reserve branch that serves the paying bank captures the entire MICR line on a MICR file. Checks rejected by the high-speed sorters are also included on this line. The checks themselves are microfilmed, and sequencing numbers for expedited future retrieval are placed on the checks, microfilm, and MICR file. This file is then delivered to the paying bank, either by data transmission, or magnetic tape. The physical checks and the microfilm are kept by the Reserve bank for a negotiated period, usually 90 days and 7 years, respectively.

The paying bank processes and posts the MICR data to its customer accounts. If it decides to

with additional Board proposals¹⁷⁹ will benefit both banks and

dishonor one of the "items," it notifies the Reserve branch no later than the established deadline hour on the business day following the day the MICR information was received. The Reserve bank retrieves the physical check, and begins the return process to the depository. A paying bank may also request a photocopy of the check, or the check itself from the local Reserve bank, before it is destroyed.

The participants' reactions to this program have been positive, and processing costs less than anticipated. For a more detailed description of the truncation pilot, including fee schedules, see 53 Fed. Reg. 19,493-95 (1988).

The possible benefits of a national check truncation are considerable. Truncating the physical check, and transmitting the pertinent information, especially by wire, would clear those channels for other items, and obviate the need for expensive procedures such as jet couriers. This would reduce banks' transportation, storage and personnel costs, permitting them to pass the savings to their customers. In addition, this would provide a natural transition to total electronic payments systems.

There are problems, however. Legal issues under the U.C.C. will be raised because the paying bank will pay the item without a physical examination. Thus certain improperly payable checks will result in automatic payor liability without examination. Paying banks may naturally be hesitant to embrace such a system, but placing dollar caps on truncation could prevent large losses before new methods of liability allocation are developed. Currently, the dollar cap on check truncation is \$2,500; checks larger than this are processed normally. *Id.*

178. Extended MICR capture service is similar to check truncation, but not as effective because it does not stop the actual flow of the paper check. The Reserve bank keeps the physical check and forwards the same MICR information as in truncation, but the physical checks are then sent to the payor by less time-critical means of transportation.

This service is beneficial because it provides a transition between current procedure and full check truncation. Further, the paying bank can still physically examine the checks.

The Federal Reserve has conducted a pilot of this service and is now offering it as a permanent service. For fees and other detailed information see 53 Fed. Reg. 19,494-94 (1988).

179. The Board has described possible long-term improvements to the check collection system in Docket No. R-0622, 52 Fed. Reg. 47,176 (1987). These ideas for enhanced collection will literally take the system into the twenty-first century, both in degree of sophistication and in implementation.

The proposals outline four systems: bar-code indorsements, digitalized image processing, electronic clearing zones, and electronic clearinghouses. In addition, the Board addresses possible improvements to the forward collection system. *See* 52 Fed. Reg. 47,176-79 (1987).

The Board has been investigating machine readable indorsements to improve return time by completely automating the process. MICR does this to some extent, but bar-code technology offers greater speed and flexibility. A bar-code routing number would be placed on the check by the depository; the rest of the information could be in human-readable form. A machine or a human using a reader wand could read the routing number from the check, and a carrier envelope or strip would be generated for the check's return. The technology already exists to automate fully this process on high speed reader-sorters, but is currently very costly. *Id.* at 47,177.

Digitalized image processing is currently the subject of a Federal Reserve Bank research and development effort and has already been adopted for use in lock-box operations.

In image processing a check is "photographed" by a computer and the image is broken into bits, compressed and stored in the computer. This data can later be retrieved and analyzed, and perhaps more importantly, sent over wires by modem. Problems, however, exist. Foremost is the quality of the image. The Federal Reserve has been using government checks to test the system to determine if it would be a cost-effective substitute for microfilm.

The time saved in check return would be tremendous. An image of a check could be transmitted

consumers.

V. CONCLUSION

Congress passed the Expedited Funds Availability Act as a result of Congressional impatience with foot-dragging by banks and the Federal Reserve Board in expediting check returns. In reality, the majority of banks were already making their customers' funds available within the limits now required by the Act. These banks may now be paying for the misdeeds of the minority.

The main risk all banks currently face under the E.F.A.A. is that they must make customers' funds available before notice of nonpayment can currently be expected to arrive. The Board's final rules have softened this effect somewhat. However, banks are still subject to higher processing costs, as well as greater risks of fraud. On the other hand, the rules do obviate the problem of MICR fraud. While it may be true that Congress had to intervene to spur banks to action, the result may prove too heavy-handed, and has been described as "legislative overkill."¹⁸⁰

On the other hand, the E.F.A.A. will force the true offenders to make deposits available on a reasonable basis. Even the high risk of fraud loss has a beneficial side. Finally, both banks and the Federal Reserve now

electronically to the paying bank, maintaining the speed advantages of check truncation, *supra* note 176, with none of the attendant disadvantages.

Creation of "electronic clearing zones" is another innovation the Federal Reserve is currently considering. That system entails creation of a zone in which all banks agree to receive their checks by electronic presentment of MICR line data. A paying bank dishonoring an item would wire back its data, and the physical check would arrive at the depository one or more days in advance of contemporary schedules.

This differs from extended MICR capture, *supra* note 177, in that all banks in a specific geographical area would accept presentment electronically. This could allow for later deposit deadlines for collecting checks, and thus improve availability for collecting banks. In addition, costs could be allocated more evenly, because both collecting and paying banks benefit, and share the cost of the service. *Id.*

Section 609(f) of the Expedited Funds Availability Act requires the Board to report to Congress on the possibility of an "electronic clearinghouse" system. This is an electronic message service through which checks are electronically presented for collection, and return. The Board is investigating this possibility, and reported its finding to Congress in May 1988.

All of these services are precursors to a possible "electronic payments" system. Consumers would carry debit cards which will allow instantaneous transfer of funds from their accounts to those of merchants. For a description of initial studies and experiments see PENNY & BAKER, *supra* note 9.

The final regulation makes no mention of further development of these services. If the new check truncation and extended MICR capture services are successful, perhaps it will speed implementation of the even more modern procedures mentioned above.

180. Telephone interview with Robert Glover, *supra* note 161.

have incentive to develop electronic payments technologies that will not only expedite check return, but set the stage for the payments systems of the next century.

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