



Evaluation of the Adequacy of the Indemnity for Electronically Created Items included in The Federal Reserve Board’s 2013 Regulation CC Proposal

In 2013, the Board of Governors of the Federal Reserve System (“Federal Reserve Board” or “Board”) proposed to revise Regulation CC to address issues related to electronic check clearing, including by providing a new indemnity that would apply to any bank that transfers an electronically created item (“ECI”) for collection (“2013 Proposed Rule”).¹ Specifically, the 2013 Proposed Rule sets forth an indemnity providing that “a bank that transfers an electronic image or electronic information that is not derived from a paper check (i.e., an electronically-created item) indemnifies each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim, or damage that results from the fact that the image or information was not derived from a paper check” (“Proposed Indemnity”).²

This paper examines the application of the Board’s Proposed Indemnity to a number of hypothetical scenarios. The purpose of this effort is to identify potential situations in which the Proposed Indemnity may not adequately protect a bank handling an ECI in the check collection process (i.e., situations where a bank (other than the depository bank) may suffer a loss or damages on account of an item’s status as an ECI against which the Proposed Indemnity would not adequately protect the bank), and, where present, how such inadequacies may be addressed to provide sufficient protections (such as, for example, through the extension of depository bank transfer and presentment warranties for remotely created checks (“RCCs”) under Regulation CC to all ECIs).³

I. Executive Summary

The Proposed Indemnity generally will protect banks (other than depository banks) against losses that result from the fact that an ECI is not an image captured from a paper item. However, the Proposed Indemnity may be inadequate under certain circumstances to fully

¹ Availability of Funds and Collection of Checks, 79 Fed. Reg. 6674 (Feb 4, 2014). Note that while the 2013 Proposed Rule was not published in the *Federal Register* until February 2014, it was published on the Board’s website on December 12, 2013.

² The Board has explained that even though an ECI “cannot be used to create a substitute check that meets the legal equivalence requirements of the Check 21 Act and Regulation CC ... [a]s a practical matter ... a bank (including perhaps the depository bank) receiving an electronically-created item might be unable to distinguish the item from any other image of a check that it receives electronically.” As a result, a “bank unknowingly may transfer the image as if it were an electronic check or electronic returned check (i.e., as if it were derived from a paper check), or produce a paper item that is indistinguishable from a substitute check (although not a valid substitute check because it was not derived from a paper check).”

³ 12 C.F.R. § 229.34(d).

protect banks against ECI-related risks of loss (e.g., where losses result from a forged drawer's signature on an ECI or from a counterfeit ECI). Thus, while we support the Proposed Indemnity and the measure of protection it provides to banks handling ECIs in the check collection process, we recommend supplementing the Proposed Indemnity with a warranty that extends the transfer and presentment warranties for RCCs set forth in 12 C.F.R. § 229.34(d) (in particular, the authorization warranty) to all ECIs.

Additionally, there is a scenario in which the Proposed Indemnity, even in combination with the supplemental warranties described above, may not fully protect banks that handle ECIs. Specifically, because of differing definitions of recoverable losses under the Proposed Indemnity and Operating Circular #3, the Proposed Indemnity (even when combined with supplemental warranties) may be inadequate to fully protect a collecting bank that forwards an item to a Reserve Bank in violation of the electronic item warranty in Operating Circular # 3.

In addition, it appears that the Board is considering whether the Proposed Indemnity should allow a paying bank to recover from a prior sending bank for losses that result from the paying bank customer's assertion of Regulation E rights. However, if the final rule permits a paying bank to recover such losses, the damages limitation associated with the Proposed Indemnity may prevent an institution from collecting the full amount of its costs associated with Regulation E compliance or non-compliance.

II. Discussion

A. Existing Check Law and Electronically Created Items

Checks as payment instruments are subject to an extensive body of state and federal law in the United States that governs, among other things, the responsibilities of financial institutions that collect and present checks for payment and the allocation of liability among financial institutions when problems arise in connection with settled checks. The applicable legal framework includes Articles 3 and 4 of the Uniform Commercial Code ("UCC")⁴; the Expedited Funds Availability Act ("EFAA"); and Regulation CC, which was issued by the Board to implement the EFAA. This body of check law is supplemented by other regulations and industry rules, including Federal Reserve Board Regulation J and Federal Reserve Banks Operating Circular #3 (which establish additional requirements regarding the collection of checks and other items by the Federal Reserve Banks) and private sector image exchange rules (such as the rules of the Electronic Check Clearing House Organization ("ECCHO")).

A fundamental tenet of current check law is that an item cannot be a "check" (or a valid derivative of a check) if it never existed in paper form (or was not derived from a check that existed in paper form). For example, to be a "check" under the UCC (and thus subject to UCC provisions regarding checks), an item must be an "order," which is defined to mean a "written

⁴ For purposes of this White Paper, references to the Uniform Commercial Code are references to the version published by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. We have not consulted the Uniform Commercial Code as enacted by any particular state.

instruction to pay money signed by the person giving the instruction.”⁵ Similarly, Regulation CC defines “check” to include either an “original check” (i.e., the first paper check issued in a payment transaction) or a “substitute check” (i.e., a paper reproduction of an original check).⁶ In recent years, payments industry participants have introduced ECIs (also commonly known as “electronic payment orders” or “EPOs”) to the check collection system. The Federal Reserve Board has described ECIs as “electronic images that resemble images of the fronts and backs of paper checks but that were created electronically and not from, for example, scanning a paper check in order to create the electronic image.”⁷ Notably, because today almost all checks are cleared through electronic image exchange⁸ and banks that receive ECIs do not have the ability to distinguish them from electronic images derived from paper checks, banks cannot practically reject ECIs when presented for processing and payment.

ECIs come in three variations: (i) ECIs issued by the account holder/drawer (which typically are indistinguishable from check images); (ii) ECIs issued by a payee (i.e., an electronically-created item that does not bear the drawer’s signature and that resembles the image of an RCC)⁹ (“eRCC”); and (iii) ECIs issued by a paying bank on a drawer’s behalf.¹⁰

⁵ Specifically, the UCC defines “check” to mean “a draft, other than a documentary draft, payable on demand and drawn on a bank.” UCC § 3-104(f). “Draft” is defined to mean a negotiable instrument that is an “order,” which is a “written instruction to pay money signed by the person giving the instruction.” See *id.* § 3-104(e) and § 3-104(a)(8). “Writing” and “written” are defined to include “printing, typewriting, or any other intentional reduction to tangible form.” *Id.* § 1-201(43).

⁶ An “original check” is defined to mean “the first paper check issued with respect to a particular payment transaction.” 12 C.F.R. §229.2 (ww). A “substitute check” is a paper reproduction of an original check that meets certain requirements. *Id.* §229.2(aaa).

⁷ The Federal Reserve Board has explained that an ECI may be created by a corporate customer sending payments who “rather than printing and mailing a paper check, electronically create[s] an image that looks exactly like an image of the corporate customer’s paper checks, and email[s] the image to the payee. Alternatively, a consumer might use a smart-phone application through which the consumer is able to fill in the payee and amount, and provide a signature, on the phone’s screen. The application then electronically sends the image to the payee.” Fed. Reg. 6674, 6682.

⁸ “Paper check writing continues to persist as a significant portion of noncash payments, but interbank processing and clearing of these checks are virtually all electronic. As in 2009, almost all checks in 2012 were either cleared by electronic image exchange or converted to ACH payments.” The 2013 Federal Reserve Payments Study – Summary Report (Revised July 2014), http://www.frbservices.org/files/communications/pdf/general/2013_fed_res_paymt_study_summary_report.pdf.

⁹ Under Regulation CC, “remotely created check” is defined to mean a “check that is not created by the paying bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn.” 12 C.F.R. §229.2(fff). Because the definition incorporates the term “check,” a “remotely created check” must exist in paper form.

¹⁰ See Summary of the Electronic Payment Order Forum (March 28, 2013), http://www.frbatlanta.org/documents/rprf/rprf_pubs/130521_summary_paper.pdf?elq=2ad3415b8ee84a1ba01b96cc9ea7a5fb.

Because, by definition, an ECI will not be an image captured from an item that existed in paper form before it was introduced into the check collection system, there is uncertainty about the legal framework that applies to these ECIs. For example, the UCC and Regulation CC do not specifically address ECIs and, because they are not derived from a paper check, “they cannot be used to create substitute checks that are the legal equivalent of original paper checks” under the Check Clearing for the 21st Century Act (“Check 21 Act”).¹¹ As noted in a summary of a recent forum hosted by the Federal Reserve Bank of Atlanta,¹² the “laws and rules that apply to checks are written in terms of instruments that originate as paper, but [ECIs] begin as electronic documents.”¹³ For example, the ECCHO Rules generally provide that an electronic image of a check processed pursuant to those rules will be treated as a “check” for purposes of Regulation CC and an “item” for purposes of the UCC.¹⁴ However, to be eligible for imaging and exchange under the ECCHO Rules, the electronic image must be derived from a “check” as defined in Regulation CC.¹⁵

Notwithstanding their uncertain legal status, industry participants have identified certain features of ECIs that make them a desirable payment option, including speed (they can be delivered and handled electronically without delays of mailing and handling paper); shorter return period (assuming they are treated as being subject to check laws and rules, in contrast with ACH debits that may be returned up to 60 days after the original settlement date), relatively low handling cost (compared to paper checks), and ubiquity (as a result of the widespread use of checking accounts).¹⁶ Consequently, ECIs are increasingly common and “are

¹¹ “The Check 21 Act, which became effective in October 2004, facilitated electronic collection and return of checks by permitting banks to create a paper ‘substitute check’ from an electronic image of a paper check and from electronic information related to the paper check. The Check 21 Act authorized banks to provide substitute checks to a bank or a customer that had not agreed to electronic exchange.” Availability of Funds and Collection of Checks, 79 Fed. Reg. 6674, 6675 (Feb. 4, 2014). However, “[a] substitute check is the legal equivalent of the original check only if the substitute check accurately represents all of the information on the front and back of the original check when the original check was truncated. Truncate, as defined in the Check 21 Act and Regulation CC, means removing an original paper check from the check collection or return process. In the case of an electronically-created item, there is no original check of which a substitute check can be a reproduction.” *Id.* at 6675 (FN 54).

¹² The forum was attended by “payments industry participants, including banks, nonbank payment service providers, retailers, and regulators.”

¹³ Summary of the Electronic Payment Order Forum. The summary further states that “[e]ven though check law applicability has been altered by agreements over the years to address innovations that generated new check products, such as check image exchange agreements, the technology innovations that have led to an electronic-generated order have not seen a commensurate alteration of the laws, regulations, or rules.”

¹⁴ ECCHO Rules Section XIX(F) (stating “[r]egardless of its status in the absence of this Section XIX(F), an Electronic Image shall be deemed to be: (1) an ‘item’ for purposes of [the UCC], (2) a ‘check’ for purposes of Regulation CC, and (3) an ‘item’ for purposes of the [ECCHO Rules]”).

¹⁵ *Id.* Section XIX(C) (stating “[a]n item is eligible for imaging ... if: (a.i.) the item is defined as a ‘check’ under Section 229.2(k) of Regulation CC ...”). Note that a bank that submits an item for imaging and exchange under the ECCHO Rules warrants that it has complied with the ECCHO Rules with respect to the electronic image, including that the paper item was eligible for imaging.

¹⁶ See Summary of the Electronic Payment Order Forum.

often sent through the check-collection system as if they are electronic images of paper checks.”¹⁷

B. Overview of Indemnity Proposed for Inclusion in Regulation CC

To reduce industry concerns over the uncertain legal framework applicable to ECIs that make their way into the check processing system, the Federal Reserve Board has proposed to revise Regulation CC to include the Proposed Indemnity. The 2013 Proposed Rule revises Regulation CC amendments proposed by the Board in 2011 (the “2011 Proposed Rule”) based, in part, on comments the Board received in response to the 2011 Proposed Rule.¹⁸ The 2011 Proposed Rule would have applied the existing warranties in Section 229.34 of Regulation CC¹⁹ to ECIs by providing that “a bank that transfers or presents an electronic image and related electronic information ‘as if’ they were derived from a paper check would make all the warranties in current § 229.34, even if the electronic image and information were not derived from a paper check.” The 2011 Proposed Rule also would have applied the existing authorization warranties for RCCs to eRCCs.²⁰

Rather than extend the Section 229.34 warranties to ECIs (including the existing authorization warranties for RCCs to eRCCs), the 2013 Proposed Rule would create an indemnity regarding these items. Specifically, the 2013 Proposed Rule sets forth an indemnity providing that “a bank that transfers an electronic image or electronic information that is not derived from a paper check (i.e., an electronically-created item) indemnifies each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim, or damage that results from the fact that the image or information was not derived from a paper check.”²¹ Claims pursuant to the Proposed Indemnity would be subject to a one year statute of

¹⁷ 79 Fed. Reg. 6674, 6682.

¹⁸ Availability of Funds and Collection of Checks, 76 Fed. Reg. 16862 (March 25, 2011).

¹⁹ Regulation CC sets forth certain warranties regarding (i) returned checks (Section 229.34(a)); (ii) notices of nonpayment (Section 229.34(b)); and (iii) settlement amounts, encoding, and offsets (Section 229.34(c)). In addition, Regulation CC sets forth transfer and presentment warranties regarding RCCs (Section 229.34(d)), but does not include transfer and presentment warranties for checks other than RCCs.

²⁰ Regulation CC provides that a bank that “transfers or presents a remotely created check and receives a settlement or other consideration warrants to the transferee bank, any subsequent collecting bank, and the paying bank that the person on whose account the remotely created check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check.” 12 C.F.R. § 229.34(d). Under the 2011 Proposed Rule, a bank that transfers or presents an eRCC would make the same warranties.

²¹ The Board has explained that even though an ECI “cannot be used to create a substitute check that meets the legal equivalence requirements of the Check 21 Act and Regulation CC ... [a]s a practical matter ... a bank (including perhaps the depository bank) receiving an electronically-created item might be unable to distinguish the item from any other image of a check that it receives electronically.” As a result, a “bank unknowingly may transfer the image as if it were an electronic check or electronic returned check (i.e., as if it were derived from a paper check), or produce a paper item that is indistinguishable from a substitute check (although not a valid substitute check because it was not derived from a paper check).”

limitations (similar to the existing statute of limitations in Regulation CC for breach of warranty claims).²²

Under the 2013 Proposed Rule, a bank (other than the bank of first deposit) that is unable to make a warranty claim under existing check law because an image and accompanying information was not derived from a paper check would be able to bring an indemnity claim against a prior sending bank for losses caused by that fact (such as losses the bank would have been able to recover through assertion of a warranty claim had the image and accompanying information been derived from a paper check). The Proposed Indemnity limits the potential damages a bank asserting an indemnity claim may receive. Specifically, the indemnity amount may not exceed “the sum of the amount of the loss, up to the amount of the settlement or other consideration received by the indemnifying bank, and interest and expenses (including costs and reasonable attorney’s fees and other expenses of representation).”²³ In addition, the Board has proposed a comparative negligence defense that would be available to indemnifying banks, which would potentially reduce the indemnity amount “by the portion of the indemnified bank’s loss that is attributable to the indemnified bank’s negligence or failure to act in good faith.”²⁴ Note that the provision also specifically states that it does not operate to “[reduce] the rights of a person under the UCC or other applicable provision of state or federal law” such as Regulation E.²⁵

The Board’s release of the 2013 Proposed Rule includes two examples of how the Proposed Indemnity might apply. The first relates to a situation involving a purported “substitute check” that does not meet the requirements for legal equivalence under Regulation CC because it is not derived from a paper check:

“A bank receives an electronic image of and electronic information related to an electronically-created item and, in turn, produces a paper item that is indistinguishable from a substitute check. The paper item is not a substitute check because the item is not derived from an original, paper check. That bank may incur a loss because it cannot produce the legal equivalent of a check (See § 229.53 and commentary thereto). The indemnity in § 229.34(b) enables a bank that received the electronically-created item to recover from the bank sending the check for the amount of the loss permitted under § 229.34(i).”²⁶

²² See 12 C.F.R. § 229.38(g).

²³ Proposed 12 C.F.R. § 229.34(i) (Indemnity Amounts).

²⁴ The Board explains that this provision is “intended to allocate liability in the same manner as the comparative negligence provision of § 229.38(c).” 79 Fed. Reg. 6674, 6728. Section 229.38(c) states that “[i]f a person, including a bank, fails to exercise ordinary care or act in good faith under [Subpart C of Regulation CC] in indorsing a check (§229.35), accepting a returned check or notice of nonpayment (§§229.32(a) and 229.33(c)), or otherwise, the damages incurred by that person under §229.38(a) shall be diminished in proportion to the amount of negligence or bad faith attributable to that person.”

²⁵ Proposed § 229.34(i)(2)(ii); see also 79 Fed. Reg. 6674, 6697.

²⁶ See 12 C.F.R. §§ 229.52(a)(1) and 229.51(a)(1).

The Board explains that the Proposed Indemnity “would protect a bank that receives an electronically-created item, creates a substitute check from it, and incurs losses because the substitute check it created was not the legal equivalent of the original check.”²⁷ In particular, the bank may be liable for losses resulting from its breach of the substitute check warranties set forth in Section 229.52 of Regulation CC, under which any bank that transfers, presents, or returns a substitute check (or a paper or electronic representation of a substitute check) warrants that the substitute check “[a]ccurately represents all of the information on the front and back of the original check as of the time the original check was truncated” (i.e., removed from forward collection or return).²⁸

The second example relates to an ECI that the paying bank’s customer claims was unauthorized, but which the paying bank cannot contest because there is no paper check to examine:

“A paying bank pays an electronically-created item, which the paying bank’s customer subsequently claims is unauthorized. The paying bank may incur liability on the item due to the fact the item is electronically created and not derived from a paper check. For example, the paying bank may have no means of disputing the customer’s claim without examining the physical check, which does not exist. The indemnity in § 229.34(b) enables the paying bank to recover from the presenting bank or any prior transferor bank for the amount of its loss, as permitted under § 229.34(i), due to receiving the electronically-created item.”

Under the 2013 Proposed Rule, the indemnity “would not flow to the drawer, payee or depository bank of the item.”²⁹ The Board explained that it believes that “a depository bank that accepts an item for deposit electronically should assume the risk that the item was not derived from a paper check.”³⁰ Moreover, the Board notes that “the depository bank can contractually protect itself by, if necessary, modifying the terms of its agreement with its depositor that permits items to be deposited electronically.”³¹

C. Application of Proposed Indemnity to Certain Scenarios

1. Unauthorized ECI that Resembles a Check Image

In this scenario, a paying bank receives and pays an ECI purportedly signed by the accountholder but that was, in fact, unauthorized. Subsequently, the paying bank attempts to recover from the

²⁷ 79 Fed. Reg. 6674, 6684

²⁸ As the Board explains, because ECIs “never existed in paper form ... they cannot be used to create substitute checks that are the legal equivalent of original paper checks.” *Id.* at 6682. Note that in certain situations involving purported substitute checks, it appears that a collecting bank that receives a purported “substitute check” may be able to recover under both the Proposed Indemnity and the substitute check warranties set forth in Section 229.52.

²⁹ 79 Fed. Reg. 6674, 6696.

³⁰ *Id.*

³¹ *Id.*

prior sending bank for losses resulting from the unauthorized ECI. Under the UCC, a paying bank may bring a breach of warranty claim against a prior sending bank if a check contains a forged endorsement.³² However, the UCC does not provide a paying bank with a breach of warranty claim where the drawer's signature is forged or the check itself is counterfeit; rather, the paying bank is held accountable if it pays a counterfeit check or a check on which the drawer's signature was forged.³³ This rule is based on the principle from *Price v. Neal* that the paying bank should be responsible for the loss resulting from a check containing the forged signature of the drawer because the paying bank is in the best position to recognize that its customer's signature has been forged.³⁴

The Proposed Indemnity would allow a paying bank to recover for losses that result from a forged endorsement (because if the image had been captured from a check that existed in paper form, the paying bank would have been able to bring a breach of warranty claim against the prior sending bank). However, because the UCC does not provide a breach of warranty claim where the drawer's signature is forged or the check itself is counterfeit, the Proposed Indemnity may not permit a paying bank to recover for losses that result when it pays an unauthorized ECI, even though the paying bank could not reasonably verify the validity of the signature on an ECI (because electronic signatures frequently do not resemble wet signatures) and the ECI itself may not have carried the same security features as would paper check stock approved by the paying bank.

As a practical matter, it is frequently impossible to distinguish an ECI from an electronic image of a check, and most banks assume that images presented for collection were derived from checks (and handle them accordingly). That an ECI was not captured from a check that existed in paper form could, however, be discovered as part of an investigation regarding a fraudulent ECI (e.g., during discovery in subsequent litigation).

If it was discovered that the ECI was not an image captured from an item in paper form, the Proposed Indemnity may not provide adequate protection for the paying bank in situations where losses result from a forged drawer's signature on the ECI. While the Proposed Indemnity would put the paying bank in the same position it would have been in had the electronic image been derived from a paper check (i.e., the paying bank would be responsible for unauthorized ECIs where the drawer's signature is forged), we do not believe that the rule from *Price v. Neal*

³² UCC § 3-417(a)(1); § 4-208(a)(1).

³³ Note, however, that UCC § 3-418 (payment or acceptance by mistake) may allow the paying bank to recover under certain circumstances. In addition, provisions in private clearinghouse rules (e.g., the "Rule 9" warranty under the ECCHO rules) may allow a paying bank to recover to the extent that the transaction is subject to those rules and the bank has not elected to opt out from their coverage. ECCHO has explained that "[s]ome member institutions do not support a rule that allows the Paying Bank to make a warranty claim on the basis that the drawer signature is unauthorized, viewing this signature responsibility appropriately placed on the Paying Bank under the UCC." Understanding "Rule 8" and "Rule 9" Warranty and Claims Processes (October 2012), <http://www.eccho.org/uploads/Rules%208%209%20White%20Paper.pdf>.

³⁴ See *Price v. Neal*, 97 Eng. Rep. 871 (KB 1762) (stating that "it was incumbent on the plaintiff to be satisfied that the bill drawn on him was in the drawer's hand, before he accepted or paid it; but it was not incumbent on the defendant to inquire into it").

should apply to unauthorized ECIs because ECIs do not contain a traditional handwritten signature of the drawer. Rather, we believe that depository banks should assume the risk of loss for all unauthorized ECIs, including those containing a forged electronic or facsimile of a drawer's signature, because a depository bank is best positioned to control whether it facilitates the introduction of ECIs into the check processing system and can use its customer relationships and agreements to control and detect fraudulent ECIs more effectively than can a paying bank.

Accordingly, we support a requirement that the depository bank (and other banks that transfer or present an ECI for payment) warrant that the ECI was authorized by the person on whose account the ECI is drawn, for the amount stated on the ECI and to the payee stated on the ECI. Such a warranty would be similar to the transfer and presentment warranties for RCCs set forth in 12 C.F.R. § 229.34(d) and the approach that was set forth in the 2011 Proposed Rule³⁵ and would promote consistency in the treatment of unauthorized electronic transactions across payment systems (which generally put the onus of ensuring transaction authorization on the bank that introduces the item into the system).³⁶

2. Unauthorized eRCC

In this scenario, a paying bank receives an unauthorized "eRCC" (i.e., an ECI that does not bear a signature applied, or purported to be applied, by the drawer). Had the eRCC been captured from a paper RCC, the paying bank would be able to bring a claim against a prior sending bank for breach of the transfer and presentment warranties for RCCs set forth in Regulation CC.

The Proposed Indemnity would allow the paying bank to recover from a prior sending bank for losses that result because these breach of warranty claims are not available (due to the fact that the eRCC was not an image captured from an item that existed in paper form). Thus, the Proposed Indemnity appears to provide sufficient protection for a paying bank that suffers losses as a result of this scenario.

3. Altered ECI Amount or Payee

In this scenario, a depository bank receives an ECI for an amount that is greater than the amount authorized by the drawer (or payable to a payee other than the payee intended by the drawer) and forwards the ECI for collection. Under the UCC, the paying bank that pays the ECI would have been able to bring a breach of warranty claim for fraudulent alteration had the image been captured from a paper check.³⁷ The Proposed Indemnity would allow the paying bank to recover

³⁵ Under the 2011 Proposed Rule, a bank that transfers or presents an eRCC would make the warranties for RCCs set forth in § 229.34(d) (i.e., it would warrant to the transferee bank, any subsequent collecting bank, and the paying bank that the person on whose account the remotely created check is drawn authorized the issuance of the check in the amount stated on the check and to the payee stated on the check).

³⁶ For example, the NACHA Rules for ACH transactions require an Originating Depository Financial Institution to warrant that ACH entries have been properly authorized by the Originator and the Receiver in accordance with the ACH Rules. NACHA Rule 2.4.1.1.

³⁷ UCC § 3-417(a)(2); § 4-208(a)(2).

from a prior sending bank for losses that result because this breach of warranty claim is not available (due to the fact that the item was not an image captured from a paper check).

Note that under UCC 4-406 (the “Repeater Rule”), an accountholder may bear responsibility for failing to discover and report checks that are altered or contain a forged signature within 30 days of being provided the account statement on which the unauthorized checks are reflected. Under such circumstances, the customer is precluded from asserting against the bank any later unauthorized transactions by the same wrongdoer. The rationale for this rule is that the customer is in the best position to review his/her account statements and to discover a check that was altered or included a forged signature. The Proposed Indemnity would allow a paying bank to recover from a prior sending bank in situations where, if the ECI had been an image captured from a paper check, the “Repeater Rule” may have been available as a defense to the paying bank to protect the paying bank from an account holder’s claims that subsequent items were altered or unauthorized. Even if the Repeater Rule is not applicable to an ECI (because the ECI is not an image captured from an item that existed in paper form and therefore Article 4 of the UCC, including the Repeater Rule, is inapplicable), an account agreement between a paying bank and its customer may impose a duty on the customer to detect and report unauthorized items (and limit the customer’s ability to recover from the bank for failing to satisfy this duty) even where such items are ECIs. Where a paying bank has expanded the application of the Repeater Rule through an account agreement with the customer from whose account the unauthorized item was drawn, it seems appropriate that the paying bank’s recovery under the Proposed Indemnity should be reduced to the extent that the paying bank can assert the Repeater Rule-like contract provision in defense against the customer for failing to report the unauthorized ECIs in a timely manner.

4. Altered ECI / Comparative Negligence Defense

In this scenario, as in the scenario immediately above, a paying bank receives and pays an ECI that is in an amount greater than the amount authorized by the drawer. The paying bank attempts to recover from a prior sending bank by asserting the Proposed Indemnity and the prior sending bank raises a comparative negligence defense, asserting that the paying bank’s negligence contributed to its losses.

Under the UCC, the paying bank would be able to bring a breach of warranty claim against a prior sending bank for fraudulent alteration had the electronic item been captured from a paper check.³⁸ Consequently, the Proposed Indemnity would allow the paying bank to recover from a prior sending bank for losses that result because a claim based on breach of the UCC presentment warranties is unavailable. However, the amount of the indemnity may be reduced “by the portion of the indemnified bank’s loss that is attributable to the indemnified bank’s negligence or failure to act in good faith.”³⁹

³⁸ *Id.*

³⁹ Note that UCC § 3-406 allows a paying bank to defend against a customer’s claim that a check is unauthorized if the customer’s negligence contributed to a forged signature or alteration. In addition, Regulation CC permits a bank that transfers or presents an RCC to defend against a breach of warranty claim “by proving that the customer of the paying bank is precluded under U.C.C. 4-406, as applicable, from asserting against the paying bank the unauthorized issuance of the check.” 12 C.F.R. § 229.34(d)(2).

While we generally support the view that an indemnified bank should not recover for losses that are attributable to its own negligence, as a policy matter, we do not believe that the comparative negligence defense to the Proposed Indemnity should reduce an indemnified bank's recovery from a prior sending bank if the prior sending bank would not have otherwise had a comparative negligence defense under Regulation CC or the UCC had the electronic item been captured from a paper check. For example, we do not believe that the comparative negligence defense to the Proposed Indemnity should be usable to attribute responsibility to a paying bank on the theory that the paying bank was negligent for failing to recognize that it was paying an ECI and not a paper check image. Although the Board does not explicitly state in the 2013 Proposed Rule that the comparative negligence defense would not operate in such a way, it may be difficult for a prior sending bank to demonstrate that a paying bank was negligent for having accepted and paid an ECI given that a paying bank may have no way of distinguishing an ECI from an electronic image derived from a paper check.⁴⁰

5. Federal Reserve Operating Circular #3 Warranty Claim

In this scenario, a collecting bank receives an unauthorized ECI and forwards it to a Federal Reserve Bank for collection. Federal Reserve Operating Circular #3 provides that a bank sending data to a Reserve Bank for collection or return as an "electronic item" warrants to each Reserve Bank that handles the data that the data was captured from a paper check.⁴¹ Further, a sending bank indemnifies the Reserve Banks against any loss that results if this warranty is breached.⁴² The amount of the indemnity "shall be the amount of any loss (including reasonable attorney's fees and other costs or expenses of representation) proximately caused by" a breach of the warranty.

It is worth considering whether such concepts should be extended to situations in which the negligence of a paying bank's customer contributes to an unauthorized or altered ECI.

⁴⁰ For example, the Board acknowledges that "a bank ... receiving an electronically-created item might be unable to distinguish the item from any other image of a check that it receives electronically." 79 Fed. Reg. 6674, 6684.

⁴¹ Section 2.3 of Operating Circular #3 states that "a sender that sends data to a Reserve Bank for collection or return as an electronic item under this Operating Circular warrants to each Reserve Bank that handles the data that the data is an electronic item as described in paragraph 1.3(d) of this Circular." Federal Reserve Banks Operating Circular #3 (Collection of Cash Items and Returned Checks), http://www.frbservices.org/files/regulations/pdf/operating_circular_3_07122012.pdf. The circular further explains that "[d]ata sent to a Reserve Bank in the form of an electronic item is not an 'electronic item' unless the data was captured from a check. By definition, the check from which the data was captured must be paper." (Emphasis added.)

⁴² In addition, note that Regulation J states that "[t]he sender [of an electronic item to a Federal Reserve Bank] makes all the warranties set forth in and subject to the terms of 4-207 of the U.C.C. for an electronic item as if it were an item subject to the U.C.C. and makes the warranties set forth in and subject to the terms of §229.34(c) and (d) of this chapter for an electronic item as if it were a check subject to that section." 12 C.F.R. § 210.5(a)(3). Regulation J defines "electronic item" to mean "[a]n electronic image of an item described in paragraph 12 C.F.R. § 210.2(i)(1)(i)], and information describing that item, that a Reserve Bank agrees to handle as an item pursuant to an operating circular."

The Proposed Indemnity would allow a bank (other than the bank of first deposit)⁴³ to recover in the event that a loss results from the breach of this Operating Circular #3 warranty because the breach would not have occurred had the electronic item been captured from a paper check. Note, however, that while Operating Circular #3 provides that the indemnifying bank is responsible for “any loss proximately caused” by the breach of the warranty regarding “electronic items” set forth in the circular, the Proposed Indemnity is limited to “the sum of the amount of the loss, *up to the amount of the settlement or other consideration received by the indemnifying bank*, and interest and expenses (including costs and reasonable attorney’s fees and other expenses of representation).”⁴⁴

The differing definitions of recoverable losses under Operating Circular #3 and under the Proposed Indemnity create the potential for a disparity in recoverable loss amounts, depending on the particular facts and circumstances giving rise to the ECI processing loss. Thus, a collecting bank that forwards an item to a Reserve Bank in violation of the electronic item warranty in Operating Circular #3 *may not* be protected by the Proposed Indemnity for the full amount of the loss that results from the breach of that warranty.⁴⁵

6. Improper Coding / Accompanying Information

In this scenario, a depository bank receives an ECI and forwards it to the paying bank for collection along with electronic information that does not accurately reflect the amount of the ECI. Had the ECI been an image captured from a paper item, the paying bank would be able to bring a claim against a prior sending bank for breach of Regulation CC warranties regarding proper encoding and the accuracy of accompanying information (12 C.F.R. § 229.34(c)).

The Proposed Indemnity would allow a paying bank to recover for losses that result because these breach of warranty claims are not available (due to the fact that the ECI was not an image captured from a paper item).

7. Regulation E

In this scenario, a paying bank pays an ECI that the accountholder claims was unauthorized and the accountholder asserts Regulation E rights in connection with the ECI. Regulation E excludes

⁴³ Note that the Proposed Indemnity does not flow to the depository bank.

⁴⁴ Emphasis added.

⁴⁵ The Proposed Indemnity was issued pursuant to the Board’s general authority under the EFAA to impose or allocate the risks of loss or liability related to payment transactions. Note that, absent bad faith, the scope of recoverable loss under rules the Board issues to allocate the risks of loss or liability is limited to the amount of the check giving rise to the loss or liability. See 12 U.S.C. § 4010(f) (stating that “[t]he Board is authorized to impose on or allocate among depository institutions the risks of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks, and any related function of the payment system with respect to checks. Liability under this subsection shall not exceed the amount of the check giving rise to the loss or liability, and, where there is bad faith, other damages, if any, suffered as a proximate consequence of any act or omission giving rise to the loss or liability.”)

transfers of funds originated by a “check, draft or similar paper instrument” from the definition of “electronic fund transfer” and, thus, from Regulation E coverage. However, this exclusion likely does not apply to ECIs because they never existed in paper form.

It appears that the Proposed Indemnity would allow a paying bank to recover from a prior sending bank for losses that result from the paying bank customer’s assertion of Regulation E rights because those rights would not have applied had the item originated as a paper check. The 2013 Proposed Rule also states that in the event of an unauthorized eRCC, the paying bank’s customer should “normally be made whole for the unauthorized debit in accordance with UCC 4–401 or Regulation E (12 CFR part 1005), assuming either is applicable.”⁴⁶

Separately, the Board requested comment, in issuing the 2013 Proposed Rule, on “whether losses proximately caused from not being able to make the warranty claim should be interpreted to cover damages awarded for violations of Regulation E.”⁴⁷ An equally important question not raised by the Board is whether a paying bank’s costs of complying with Regulation E (including error resolution and recredit rights) not applicable to checks and check images would be recoverable under the Proposed Indemnity. Assuming the final rule amending Regulation CC includes the Proposed Indemnity to cover such damages and costs, we note that the liability limitation associated with the Proposed Indemnity may prevent an institution from collecting the full amount of its damages and costs associated with Regulation E compliance or non-compliance if such damages and costs exceed the settlement amount of the item and interest and expenses.⁴⁸

III. Conclusion

The increasing prevalence of ECIs in the check collection system justifies changes to its legal framework to provide additional protections for banks that handle ECIs in the check collection process. As discussed above, the Proposed Indemnity generally will protect banks (other than depository banks) against losses that result from the fact that an ECI is not an image captured from a paper item. However, the Proposed Indemnity may be inadequate under certain circumstances to fully protect banks against ECI-related risks of loss (e.g., where losses result from a forged drawer’s signature on an ECI or from a counterfeit ECI). Thus, while we support the Proposed Indemnity and the measure of protection it provides to banks handling ECIs in the check collection process, we recommend supplementing the Proposed Indemnity with a warranty that extends the transfer and presentment warranties for RCCs set forth in 12 C.F.R. § 229.34(d) (in particular, the authorization warranty) to all ECIs. Requiring depository banks to be responsible for the due authorization of all ECIs they introduce into the check processing system properly allocates risk to the bank best positioned to prevent ECIs from entering the system (should the depository bank choose to prohibit customers from depositing ECIs) and best

⁴⁶ 79 Fed. Reg. 6674, 6696.

⁴⁷ 79 Fed. Reg. 6674, 6684.

⁴⁸ Under the Proposed Indemnity, the indemnity amount may not exceed “the sum of the amount of the loss, up to the amount of the settlement or other consideration received by the indemnifying bank, and interest and expenses (including costs and reasonable attorney’s fees and other expenses of representation).” Proposed 12 C.F.R. § 229.34(i).

positioned to allocate authorization risk and liability to ECI-depositing customers (should the depository bank choose to introduce ECIs into the check processing system).