

ECCHO Rule 9 At A Glance Forged & Counterfeit Warranties

What is Rule 9?

Rule 9 is a portion of the ECCHO Rules in which a depository bank for an electronic check warrants to the paying bank for that electronic check that (i) the signature of the purported drawer of the related physical check is not forged or otherwise unauthorized, and (ii) the related physical check is not counterfeit. Rule 9 is set out in section XIX(O) of the ECCHO Rules.

Who can use Rule 9?

Rule 9 is only available for electronic checks exchanged, directly or indirectly, between two ECCHO members that have not opted out of Rule 9.

What is the purpose of Rule 9?

Forged and counterfeit items are often identified by bank customers after return deadlines have passed. Rule 9 allows a paying bank to file a claim to recover for a fraudulent item after the UCC midnight return deadline. Rule 9 shifts responsibility, in some cases, from the paying bank to the depository bank (and potentially the depositing customer) when there are sufficient funds in the depositor's account. The depositor is generally in the best position to have prevented the loss. If there are insufficient funds in the depositor's account, the loss remains with the paying bank.

Why shift responsibility?

Checks are no longer processed as in the past:

- Financial institutions no longer verify signatures on checks presented in in-bound cash letters;
- Checks are collected electronically so paying banks never see the paper originals; and
- Items are often remotely deposited, meaning even depository banks often does not receive the paper originals.

Inception of Rule 9

In the 1980s, Rule 9 was developed for paper check exchanges in a Texas clearinghouse, where it first received its name. Financial institutions have benefited from Rule 9 claims ever since.

Check fraud is up

Check fraud losses, along with certain other types of payments fraud, have trended up the last few years. Counterfeit checks top the list of check fraud losses for banks. Today's fraud detection and mitigation programs are best when fraud experts are paired with other tools such as layered antifraud technology (e.g., behavioral rules-based systems, artificial intelligence, sophisticated signature algorithms), documented risk controls, education/training, and partnerships with law enforcement. Rule 9 is another useful tool in the fraud management toolkit.

Evolution of check fraud detection

In the 20th century, paying banks compared signatures they held on file to the signature on each check. As check volumes increased, paying banks began comparing signatures on checks above a certain dollar amount. Even though the UCC does not generally mandate a bank to "examine an instrument" during the check collection process, the UCC generally places liability for forged or counterfeit checks on paying banks (UCC § 4-401). With electronic check exchange and remote deposit capture, physical checks are now digitized as soon as possible, often prior to deposit, and manual examination is a thing of the past.

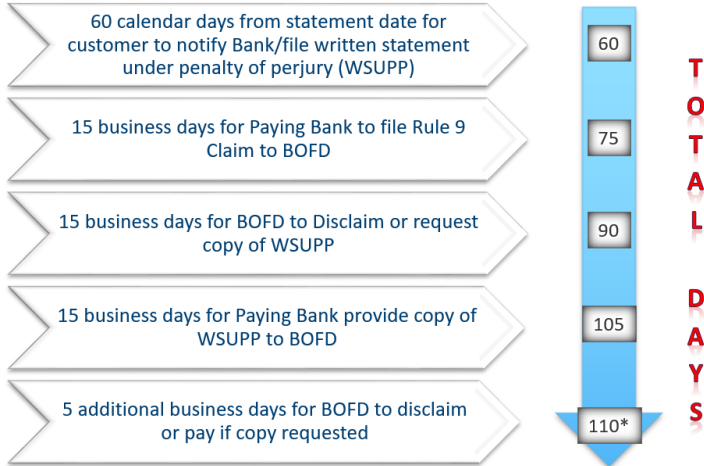
History of forged/counterfeit responsibilities

The assignment of responsibility for forged drawer's signature fraud to the paying bank dates back to an English legal case from 1762, *Price v. Neal*. The judge in that case, Lord Mansfield, could never have imagined how far-reaching his decision would be when he ruled that a drawee could not seek to recover from the presenter of a draft that bore a forgery of the drawer's signature. Clearly, he could not have anticipated electronic checks or the role technology would play in fraud. His decision lives on in the limited presentment warranties given under UCC §§ 3-417, 4-208. Rule 9 varies the UCC by agreement to conditionally modify responsibility for a forged/counterfeit check to better reflect 21st century check collection.



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Rule 9 process



Analyzing the pros and cons of Rule 9

Some financial institutions believe that the risk for counterfeit/forgery is properly placed on the paying bank under UCC. That was certainly true prior to the advent of electronic check exchange, but the massive change in processing has compelled the industry to consider new practices. Moving risk to the point of entry into the check system seems reasonable. Historically, banks were expected to know the hand of their customers. But technology today allows forgers to replicate a customer's hand. These days, banks must have know your customer (KYC) policies and, increasingly, have KYCC (know your customer's customer) policies too.

While there has been some concern that Rule 9 can affect customer service, in fact, Rule 9 does not govern how the customer is treated. Rule 9 is an interbank warranty. Each financial institution is in control of how it interacts with its customers through its customer agreements. Although Rule 9 allows institutions to disclaim Rule 9 claims when there are insufficient funds in the depositing customer's account, it does not mandate whether the customer is charged if there are sufficient funds. If the institution pays the Rule 9 claim, it can choose whether to absorb the loss or charge its customer's account for the fraudulent item.

The opt-out decision is a decision each institution should make by carefully weighing the risks against the benefits and under the guidance of your legal team. Under the rule, both paying banks and depositary banks are subject to deadlines (see graphic above). Institutions may also wish to analyze their forged/counterfeit write-offs to understand which customers are experiencing losses and how often they occur. They can use this information to help educate customers on fraud-avoidance techniques, systems, and policies.

Over 99% of ECCHO members have found Rule 9 beneficial. While Rule 9 allows paying banks to make breach of warranty claims for forged/counterfeit items to depositary banks, the rule also protects depositary banks by allowing them to disclaim such claims under certain conditions. This is important and, we believe, equitable since institutions generally act alternately as depositary bank and paying bank.

Rule 9 claims are not returns

Although Rule 9 claims may be made via a return channel in some instances (the ECCHO rules do not provide for use of the Fed's return process, however), such claims are breach of warranty claims and not returns; therefore, they are not subject to expedited return deadlines. Rule 9 claims that utilize the return channel occur with entry, which starts the clock for the depositary bank to disclaim a Rule 9 claim for cause.

Alternatively, Rule 9 claims may be made directly by letter or through an adjustment service if the adjustment service allows such claims.

Reasons to disclaim a Rule 9 claim

A depositary bank may disclaim a Rule 9 claim for a number of reasons, including:

- *Insufficiency of funds* - The claim amount exceeds the available funds in the depositing customer's account or the customer has closed the account;
- *Opt out* - The depositary bank has opted out of Rule 9.
- *Rule 9 deadlines not met* - The paying bank failed to meet one or more of the deadlines set in the rule.

For more information

FAQs: <http://www.theclearinghouse.org/ECCHO/ECCHO-FAQ>

Sample forms: <https://www.theclearinghouse.org/ECCHO/Check-Resources>