



May 3, 2005

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the  
Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, DC 20551

Re: Docket No. R-1226  
Regulations J and CC: Collection of Checks and Other Items  
Proposed rule

Dear Ms. Johnson:

The Association for Financial Professionals (AFP) welcomes the opportunity to respond to the Federal Reserve Board's request for comment on proposed amendments to Regulation CC. The amendments would shift liability for unauthorized remotely created checks to the depository bank, which is generally the bank for the person that initially created and deposited the remotely created check.

AFP represents approximately 14,000 finance and treasury professionals who, on behalf of over 5,000 corporations and other organizations, are significant participants in the payments system. Organizations represented by its members are drawn generally from the Fortune 1,000 and the largest of the middle market companies. AFP members' organizations receive remotely created checks and they also create and deposit remotely created checks for legitimate business purposes. They thus have a sizeable stake in the adoption of regulations that provide the legal framework for these payment instruments, protect against their fraudulent use, and assign liability for unauthorized transactions to the responsible parties

#### **Current Law on Remotely Created Checks**

Remotely created checks are created when the holder of a checking account authorizes another person (typically the payee) to draw a check on the holder's account. In place of a signature, these checks bear a statement that the customer authorized the check or have the customer's printed or typed name. Because they do not bear a signature and are not

created on check stock the customer generally uses, remotely created checks are vulnerable to fraud. Companies and other organizations, as well as consumers and banks, have experienced many instances of their fraudulent use.

Remotely created checks are currently subject to state law on negotiable instruments, specifically the Uniform Commercial Code (UCC) Articles 3 and 4. Under the UCC, a paying bank may charge a customer's account for a check only if the check is properly payable. A bank generally must recredit its customer's account for the amount of any unauthorized check it pays. The UCC requires the paying bank to bear the economic loss of an unauthorized check because it is in the best position to judge the authenticity of its customer's signature and check. A paying bank may, until midnight of the banking day after a check has been presented to the bank, return the check to the depositary bank if the paying bank believes the check is unauthorized.

In the case of most remotely created checks, the depositary bank's customer created the check. However, in a high-speed check processing environment, paying banks have no way of knowing which checks are remotely created, and therefore cannot return unauthorized remotely created checks to the depositary bank by the deadline of midnight of the banking day following presentment.

The UCC was revised in 2002 to shift liability for unauthorized remotely created checks to the depositary bank and intermediate banks. However, only 14 states have adopted the revision and their statutes are not uniform in scope or requirements.

### **Proposed Rule**

The Federal Reserve Board's proposal would shift liability for the loss created by an unauthorized remotely created check from the paying bank to the depositary bank. The transfer and presentment warranties under the proposed Federal Reserve rule would apply only to banks; the Federal Reserve's authority to establish rules regarding losses and liability extends only to depositary institutions, not to nonbank payees.

AFP agrees with the proposal to shift liability for unauthorized remotely created checks to the depositary bank, the bank whose customer deposited the check. The depositary bank should be responsible for knowing its customer and evaluating the potential for fraudulent or careless check activity. AFP's comments deal with general questions regarding the coverage and approach of the proposed rule, and with technical questions relating to the definition of remotely created checks, the scope of the warranty and the settlement of the warranty claim.

### **Summary of AFP Recommendations**

- AFP agrees with the Board's proposal that the rule cover the accounts of non-consumers, such as businesses and other organizations, as well as consumer accounts.
- AFP supports a nationwide, uniform federal rule on remotely created checks, rather than waiting to have the individual states adopt an amendment to the UCC that deals with the issue.

- AFP recommends that the definition of “remotely created check” in the Board’s rule more closely follow the definition contained in the UCC amendment.
- AFP recommends that the Board adopt the warranty scope of the UCC amendment, under which a bank would warrant that the person on whose account the item is drawn has authorized the issuance of the item in the amount for which the item is drawn.
- Pending further study and analysis, AFP does not recommend at this time that recovery of losses through the check system be accomplished by extending the UCC midnight deadline, which would have wide-ranging consequences for UCC Articles 3 and 4. Instead, AFP recommends that the Board set forth, through a Federal Reserve Operating Circular, procedures and processes for a paying bank to make a warranty claim to the depository bank for an unauthorized remotely created check and a time frame for payment of that claim through return-like processes and with settlement entry.

### **I. Coverage of Consumer and Non-Consumer Accounts**

The Board’s definition of remotely created checks under the proposed rule would apply to checks drawn on both consumer and non-consumer accounts. The amendment to the UCC dealing with remotely created checks, referenced earlier, applies only to consumer items.

AFP agrees with the Board’s proposal that the rule cover the accounts of non-consumers, such as businesses and other organizations, as well as consumer accounts. Businesses, including AFP members’ organizations, have reported a number of fraud attempts using remotely created checks. The rationale for shifting liability to the depository bank applies equally to non-consumer items as to consumer items. If a loophole were to exist for remotely created checks drawn on non-consumer accounts, the frequency of fraud against these accounts is likely to escalate. In addition, it is more efficient to treat remotely created checks drawn on consumer and non-consumer accounts similarly, especially since it is often difficult for banks processing the checks to distinguish between the two types of accounts.

### **II. Nationwide vs. State-by-State Approach**

The Board requested comment on whether it should refrain from establishing a nationwide rule on remotely created checks and allow the states to adopt the UCC amendment shifting liability to the depository bank.

AFP supports a nationwide, uniform approach to this issue and recommends that the Board issue a federal rule dealing with liability for unauthorized remotely created checks. A state-by-state approach complicates the trail of liability for checks collected across state lines. States have been slow to adopt the UCC amendment, and those that have enacted it have varied its provisions, creating uncertainty for all parties. Moreover, the UCC amendment is restrictive in its coverage, limited only to items drawn on consumer accounts.

### **III. Definition of Remotely Created Checks**

The Board's proposal defines "remotely created check" as a check that is drawn on a customer account at a bank, is created by the payee, and does not bear a signature in the format agreed to by the paying bank and the customer. This definition includes checks that are created by payees or their agents. AFP is concerned about several elements of this definition and recommends that it be revised, as explained below.

#### "Created by the payee"

The Board's definition of a remotely created check as a check created by the payee or its agent creates two uncertainties that can be eliminated by adopting the language of the UCC amendment on this issue. A paying bank and its customer against whose account the fraudulent item was drawn may find it difficult to determine whether or not the remotely created check was created by the payee or its agent, as would be required by the Board's definition. Yet such a determination would be necessary in order for the customer or its bank to fill out an affidavit or form alleging the elements necessary for the paying bank to make the warranty claim.

The UCC amendment defined a remotely created check as an item "which is not created by the payor bank...." This definition avoids uncertainty about who created the item. Moreover, Regulation CC (12 CFR Sec. 229.41) pre-empts state law (UCC) if there is inconsistency between the federal regulation and state law. Variation in the definition of remotely created checks between Reg. CC and the UCC amendment may lead to confusion in states that have adopted the UCC amendment regarding whether the federal and state rules are inconsistent.

For reasons of clarity and consistency, it would be preferable to follow the UCC in this element of the definition.

#### "Signature in the format agreed to"

The Board defines a remotely created check as a check that "does not bear a signature in the format agreed to by the paying bank and the customer." The Board's definition assumes that the paying bank and its customer have agreed to a format for the customer's signature. This is not always the case. Deposit agreements are often silent as to the form of the customer's signature, which may be handwritten, or in the case of business checks, a facsimile, a corporate logo or other symbol. If there is no such agreement, AFP is concerned that the depositary bank could justifiably deny the claim since the item at issue was not a "remotely created check."

The UCC amendment defines a remotely created check as an item that "does not bear the handwritten signature purporting to be the signature of the drawer." This approach to excluding signed items appears to more clearly distinguish between a check subject to the proposed new warranty and a check containing a fraudulent or unauthorized signature not subject to the warranty associated with remotely created checks. For example, in the case of a completely fraudulent item, there typically is some kind of signature purporting to be that of the customer, and these would not be covered by the new warranty. AFP recommends, however, that the word "handwritten" be deleted in order to include within

the definition items that do not have a handwritten signature as in the case of facsimile signatures used by businesses.

In summary, AFP suggests that a remotely created check be defined as a check that: (i) is drawn on a customer account at a bank, (ii) is not created by the payor bank, and (iii) does not bear a signature purporting to be the signature of the customer. AFP's suggestion is in accord with the definition suggested by the Electronic Check Clearing House Organization (ECCHO).

#### Coverage of payable-through checks

The Board's proposal and its current definition of a remotely created check do not appear to address payable-through checks—checks that are payable through a bank and drawn on another bank or a non-bank payor. Payable-through checks generally do not bear the signature of the drawer. However for purposes of the definition, it is unclear whether payable-through checks are “drawn on a customer account at a bank.”

AFP suggests that payable-through checks be included within the definition of remotely created checks and be covered by the related warranty. A bank or non-bank payor cannot review a customer signature on a payable-through check and should have recourse to the bank that transferred the check. We recommend that the Board revise our proposed definition accordingly or indicate within the Commentary that a check payable through a bank is within the definition of a remotely created check.

#### **IV. Scope of Warranty**

The Board proposes to create warranties under which any transferor bank, collecting bank, or presenting bank would warrant that the remotely created check that it is transferring or presenting is authorized according to *all of its terms (emphasis added)* by the person on whose account the check is drawn.

AFP recommends that the Board adopt the limited warranty scope of the UCC amendment, under which a bank would warrant that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.

In a business context, the name of the payee may be subject to many legitimate variations. Given the frequency of variation in payee name, an inclusion of the payee name under the warranty might create unnecessary disputes and payment delays. Corporate lockbox processing practices accommodate this variability by accepting checks made out to a variety of payee names, often specified in the bank-customer lockbox agreement. For example, the check may be made out to a large company's subsidiary or division, rather than to the parent company. As another example, a hospital chain may receive checks on which the payee name is the local hospital rather than the hospital company name, as requested.

If the Board decides against adopting the limited scope of the UCC warranty and includes the payee name under the warranty, AFP urges the Board to indicate in its Commentary

that variation in payee names should not be subject to a warranty claim, and to provide examples that illustrate the business scenarios in which this might occur.

#### Situations of “buyer’s remorse”

In its proposal, the Board’s points out that, under existing law on remotely created checks, the paying bank may have evidence that the depositor did in fact authorize the check and is suffering buyer’s remorse. In this case, the bank does not have to recredit the amount of the check.

AFP suggests that the Board clarify in its rule and/or Commentary that the warranty for remotely created checks does not extend to situations where the customer has claimed payment was unauthorized, the paying bank recredited its customer, but there is evidence of buyer’s remorse. We support language similar to that suggested by ECCHO stating that a remotely created check is not unauthorized for purposes of the warranty in situations where the paying bank has recredited its customer’s account for the remotely created check because the customer alleged that the goods or services provided were not consistent with the terms of purchase or otherwise has a dispute with the merchant or provider regarding the goods or services.

#### **V. Extension of the Midnight Deadline; Settlement of the Warranty Claim**

Under the proposed rule, a paying bank would recover losses caused by an unauthorized remotely created check by making a warranty claim outside of the check collection and return system. Payments are final after the midnight deadline and there is no longer a right within the check system to return an unauthorized check. However, outside of that system, banks do have a one-year time frame to make a Reg. CC warranty claim.

As an alternative to the proposed rule, the Board invited comment on a rule that would allow a paying bank to return the unauthorized remotely created check through the check system by extending the UCC midnight deadline for a period of time, such as 60 days.

The Board pointed out that such a rule could reduce the cost of recovering losses. However, the Board adds, it would extend the midnight deadline considerably and delay finality of payment and discharge of the underlying obligation with respect to remotely created checks.

At this time, AFP does not recommend that recovery of losses through the check system be accomplished by extending the UCC midnight deadline. The midnight deadline impacts many parts of UCC Articles 3 and 4 and the check collection and return system. In addition to its impact on finality of payment, extending the midnight deadline could have wide-ranging and unanticipated consequences for the UCC. The implications of a change of such momentous nature call for further study and analysis. The Board is urged to proceed with adoption of the rule in its current form, and to issue a further proposal at a later date if a change is judged advisable after an extensive examination of the issue.

However, AFP agrees that costly and lengthy litigation is not an efficient procedure for recovering losses. Moreover, if the paying bank recovers its losses promptly, it will have an incentive to recredit its customer's account on a more timely basis.

AFP recommends that the Board set forth, through a Federal Reserve Operating Circular, procedures and processes for a paying bank to make a warranty claim to the depository bank for an unauthorized remotely created check and a time frame for payment of that claim through return-like processes and with settlement entry. Private sector check clearinghouses should also be encouraged to adopt similar rules. This solution should facilitate cost-effective and timely settlement of the warranty claim.

MICR Line Identifier


The Board also requested comment on the use of Position 44 of the MICR line to identify remotely created checks. AFP recognizes the operational difficulties associated with implementing this proposal as described in the comments of the financial services industry, and does not support adoption of this solution.

AFP thanks the Federal Reserve for the opportunity to comment on the definition of remotely created checks and the transfer and presentment warranties for such checks. Should you have questions about the Association's positions, please call Arlene Chapman of AFP at 301-907-2862.

Sincerely,



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