

# Articles 3 and 4 of the Uniform Commercial Code in an Electronic Fund Transfer Environment

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*The electronic computer has revolutionized the payments and transfer of funds mechanism, making possible paperless entry payments (PEP) and electronic fund transfers (EFT). Concurrently, it raises legal issues and problems stemming from the new relationships among the participants.*

*Articles 3 and 4 of the Uniform Commercial Code have not impeded development of new systems and should remain viable as a legal framework governing payment and transfer transactions during the transition from paper to paperless electronic operations. Both articles can be amended and effectively used as basic rules for allocating rights and responsibilities among the parties to electronic processing of the data and information.*

The most common payment transaction medium in the United States today is the check. During the fiscal year 1976-1977, 27.7 billion checks for \$2.1 trillion were used for retail payments, contrasted with 5 billion credit card slips for \$71 billion.<sup>1</sup> Transfers of funds over interbank wire systems totaled 26 million transactions shifting \$34.8 trillion.<sup>2</sup> The bank check collection process is the core of the check payments system and remains one of the most important routine services provided by commercial banks. Although improved transportation facilities and the substitution of

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1. FEDERAL RESERVE BANK OF CLEVELAND, ANNUAL REPORT 9 (1977).

2. *Id.*

data processing equipment for manual-mechanical operation have significantly increased the efficiency of the system, the paperwork associated with a paper-based payments system remains a major obstacle to attainment of ideal efficiency. Thus the need exists for an alternative nonpaper-based payment system.

The developing electronic fund transfer (EFT) and paperless entry payment (PEP) systems offer an option to a paper-based system. In a pure EFT and PEP environment, the visual deposit and collection process would be replaced with a series of electronic impulses passed among computers that would read and process the instructions, perform the necessary deposit accounting function, and transfer the funds from bank to bank and from drawer to the authorized party. Payment would be almost instantaneous and no paper would be produced.

The developing EFT and PEP systems are presently directed toward meeting the needs of business organizations and government bodies, which make income payments in large volume (direct deposits or credits). These payments are usually to repetitive payees and are preponderantly for wages and salaries; dividends, interest, and annuities; and retirement and welfare benefits. Because the payment function is usually centralized in such organizations, conversion to an electronic system involves a minimum of disturbance to existing arrangements. These systems also have the potential to serve the needs of the individual consumer whose payment volume is small and irregular in timing and point of origin, but which more often than not occurs at the place of purchase of some good or service (the point of sale).<sup>3</sup>

EFT and PEP payment systems are at present merely supplementing the existing paper-based system. The "checkless society" has not arrived yet, and probably there will not be even a substantially "checkless society" for another decade. In the interim, the volume of paper instruments will continue to be far in excess of the volume of paperless entries and will have to be handled contemporaneously.

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3. These emerging EFT and PEP systems accommodate two other payment arrangements. In one, the consumers agree to permit their accounts to be electronically debited for contractual obligations, such as insurance premiums, rents, mortgage and installment credit payments, utility bills, credit card purchases, and similar payments. The other is electronic giro, by which the consumer or business remitter or payor receives a machine-readable statement or invoice in a specified format incorporating the necessary payment or transfer of funds data, to be used as the input document for the payment or remittance process to be accomplished electronically. For further discussion, see J. VERGARI, *NEGOTIABLE INSTRUMENTS AND THE PAYMENTS MECHANISM* 1-5 (1976); J. WHITE, *TEACHING MATERIALS ON BANKING LAW* 700-10 (1976); White, *EFT Can Function Better Without a New Payments Code*, *PAYMENT SYSTEMS NEWSLETTER*, Aug. 1978.

The contemporaneous use of a paper-based and a paperless payment system presents a number of legal problems. At present, two separate laws may be applicable to a payment transaction involving both systems. Articles 3 and 4 of the Uniform Commercial Code provide a legal framework for a check-based system,<sup>4</sup> and the recently enacted Electronic Fund Transfer Act<sup>5</sup> applies to transactions using EFT or PEP systems. This article will examine the flexibility of articles 3 and 4 in governing payment transactions until such time as a check-based payment system becomes obsolete. The first section of this presentation discusses the flexibility and application of articles 3 and 4 in an EFT environment. The second section analyzes some legal aspects of electronic processing of the data from EFT and PEP transactions. The third section analyzes the current statutory allocation of rights and duties of consumers and financial institutions in EFT transactions. Finally, a new division is postulated for article 4 as the foundation for the new relationships of all parties to EFT and PEP transactions.

#### SCOPE AND FLEXIBILITY OF ARTICLES 3 AND 4 OF THE UNIFORM COMMERCIAL CODE

The scope of article 3 of the Code, entitled "Commercial Paper," is restricted to paper instruments. Such instruments include drafts, checks, promissory notes, certificates of deposit, and other short-term commercial paper. Money itself, for example, Federal Reserve currency, is excluded.<sup>6</sup> Article 3 governs the formal requirements and characteristics of drafts, checks, notes, and other commercial paper and the general rights and obligations of the parties on negotiable instruments from their issuance to their entry into bank deposit and collection channels.<sup>7</sup>

Article 4 of the Code, entitled "Bank Deposits and Collections," deals primarily with the check collection process and applies specifically to checks and other items during the course of bank processing. It sets forth the rights and responsibilities of collecting banks and their customers in presentment, settlement, or return of a check or item.<sup>8</sup> The payor bank's responsibility upon

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4. U.C.C. §§ 3-101 to 805, 4-101 to -504.

5. Electronic Fund Transfer Act, 15 U.S.C.A. §§ 1693-1693r (West Supp. 1979).

6. U.C.C. § 3-103(1).

7. *Id.* §§ 3-103(2), 4-102(1).

8. *Id.* §§ 4-103(5), -202, -207, -211, -212.

receipt of a check or item drawn on it is also set forth, along with the consequences for failure to act in a timely manner.<sup>9</sup> Article 4 outlines the priorities of stop payment orders and legal processes, such as attachment, notices, and setoff, which are in competition with the final payment of a check or item from the customer/drawer's account.<sup>10</sup> Finally, article 4 regulates certain specified relationships between a payor bank and its checking (demand deposit) customers.<sup>11</sup>

Although articles 3 and 4 deal generally with negotiable instruments,<sup>12</sup> any instrument used for the payment of money through bank collection channels, even though not negotiable, is within the scope of article 4.<sup>13</sup> Article 3 and article 4, part 4 establish the rights and obligations of the customer and the bank for items directing the payment or transfer of funds and are designed for transactions involving third and subsequent parties in addition to the immediate parties consisting of the drawer, payee, and drawee/payor bank. Neither article relates to deposit credit except for the incidence of availability of funds to the customer as of right and the firming up of provisional credit in the bank collection process.<sup>14</sup>

Freedom of contract is the vital element in the dynamic nature of article 4. Without this element, existing methods of operation would be frozen by mandatory statutory rules. All provisions may be varied by agreement between banks and their customers or among banks, except that an agreement may not disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care and may not limit the measure of damages for such lack or failure. The parties may agree to reasonable standards for ordinary care.<sup>15</sup> This possibility goes far toward meeting the requirements of flexibility.

However, approximately 80 million items are handled in bank deposit and collection process every banking day;<sup>16</sup> and many parties may be involved, including the owner of the item, the

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9. *Id.* §§ 4-301, -302.

10. *Id.* §§ 4-213, -303.

11. *Id.* §§ 4-401 to -407.

12. *Id.* § 3-104(1) states: "Any writing to be a negotiable instrument within this Article must (a) be signed by the maker or drawer; and (b) contain an unconditional promise or order to pay a sum certain in money . . . and (c) be payable on demand or at a definite time; and (d) be payable to order or to bearer."

13. *Id.* § 4-104(1)(g).

14. *Id.* §§ 4-201(1), -211(3), -213(2) to -213(4).

15. *Id.* §§ 1-102(3); 4-103(1), Comments 1 & 2.

16. See The Payment System in the United States (paper prepared by the staff of the Board of Governors of the Federal Reserve System for the Central Bank Automation Week Symposium, sponsored by the Bank of International Settlement, Sept. 14, 1978).

drawer, the maker, the issuer, all nonbank indorsers, the payor bank or drawee, and from one to five or more collecting banks. It is obviously impossible to obtain direct agreements from all the parties on such items being processed, but all parties may become bound by the agreements on the principle that collecting banks as agents have authority to make agreements with respect to all items being handled.<sup>17</sup>

To meet this problem, section 4-103(2) of the Uniform Commercial Code provides that, subject to good faith and ordinary care limitations, Federal Reserve regulations and operating letters, clearinghouse rules, and the like, as quasi-official rules of collection or administrative provisions, have the effect of such agreements. Standing by themselves, the administrative principles and criteria permit greater flexibility for the operation and bind all parties interested in the items being processed in those channels whether or not the parties have given their assent specifically.<sup>18</sup>

#### LEGAL ASPECTS OF ELECTRONIC DATA PROCESSING (EDP)

Demand deposits at commercial banks underlie virtually all the money payment and transfer needs of individuals, corporations, and governments in the United States. The check accounting and handling operation by the 14,000 commercial banks and Federal Reserve banks involves over 600 million items per week.<sup>19</sup> An operation of this magnitude is a natural application for computer technology and EDP techniques. The cumbersome handling and shipment of checks and related paper listings of data through bank collection channels may be replaced by telecommunication of check information—euphemistically referred to as “check truncation.”

However, when EDP is applied, the resulting record of the various steps in the handling process or accounting is no longer on a visually readable hard copy, but is stored in a computer electronic memory or satellite storage facility. All intermediate steps are erased after proof and the new record has been formed. The absence of a visual trail, together with the use of EDP deposit-accounting systems in place of electro-mechanical accounting

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17. U.C.C. § 4-103, Comment 3, ¶ 1.

18. *Id.* § 4-103(2), (3), Comments 3-6.

19. J. WHITE, TEACHING MATERIALS ON BANKING LAW 702 (1976).

machines, may create significant legal questions.<sup>20</sup> For instance, it is not clear who will be liable for unauthorized transfers. Except for those checks that are truncated at the payor bank, it is not possible with present technology to verify signatures or indorsements.

Another question is raised concerning the payor bank's liability for the payment of checks bearing forged drawer's or indorser's signatures or those not in accord with the customer/drawer's instructions.<sup>21</sup> When check truncation is used and the cancelled checks or items are not returned to the customer/drawer, the times for initiating claims under section 4-406 of the Uniform Commercial Code on unauthorized signatures, alterations, forged indorsements, and errors will not be triggered as "the items [are not] sent . . . or otherwise available to customer" as prescribed in that section. As a consequence, banks may have to absorb losses that might have been uncovered by the customer's examination of the items if they had been returned the month following payment and charged to the customer's account<sup>22</sup> as is the current practice. Evidentiary problems for both the bank and the customer will result from the absence of the original checks and other paid items, because of the fact that the original items were retained and eventually destroyed by the truncating bank. To alleviate this problem, the checks would have to be stored at least for the period required to effect presentment and the dishonor of the imaged items by the payor bank.

Several other problems must be solved. Who will bear the risk of loss because of computer malfunctions? Will the malfunction be considered as a *force majeure* and the bank's delay excused?<sup>23</sup> What will be the effect on the process of posting<sup>24</sup> or on stop payment instructions?<sup>25</sup> It must be determined whether instructions on magnetic tape or any other electronic media may be considered "items" if they can be reproduced in hard copy or durable medium.<sup>26</sup> Finally, it may not be feasible to fix responsibility for

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20. For a comprehensive review, see Ege, *Electronic Funds Transfer: A Survey of Problems and Prospects in 1975*, 35 Md. L. REV. 3 (1975).

21. U.C.C. § 4-406(2), -406(4).

22. *Id.* § 3-404 to -407, -417, 4-207, 4-406(3).

23. *Id.* § 4-108(2). See also *Port City State Bank v. American Nat'l Bank*, 486 F.2d 196 (10th Cir. 1973); *North Carolina Nat'l Bank v. South Carolina Nat'l Bank*, 449 F. Supp. 616 (D.S.C. 1976); *Security Trust Co. v. First Nat'l Bank*, 79 Misc. 2d 523, 358 N.Y.S.2d 943 (Sup. Ct. 1974).

24. See, e.g., *First Nat'l Bank & Trust v. Georgia R.R. Bank & Trust Co.*, 238 Ga. 693, 235 S.E.2d 1 (1977) (per curiam).

25. See, e.g., *Thomas v. Marine Midland Tinkers Nat'l Bank*, 86 Misc. 2d 284, 381 N.Y.S.2d 797 (Civ. App. 1976).

26. An essential element in the definition of "item" is that it be "an instrument for the payment of money." U.C.C. § 4-104(1)(g). "Instrument" encompasses a

encoding errors<sup>27</sup> by placing the loss on the bank that encoded the item with an amount or identification differing from that written by the customer as it is not technologically possible at this time to determine who did the encoding on the item or sent the electronic instruction.

Although many legal questions will arise, no changes in the basic rights and duties of the bank or customer need take place in an EFT environment. The only changes that will occur are in the equipment and processes for accomplishing the data processing and the bank collection activities in carrying out the order on the payor bank to pay money or transfer funds. The fundamental relationships and responsibilities between the banks and their customers need not be affected. The collecting bank's responsibility for presentment, settlement, or return of dishonored items and the payor bank's duty to act in a timely manner and not charge its customer's account for checks or items that were not "properly payable"<sup>28</sup> have not been revoked. As shown below,<sup>29</sup> legal problems involving the rights or duties of the bank or customer may be resolved through application of article 4 and the general principles of other applicable Uniform Commercial Code provisions.

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"writing." *Id.* 3-104(1)(2). "Written" or "writing" includes printing, typewriting, or any other intentional reduction to tangible form. *Id.* § 1-201(46). Information or data from magnetic tape, disks, cassettes, or other computer storage media can be printed or typewritten on command of the computer program. See generally Clarke, *An Item Is An Item Is An Item: Article 4 of the UCC and the Electronic Age*, 25 BUS. LAW. 109 (1969).

27. The following is an illustration of a magnetic ink character recognition (MICR) encoding error. A check is written by D for \$200. P deposits it in Bank A, which credits P's account with \$200. In the processing and handling of the check the amount inscribed on the check in MICR is \$2,000. As a result, the EDP accounting operation at the payor bank misses a stop payment order and D's account is charged \$2,000. On the next day, D's valid check for \$1,000 is dishonored as the balance in the account had been depleted by the \$2,000 charge. Who bears the risk of loss and liability resulting from the over-encoding of the amount? The payor bank would be liable to its customer D for the wrongful dishonor, and it may be liable for the payment over the stop order if D can show he suffered a loss by reason of the bank's failure to execute his stop order. Payor bank should be able to recover the overpayment from whoever encoded the check in error, if it can prove who did it.

28. U.C.C. § 4-401(1).

29. See note 30 *infra*.

THE UNIFORM COMMERCIAL CODE VIS-A-VIS EFT: A CURRENT  
ANALYSIS

During the transition from a "check" to a "checkless" economy, electronic transfers and paperless payments will be used increasingly. As a result, legal rules may have to be added to provide for dual and possibly overlapping functions and systems. Because the functional characteristics of paper-based mechanisms are not present in alternative computer-oriented paperless systems, the applicable rules need not be identical. The rights and duties of the parties founded on paper-based items or checks should continue to be governed by articles 3 and 4 of the Uniform Commercial Code, regardless of the fact that the items are sorted or processed electronically and the accounting data or payment information is handled by computer-oriented equipment. Any non-compliance, infraction, or violation of rights and responsibilities during such processing or functioning would be adjudicated according to the applicable provisions concerning fault, ordinary care, and negligence, including custom and usage, commercial standards and analogous provisions of articles 3 and 4.<sup>30</sup>

Presently, the legal structure of EFT and PEP transactions is elaborated through a network of private agreements and operating rules of automatic clearing houses,<sup>31</sup> and by Federal Reserve Regulation J.<sup>32</sup> In addition, the Electronic Fund Transfer Act provides for consumer rights and safeguards in electronic fund transfers and payments.<sup>33</sup> The Act defines "electronic fund transfers" to exclude "transactions originated by check, draft, or similar paper instrument."<sup>34</sup> Consequently, the Act does not conflict with articles 3 and 4 of the Code because it deals only with electronic fund transfers and not paperbased systems. A comparison of the two legal frameworks is appropriate at this point.

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30. U.C.C. §§ 1-103, 3-401 to -407, -417 to -419, -804, 4-103, -202, -207, -213, -303, -401 to -407.

31. An automated clearing house (ACH) is an association of depository institutions operating an apparatus similar to a check clearing center for the purpose of electronically exchanging batches or groups of paperless entries (debits and credits) and transfers of funds information. An ACH is designed to facilitate electronically routine recurring payments, such as payrolls and social security payments, insurance premium remittances, mortgage payments, and utility charges. The ACH facility processes the information on the paperless entries and distributes the payment and transfer orders in machine readable form (e.g., magnetic tape or punched cards) or paper listings to the receiving institutions, which then debit or credit the accounts of participating customers. NATIONAL COMMISSION ON ELECTRONIC FUNDS TRANSFERS, EFT IN THE UNITED STATES 205-07 (1977).

32. 12 C.F.R. § 210 (1979).

33. Electronic Fund Transfer Act, 15 U.S.C.A. §§ 1693-1693r (West Supp. 1979).

34. *Id.* § 1693a(6).



*Allocation of Responsibility, Liability, and Risk of Loss*

The choice of transfer or payment methods is usually based on the nature, cost, and convenience to the user. However, an important noneconomic element bearing on the acceptance of EFT and PEP systems may be the allocation of duties and liabilities of the parties in the applicable legal framework. Although the Electronic Fund Transfer Act may have created a framework for defining the liabilities and responsibilities of all participants in electronic fund transfers, the Act presently provides only consumer safeguards and an allocation of liability between the consumer and the financial institution.<sup>35</sup> Several questions remain unanswered: In an EFT environment, who should bear the risk of loss for unauthorized payment or transfer of funds through loss or error? What are the customer's duties and standard of care in EFT and PEP transactions? What is the responsibility of institutional providers for the results of malfunctions in the computer or electronic communication system? What are the limitations, if any, on damages for wrongful dishonor? Because electronic computer processing and communication is virtually instantaneous and simultaneous, should reversibility or stop payment instruction be permitted?

In articles 3 and 4 of the Uniform Commercial Code, liability is allocated generally on the basis of fault, but may be varied by contract of the parties except to the extent that the obligations of good faith, diligence, use of ordinary care, and exemption from negligence may not be disclaimed or changed.<sup>36</sup> Damages for wrongful dishonor are limited to direct damages unless the bank was not acting in good faith.<sup>37</sup> The customer/drawer may stop payment on any item (s)he has issued, but recovery for an improper payment is limited to actual loss suffered through the payor bank's improper payment.<sup>38</sup> To prevent unjust enrichment, the payor bank is subrogated to the rights of other parties on the

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35. *Id.* § 1693(b)(9). For an excellent analysis and discussion, see Greguras, *Electronic Funds Transfers and the Financial-Institution/Consumer Relationship*, 10 UNIFORM COM. CODE L.J. 172 (1978).

36. U.C.C. §§ 1-102(3), 4-103(1).

37. "When the dishonor occurs through mistake, liability is limited to actual damages proved. Whether any consequential damages are proximately caused by the dishonor is a question of fact in each case." *Id.* § 4-402.

38. "The burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer." *Id.* § 4-403.

item and underlying transaction.<sup>39</sup> Subrogation to the rights of other parties is not possible in electronic transactions.

The Uniform Commercial Code lays the consequences for the action or inaction on the party creating the situation or the party that is in the best position to have averted the fraud or error.<sup>40</sup> Because there are different causes for unauthorized payments or funds transfers (for example, mistake of fact, computer error or malfunction, fraud, and negligence), such causes should be considered when fixing responsibility for damages. Articles 3 and 4 of the Code cannot be the law for the new EFT and PEP systems because the articles are paper (writing) instrument bound.<sup>41</sup> However, they can be incorporated and adopted in the contracts of the parties or implemented by administrative rules so as to apply to the new systems. This procedure also has the advantage of uniformity for hybrid or mixed transactions; that is, transactions that may be initiated by written orders or agreements and then executed electronically.

### *Consumers' Rights and Duties*

The consumer appears to be concerned principally with protection from loss because of errors or unauthorized improper payments from his/her account, security of the electronic system and transaction processing, and invasion of personal privacy. Because the terms "customers" and "consumers" are ambiguous in both the Uniform Commercial Code and the Electronic Fund Transfer Act,<sup>42</sup> it is necessary to compare the provisions of both laws as they pertain to consumer rights and duties.

The first comparison involves consumer liability for unauthorized transfers. Although the Electronic Fund Transfer Act does not adopt any "substantial negligence" standard for measuring the consumer's duty of care, it does limit the consumer's liability to fifty dollars for unauthorized transfers except when the consumer participated in the fraud, entrusted the debit card to a person who improperly used it, or failed to report unauthorized use within sixty days after receiving a statement.<sup>43</sup> A \$500 limit on lia-

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39. *Id.* § 4-407.

40. *Id.* §§ 3-406, 4-302, -303; *id.* art. 4, pt. 4.

41. *Id.* §§ 3-103, Comment 1; 4-102(1), -104, Comment 4.

42. The Uniform Commercial Code speaks only of "customers." No distinction is made between consumers and other parties to negotiable instruments or other items in bank deposit and collection channels. The Electronic Fund Transfer Act provisions apply to "consumers" but not to other users of EFT services. "Consumer" is defined as "a natural person." 15 U.S.C.A. §§ 1693(b), 1693a(5) (West Supp. 1979). This may be interpreted to include individuals in businesses that are sole proprietorships.

43. 15 U.S.C.A. §§ 1693g(a)(1), 1693g(e) (West Supp. 1979).

bility is adopted for losses because of failure to report within two days of learning of the loss or theft of a debit card.<sup>44</sup> Article 4 of the Uniform Commercial Code has no comparable provision. Under the Act, the consumer bears total liability if (s)he was part of the fraud or failed to notify the financial institution or service provider of the revocation of authority entrusting an agent's access to the account.<sup>45</sup> This latter provision has no parallel in article 3 of the Code, but would be analogous to the authorized signatures provided for in a deposit agreement with a payor bank.

The second comparison involves the notification of error requirements. The Electronic Fund Transfer Act provides a ten-day period for the institutional provider to investigate a reported error, with one day to correct the error if found, and a forty-five day period is allowed if the customer's account is provisionally recredited within ten days.<sup>46</sup> Consumers must report EFT errors within sixty days.<sup>47</sup> This contrasts with the provisions of section 4-406 of the Code, which impose a general duty on the customer to exercise reasonable care and promptness to examine the bank statement and items to discover any unauthorized signature or alteration and *promptly notify* the payor bank of any such discovery. The failure to do so, in the absence of the payor bank's negligence, precludes the customer from asserting the forgery or alteration against the payor bank. A rule analogous to a statute of limitations rule in the Code prevents the customer from making a claim for forged or altered items a year or more after the statement and item become available.<sup>48</sup>

The stop payment provisions of both laws are comparable. In the Act, stop payment is permitted for preauthorized transfers or payments only, provided notice is given three days prior to the scheduled date of transfer.<sup>49</sup> This is similar to the stop payment provision of section 4-403 of the Code, except that it provides that the stop order must be received by the payor bank in time for the bank to act on it before the bank has made final payment of the item.<sup>50</sup>

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44. *Id.* § 1693g(a)(2).

45. *Id.* §§ 1693a(11), 1693g(a).

46. *Id.* §§ 1693f(b), 1693f(c).

47. *Id.* § 1693f(a).

48. U.C.C. § 4-406(4), Comments.

49. 15 U.S.C.A. § 1693e(a) (West Supp. 1979).

50. U.C.C. § 4-403(1).

Several other comparisons should be made. The consumer's rights under the Act are minimum rights and may not be waived or varied by agreement.<sup>51</sup> This is the converse of the Code, which permits variation by agreement except that there cannot be a disclaimer of the bank's responsibilities for good faith and the exercise of ordinary care.<sup>52</sup> Although the Act suspends the consumer's obligation if the computer system fails, it does not deal with other problems that may arise.<sup>53</sup> This is in contrast with the Code's requirement that the drawer's obligation on the underlying transaction be suspended during the course of the collection of the check.<sup>54</sup> Finally, it should be noted that the Act applies to "financial institutions," which has been defined to include all forms of state and federal depository institutions and other providers of EFT services.<sup>55</sup> Article 4 of the Code applies only to banks in the deposit and collection process of negotiable instruments and other items.<sup>56</sup>

Thus articles 3 and 4 of the Uniform Commercial Code, with contractual modifications by the parties and appropriate changes in Federal Reserve and Automated Clearing House Association regulations, can provide a flexible legal framework for the payments mechanism during the transition from paper to paperless payment and transfer of funds operations. However, delivery and use of EFT and PEP services in an efficient, economic, and equitable manner for all parties may require additional statutory provisions governing the new relationships in general.

#### SUGGESTED CHANGES FOR THE 1980S

Statutory changes to provide for the ongoing development of check truncation and for the transition period from paper-to-paperless payments may have to be in two stages, unless a strategic decision is made to seek federal enactment of new updated and revised Uniform Commercial Code articles 3 and 4. The need for a few noncontroversial amendments for check truncation data processing is more urgent than in the case of EFT and PEP transactions.

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51. 15 U.S.C.A. § 1693l (West Supp. 1979).

52. U.C.C. §§ 1-102(3), 4-103.

53. 15 U.S.C.A. § 1693j (West Supp. 1979).

54. U.C.C. § 3-802(1)(b).

55. 15 U.S.C.A. § 1693a(8) (West Supp. 1979).

56. "Bank" is defined as "any person engaged in the business of banking." U.C.C. § 1-201(4). This would include state and federally chartered commercial banks, mutual savings banks, and other thrift institutions such as savings and loan associations and credit unions. It would also include any person deemed to be in the banking business.

### Check Truncation

"Check truncation" is stopping the handling and processing of a check or other item after its entry into bank collection channels and communication electronically or by other approved media in an agreed upon format of the necessary payment and other accounting information (serial number, amount, drawer's account number, collecting bank and payor bank identifications, depositing party code, etc.) contained thereon. Such data and information is essential for the presentment and further processing of the item in the course of bank deposit, collection, and payment procedures, such as proofing and encoding, sorting, reconciling and balancing, returns and adjustments, and accounting and statement preparation because of the retention of the item at the place of truncation. There are two types of check truncation: truncation at the payor bank (nonreturn of paid or cancelled items); and truncation at the depository bank or intermediate collecting bank.

#### Nonreturn of Paid Items

Truncation at the payor bank may present a problem if the payor bank, without an appropriate waiver from its customer, does not make available the paid or cancelled items with the statement of account.<sup>57</sup> A similar problem would arise from truncation during the process of bank collection, as the paid item would not be available to the customer/drawer if retained at the point of truncation. Under section 4-406(1) of the Uniform Commercial Code, the customer's duty to discover and report unauthorized signature or alteration and unauthorized endorsements does not become operative until the bank "in a reasonable manner" makes the statement *and items* available to the customer/drawer. A waiver by the customer and a willingness to accept a descriptive statement that would include at least the check or item serial number, amount, date paid, and other information necessary for subsequent retrieval will be needed.

To update article 4 in this respect, it is suggested that a new subsection be added to section 4-406:

- (6) When a bank sends or otherwise makes available in a reasonable manner to its customer a statement of account describing the debit entries for items paid in good

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57. U.C.C. § 4-406(1).

faith (including the serial number, amount, date paid), and provides a reasonable method for retrieval of paid items by the customer, the times for action, and preclusions under this section take effect as if the items had accompanied the descriptive statement.

#### Impact on Presentment, Warranties, Priorities, and Right to Charge

Check truncation after the inception of the collection process raises questions about a collecting bank's responsibilities for collection and when its action is seasonable,<sup>58</sup> methods of sending and presenting,<sup>59</sup> viability of warranties by the customer and collecting bank,<sup>60</sup> final payment of an item and relevant priorities,<sup>61</sup> deferred posting and return of unpaid items,<sup>62</sup> and when a bank may charge its customer's account.<sup>63</sup> The "midnight deadline" for action on an item is not affected as the timing is based on the banking day of receipt of the item or relevant notice.<sup>64</sup>

Truncation and the resulting unavailability of the item might create a problem in applying the test of completion of the process of posting by the payor bank to determine whether the affected item was finally paid.<sup>65</sup> In addition, the lack of the item for visual verification of genuineness of signatures, date, amount, and absence of material alterations may cast some doubt on the payor's authority for debiting the drawer's account<sup>66</sup> and its accountability for late return of an item.<sup>67</sup> It might be argued that the payor bank had made a decision to pay the item based on the telecommunicated information it had received.<sup>68</sup> Also, if the truncated check data is handled through an automated clearing house (ACH), National Automated Clearing House Association (NACHA) Rules specify that the originating financial institution warrants the accuracy of the ACH transactions and will reverse incorrect transactions up to forty-five days later.<sup>69</sup>

Clarification and resolution of some of these issues might be

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58. *Id.* § 4-202.

59. *Id.* § 4-204.

60. *Id.* § 4-207.

61. *Id.* §§ 4-213, -214, -303, -403(1), 1-201(27).

62. *Id.* §§ 4-301, -302.

63. *Id.* §§ 4-401, -403, -404, -405.

64. *Id.* §§ 4-104(1)(h), -202(2).

65. *Id.* §§ 4-109(a), (c), -213(1)(c), -303(1)(d).

66. *Id.* § 4-401(1).

67. *Id.* § 4-302(b).

68. *Id.* § 4-303(1)(d).

69. NATIONAL AUTOMATED CLEARING HOUSE ASS'N, OPERATING RULES § VIII-A (rev. ed. 1979) [hereinafter cited as NACHA OPERATING RULES].

achieved by agreement between the parties,<sup>70</sup> appropriate changes for check truncation in relevant Federal Reserve regulations and operating letters, and clearing house rules.<sup>71</sup> It might be preferable, however, to resolve the legal issues in the following ways:

- (a) Broaden the definition of "item" in section 4-104(1)(g) of the Uniform Commercial Code as follows:

"Item" means any instrument for the payment of money, even though it is not negotiable, but does not include money. For the purposes of this Article, electronic or other telecommunication of pertinent accounting, transfer of funds, payment data, and other relevant information detached from the item following truncation after entry into bank deposit and collection procedures is to be considered the same as the transfer of the item and as the item itself.

- (b) To continue the effectiveness of warranties applicable to the truncated item, two new subsections should be added to section 4-207 of the Code:
  - (5) The warranties and the engagement to honor set forth in this section shall continue in effect and be binding on any item that has been truncated after its entry in bank deposit and collection procedures, even though the collection, presentment, and posting processes of the payment data and other relevant information taken from the item is communicated separately through collection channels to the payor bank or drawee.
  - (6) In addition to the warranties of subsection (1) and (2), the truncator of the item and each subsequent collecting bank warrants to the payor bank or other payor who in good faith pays the item that the data and information communicated about the item and related entries is valid and in accordance with the relevant data and information on the item itself.

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70. U.C.C. § 4-103(1).

71. *Id.* §§ 4-103(2), -103(3).

Several years ago, the Permanent Editorial Board for the Uniform Commercial Code of the American Law Institute and the National Conference of Commissioners on Uniform State Laws instituted a review of articles 3 and 4 of the Uniform Commercial Code to determine the need to amend or expand them to cover EFT systems. A report<sup>72</sup> to the "348" committee, a subcommittee of the Permanent Editorial Board, recommended a Comprehensive Payments Code that would consolidate the rules for all payments and transfer of funds systems, whether paper-based, electronic, or a combination of the two, under common general principles. Such a code would change long-standing rules and procedures and scrap and rearrange articles 3 and 4 on a functional basis. The Permanent Editorial Board authorized the 348 committee to: (a) undertake the preparation of a code that would include in varying degrees all methods of payment other than cash, which code would be a part of the Uniform Commercial Code and would amend or supplement articles 3 and 4; (b) include rules governing bank-to-bank or bank-to-merchant transactions; (c) include provisions protecting the rights of consumers; (d) involve as few substantive changes in articles 3 and 4 as possible; and (e) expand the application of the Code to others than banks and their customers.<sup>73</sup>

This proposal for a new Comprehensive Payments Code has been subjected to considerable criticism from several critics, including this writer. New rules that disturb established practices and routines would likely bring chaos that would dwarf any theoretical or demonstrable advantages of a new code. With the new Electronic Funds Transfer Act protecting the consumer's major rights, there does not appear to be any pressing need at this time for such transmutation. However, during the period when both paper and paperless systems are used to transfer funds or make payments, additional legal rules may be needed to supply a flexible legal structure as the foundation for the new relationships of all parties to EFT and PEP transactions.

To cover the processing of paperless entries and other electronic payments and transfer of funds, the following major provisions are suggested as part of a new interim division of article 4 of the Uniform Commercial Code:

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72. H. Scott, *New Payment System: A Report to the 348 Committee of the Permanent Editorial Board for the Uniform Commercial Code* (1978).

73. Haydock, *The 348 Committee—An Interim Report*, 2 *COMPUTER/LAW J.* 27 (1980).



## (1) APPLICABILITY

To the extent that paperless entries originate from "items"<sup>74</sup> within Bank Deposit and Collection Division parts of Article 4, they continue subject to those provisions as amended.<sup>75</sup> All other paperless entries are subject to the provisions of this Interim Division.<sup>76</sup>

## (2) VARIATION BY AGREEMENT

- (a) The effect of these provisions 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 damage for such lack or failure.<sup>77</sup> No agreement may waive or vary the rights accorded consumers under federal or state laws.<sup>78</sup>
- (b) Federal Reserve regulations and operating letters, clearinghouse rules, and the like have the effect of agreements under subsection (a), whether or not specifically assented to by all parties interested in the paperless entries processed.<sup>79</sup>

## (3) DEFINITIONS

## (Alternative 1)

- (a) "Paperless Entry" means any payment or transfer of funds transaction or instruction to a financial institution to debit or credit an account, other than a transaction originated by a check, draft, or similar instrument. Except where inconsistent with this division, debit paperless entries shall be deemed "items" under the Bank Deposit and Collections parts of Article 4.<sup>80</sup>

## (Alternative 2)

- (a) "Paperless Entry" means any writing contained in or on any approved medium for the issuance, transmission, or recording of debits or credits to

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74. U.C.C. § 4-104(1)(g).

75. See notes 57-70 *supra*.

76. See U.C.C. § 4-102(1).

77. See *id.* § 4-103(1).

78. 15 U.S.C.A. § 1693l (West Supp. 1979).

79. See U.C.C. § 4-103(2).

80. See 15 U.S.C.A. § 1693a(6) (West Supp. 1979); NACHA OPERATING RULES, *supra* note 69, § I-F.

accounts of a transferor, transferee, or beneficiary. The approved media include:

- (1) a letter, memorandum, or other similar writing;
- (2) a telegram (including TWX, TELEX, and any similar form of communication); and
- (3) any form of communication, other than voice, that is registered upon, or is in form suitable for being registered upon, magnetic tape, disc, or any other medium designed to capture and contain in durable form conventional signals used for electronic communication of messages.<sup>81</sup>

Except where inconsistent with this division, paperless entries shall be deemed "items" under the Bank Deposits and Collections parts of Article 4.

- (b) "Automated Clearing House" means any Federal Reserve bank or other person that operates as a clearing house for paperless entries through one or more facilities on behalf of an Automated Clearing House Association, including facilities operated by the Automated Clearing House Association itself.<sup>82</sup>
- (c) "Originating Bank" is a depository bank which originates or transmits paperless entries.<sup>83</sup>
- (d) "Receiving Bank" is a payor or receiving bank which receives paperless entries directly or indirectly for debit or credit to the accounts of its depositors.<sup>84</sup>
- (e) "Consumer Transaction" means a paperless entry initiated by a natural person which is not in excess of \$1000.<sup>85</sup>
- (f) "Company" means a person who initiates entries drawn on or payable to the deposit accounts of a company's customers.<sup>86</sup>

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81. See 12 C.F.R. §§ 210.52(b), 210.53 (1979).

82. See NACHA OPERATING RULES, *supra* note 69, § I-B.

83. See *id.* § I-K.

84. See *id.* § I-O.

85. For a definition of "consumer" as a natural person, see 15 U.S.C.A. § 1693a(5) (West Supp. 1979). For another definition, see the Truth-in-Lending Act, 15 U.S.C. § 1603(h) (1976), where "consumer" is used with regard to a credit transaction primarily for personal, family, household, or agricultural purposes. In Uniform Consumer Credit Code § 1-301-12, "consumer" is defined in terms of consumer credit extended when the amount does not exceed \$25,000.

86. See NACHA OPERATING RULES, *supra* note 69, § I-D.

- (g) "Customer" means a person or depositor who authorizes a Company to initiate entries and a Receiving Bank to debit or credit such entries to his/her account with such receiving bank.<sup>87</sup>
  - (h) "Remitter" means a person who instructs an Originating Bank to transfer funds or make payments by paperless entries.
  - (i) Transfers. A credit transfer or funds transfer is an order given by an account holder or remitter to its financial institution with directions to pay a third party. A debit transfer is a payment order or instruction initiated by the account holder authorizing its financial institution to pay or transfer funds to the indicated third party presenting the order. A remitter or transferor need not be an account holder if the financial institution is presented with a substitute payment medium.
- (4) **WARRANTIES ON PAPERLESS ENTRIES**  
Each originating bank, remitter, customer, and company shall be deemed to warrant to each receiving bank, automated clearing house, and payor that:
- (a) each credit entry transmitted is timely and valid in accordance with necessary authorizations for the related paperless entry;
  - (b) each debit entry transmitted is in accordance with a valid authorization by the customer to be charged; and
  - (c) the originating bank has no actual knowledge of a revocation of such authorization or termination of such arrangement by the receiving bank, customer, or company.<sup>88</sup>
- (5) **RIGHTS AND OBLIGATIONS OF RECEIVING BANK**
- (a) Recipient shall verify control totals received by it and notify the automated clearing house of any out of balance, unreadable, incomplete, or unprocessable file covering such paperless entries.
  - (b) Recipient shall return all credit entries received that are not credited or otherwise made available to its depositors' accounts for withdrawal by mid-

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87. See *id.* § I-E.

88. See *id.* § IV-A.

night of the banking day of receipt or following settlement date, whichever is later.

- (c) Recipient shall verify that the account number on a prenotification is for a valid account. It shall deliver or send a prenotification rejection to its automated clearing house by midnight of the banking day following the banking day of receipt for distribution to the originator of the paperless entry.<sup>89</sup>
  - (d) An entry shall be deemed received by a recipient on the banking day on which such entry is made available to it.<sup>90</sup>
  - (e) Recipient and originator of debit entries warrant to the depositor and other parties in the processing chain that the paperless entries being processed are properly authorized and that neither has actual knowledge of any revocation or termination of authorization by the customer, payor, or remitter.
- (6) **ACCURACY OF INFORMATION**  
Company, customer, payor, and remitter warrant the accuracy of the information given to the payor bank, other payor, or drawee on the paperless entry.
- (7) **RETURNS**  
Each returned entry shall be delivered or sent by midnight of the banking day following the banking day of receipt by the recipient or following the settlement date, whichever is later.
- (8) **REVERSIBILITY OR STOP PAYMENT**  
(a) A customer, payor, remitter, drawer, or account holder shall have the same right to stop payment of a debit entry initiated by a company to its account in the same manner and subject to the same limitations applicable to checks or other items under parts 3 and 4 of the Bank Deposits and Collections division of Article 4.<sup>91</sup>  
(b) Neither a company nor an originator shall have the right to reverse, adjust, or stop payment or posting of any entry after such entry has been received by a receiving automated clearing house.<sup>92</sup>
- (9) **FINAL PAYMENT**  
A debit paperless entry shall be deemed to have been

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89. *See id.* §§ VI-C, -F.

90. *See id.* § VII-A.

91. *See id.* § VIII-G; U.C.C. §§ 4-303, -403.

92. *See* NACHA OPERATING RULES, *supra* note 69, § II-B; U.C.C. § 4-303(1)(c).

finally paid when the payor bank or other payor has done any of the following, whichever happens first:

- (a) paid the entry in cash; or
  - (b) settled for the entry without reserving a right to revoke the settlement and without having such right under statute, clearing house rule, or agreement; or
  - (c) completed the process of posting or debiting the indicated account of the customer, payor, remitter, maker, or other person to be charged therewith; or
  - (d) has become accountable for the amount of entry.<sup>93</sup>
- (10) LIABILITY FOR FAILURE TO COMPLY WITH A PROPER ORDER

Except as may be provided by federal or state law for consumers, the liability of a payor bank or depository institution which has used ordinary care in accordance with reasonable commercial standards of the payor's business shall not exceed the extent of direct damages proximately caused by the dishonor or failure to comply with the customer/depositor's proper order.<sup>94</sup>

#### CONCLUSION

Development of EFT and PEP should not be stymied by legal straitjackets. Important problems will have to be resolved during the long transition period when both paper items and paperless entries are in use for transmission of related payment and transfer data and information. Articles 3 and 4 of the Uniform Commercial Code have provided a flexible framework of rules by which banks are able to conduct deposit and collection operations involving billions of checks and other items, and they have proven adaptable to the changes in business and public needs or demands for methods of payment and transfer of funds. Gaps in statutory coverage and the operational problems with automated clearing house association rules have been filled by contractual provisions and ACH rules. Thus, the relationships and responsibilities among service providers and users during the early stages of EFT and PEP usage can be handled effectively through agreements, administrative rules, and under the wide latitude provided

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93. U.C.C. § 4-213.

94. See *id.* §§ 3-406, 4-402.

in the Uniform Commercial Code for nonstatutory arrangements. For instance, the parties to EFT, PEP, or ACH can agree that the applicable rules of the Uniform Commercial Code will govern their relationship.

Nevertheless, a new division of article 4 of the Uniform Commercial Code specifically designed to provide an interim legal structure of clearly defined rules to govern the relationships of all the parties to EFT and PEP transactions should be created. This division would recognize the legitimate expectations of users and providers of these new payment systems. It would also contain a definition of minimum standards of care which could not be disclaimed or modified and a fair and equitable allocation of duties, obligations, rights, and liabilities in improper payments and transfers.