

## The Role of Private Sector Rules and Federal Reserve System Rules In Check Image Exchanges<sup>1</sup>

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This paper provides a summary of the role of Check Image Rules in the inter-bank exchange of check images. The term “Check Image Rules” as used in this paper refers to private and public sector rules governing the inter-bank exchange of check images. Check Image Rules include: (1) the Operating Rules of the Electronic Check Clearing House Organization (“ECCHO”), which govern exchanges of check images between those financial institutions that are members of ECCHO; and (2) the Federal Reserve’s Operating Circular 3 and Regulation J which govern exchanges of check images between a financial institution and a Federal Reserve Bank.

**Executive Summary:** Check Image Rules serve an important role in establishing the legal rights and obligations of financial institutions in connection with their forward and return check image exchanges, addressing operational and technical requirements, and reducing risk to exchange participants. Check Image Rules address these issues in an efficient and uniform manner by allowing the same or compatible rules to be applied to check image exchanges across multiple financial institutions and multiple exchange networks. Financial institutions that exchange check images without coverage under Check Image Rules, or otherwise expressly addressing the unique legal issues associated with check image exchange, potentially expose the sending and receiving financial institutions to increased payment and operational risks.

Section 1 of this paper provides a background summary of check law and the role of clearing house rules and Federal Reserve operating circulars in establishing interbank check collection rules. Sections 2 and 3 provide a summary of the development of Check Image Rules and describe the applicability of the Rules to check image exchanges and the parties interested in a check. Finally, Section 4 discusses the benefits for financial institutions when using Check Image Rules to govern their check image exchanges.

### **Discussion:**

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<sup>1</sup> IMPORTANT INFORMATION ABOUT THIS DOCUMENT: This document was prepared by an informal working group of representatives of various financial institutions, trade associations and check clearing houses. This working group is part of a financial services industry effort to consider issues relating to Check 21 and check imaging. The working group is co-sponsored by the Electronic Check Clearing House Organization (ECCHO) and the Retail Payments Office of the Federal Reserve Bank of Atlanta. Individual entities participating in the working group may not endorse certain of the views expressed in this document. This document is not intended as legal advice or opinion or any other form of legal or business recommendation to any person. To the extent that this document identifies or discusses a legal issue, a reader or other user of the document should consult with their legal counsel as to its application to them or to a particular situation.

## 1. Background and Applicable Check Law

The inter-bank exchange of checks is subject to both state and federal law. These laws include: the Uniform Commercial Code (“UCC”), as adopted in each of the states, the federal Expedited Funds Availability Act (“EFAA”) and the federal Check Clearing for the 21<sup>st</sup> Century Act (“Check 21 Act”). Both the Check 21 Act and the EFAA have implementing regulations under the Federal Reserve Board’s Regulation CC.

These laws, among other things, impose warranties on financial institutions when transferring and presenting checks. For example, these warranties include warranties relating to no alteration of the check and correct encoding of the MICR line of the check. In addition, these laws set forth requirements on financial institutions relating to expeditious return of the check by the paying bank and the returning bank after a check has been dishonored. Complementing these laws, there is a large body of court interpretations of particular disputes that provide guidance and understanding as to the application of these laws.

Both the UCC and Regulation CC recognize the existence and role of check clearing house rules and Federal Reserve Operating Circulars, and allow financial institutions to vary the provisions of such laws and regulations, subject to some limitations, by both clearing house rules and Operating Circulars. (See UCC Section 4-103 and Regulation CC, Section 229.37.)

Even with these laws applicable to the exchange of paper checks, there have long been clearing house rules and Federal Reserve Operating Circulars/rules that set forth additional rules and requirements for paper check collection by financial institutions, beyond the requirements imposed on financial institutions under applicable check law. For example, paper check clearing house rules address such matters as: (i) items eligible for exchange through the clearing houses or the Federal Reserve Banks, (ii) rules relating to timing of check presentment, (iii) rules relating to handling of adjustments, (iv) authorization of photo-in-lieus, (v) additional warranties attaching to the presentment of a paper check, and (vi) technical/operational matters, such as location for paper check delivery and the labeling and packaging of cash letters.

## 2. Development of Rules for Check Image Exchange

The financial services industry and the Federal Reserve developed Check Image Rules over the last decade as the paper check system began to migrate to electronic check presentment and check image exchange. The enactment of the Check 21 Act in 2003, although only addressing the paper substitute check process, served as a major impetus to the financial services industry to implement check imaging.

Even before the adoption of the Check 21 Act, UCC Article 4 had anticipated that the financial services industry would migrate from paper to electronic check truncation/image exchange. The 1990 revisions to UCC Article 4 expressly permit electronic presentment of items pursuant to an agreement for electronic presentment. The UCC states that the agreement for electronic presentment may be in the form of check clearing house rules and/or Federal Reserve regulation or Operating Circular. (See UCC Section 4-110.) However, the UCC and Regulation CC do not address the details of how these laws should apply to electronic presentment. Moreover,

there are no court decisions providing guidance on the application of these laws to check image exchange.

As noted above, the Check Image Rules issued by the Federal Reserve are used when check images are exchanged between a Federal Reserve Bank and a financial institution. The Check Image Rules issued by ECCHO are used for exchanges of check images between member institutions of ECCHO. The legal and operational approaches of the two respective Check Image Rules sets are generally the same, including the use of unique warranties and indemnities for check images. The Federal Reserve's Check Image Rules also include provisions to support certain payment services offered by the Federal Reserve Banks and reflect the collecting bank role of the Federal Reserve Banks.

Check Image Rules generally do not apply automatically as a matter of law to every check image transaction exchange by financial institutions. Rather, the exchanging financial institutions agree (usually at the start of an exchange relationship) that check image transactions exchanged between them will be subject to specified Check Image Rules. For example, the financial institutions that participate in an image exchange network may agree when joining the network that all transactions sent through the network will be subject to a particular set of Check Image Rules. In the context of a check image exchange with a Federal Reserve Bank, there is both an agreement to the Federal Reserve's Check Image Rules, as well as the application of Regulation J as a matter of law to the parties' check image transactions.

### 3. Summary of Legal Landscape for Check Image Exchange

To understand the role of Check Image Rules, it is helpful to review the overall legal structure that applies to a check image exchange from start to final payment. Different laws, private sector rules, and agreements of the parties may apply to different aspects of a single check transaction as it passes from one person to the next. As described below, the Check Image Rules do not seek to govern the entire check image collection process.

When the check writer (the "drawer") and the payee on the check exchange a paper check, that relationship is subject to the UCC and often a written or oral agreement between the payee and the drawer relating to the underlying obligation (such as in the case of merchant payees). When the payee deposits the check with its financial institution (the "bank of first deposit"), that relationship is governed by the UCC and the payee's deposit agreement with the financial institution. This deposit agreement may include terms governing the payee's use of remote deposit via image transmission, such as warranties relating to accuracy of the check image and prohibitions on duplication. When the bank of first deposit transfers a check image to other financial institutions for collection or payment, that transfer of the check image is subject to the Check Image Rules and (by agreement and/or application of law as discussed further in Section 4.A below) the EFAA/Regulation CC and the UCC. These Check Image Rules may be further supplemented with business practices agreements (referred to as "BPAs") or network agreements that detail certain technical, operational and communications-related matters for the exchange of check information.

Finally, when the paying bank (which holds the drawer's account) receives the check image, the posting of that check image to the drawer customer's account is governed by the UCC and the account/check writing agreement between the drawer and the paying bank. If the paying bank

creates a substitute check from the image for delivery to its drawer customer, that substitute check will be governed by the Check 21 Act. If the paying bank elects to return the check image for any reason, the return of that check image to the presenting bank will be governed by Check Image Rules and the EFAA/Regulation CC and the UCC.

There may be variations on the above described structure and application of laws and rules, as it is not possible to summarize every permutation of financial institution and customer relationships possible for the forward presentment and return of a check image.

#### 4. Purposes and Benefits of Check Image Rules

Check Image Rules serve a number of purposes and provide a number of benefits for financial institutions that exchange and return check images. These purposes and benefits primarily include:

- A. *Legal Status of Check Images.* Applicable check law does not expressly address the status of a check image or other electronic representation of a check under such law. Accordingly, Check Image Rules generally provide that the financial institutions will treat a check image exchanged between them as “check” and “item” for all purposes under applicable law. This provision removes uncertainty as to whether a bank that is transferring a check image is making the same transfer warranties that a bank makes when exchanging a paper check. Similarly, this type of provision in Check Image Rules clarifies that banks have the same responsibility in handling the check image as they do with paper checks, such as the responsibility for expeditious handling of returns.
- B. *Unique Provisions for Check Images.* Check Image Rules provide that a bank makes additional warranties and indemnities when exchanging a check image in either forward presentment or return that are not set forth in applicable law for paper check exchanges. These additional warranties and indemnities of the presenting bank or returning bank reflect the unique aspects of the creation and exchange of check images. For example, Check Image Rules provide warranties to address the quality of the check image and the accuracy to which the check image reflects the information from the paper check from which the check image was created.
- C. *Relationship of Check Images and the Check 21 Act.* The Check 21 Act does not apply to the inter-bank exchange of check images. However, the Check 21 Act does authorize any bank in the check collection process to convert a check image to a substitute check and transfer that substitute check as if it were the original paper check. In doing so, the reconverting bank (that is, the bank that creates the substitute check) makes a number of warranties regarding the substitute check and provides a related indemnity to the receiver of the substitute check. Where the reconverting bank has obtained the check image from another financial institution, the reconverting bank will want to have the right to seek indemnification from the financial institution that sent it the check image, if the reconverting bank incurs liability on the substitute check as a result of a problem with the check image. The Check 21 Act does not address the liability of the financial institution that created the image from which a subsequent financial institution created a substitute check. Check

Image Rules address this element of the substitute check process by including additional warranties and indemnities from the sending financial institution to the reconverting bank to allow Check 21 liability in certain instances to be passed back from the reconverting bank to the sending financial institution.

- D. *Operational and Technical Requirements for Check Image Exchange.* The exchange of check images raises numerous technical and operational elements that are not present with exchange of paper checks. Check Image Rules address, among other topics: (i) when a check image is deemed to be received by a financial institution in a forward presentment or return exchange, (ii) the electronic location for presentment/receipt/return of a check image, (iii) the application of electronic indorsements, (iv) minimum technical requirements for the creation and exchange of a check image, (v) check images eligible for exchange under the rules, (vi) types of receipt notices and confirmations sent by participants, (vii) the total number of times a financial institution may re-present the same image after return, (viii) the application of technical industry standards, and (ix) check image quality standards.
- E. *Payment System Risk Reduction.* Check Image Rules serve a role in overall payment system risk reduction. By establishing uniform rules that set forth financial institutions' rights and responsibilities in creating and handing check images for collection and return, financial institutions reduce legal, operational and settlement risk associated with participating in the check image exchange programs. For example, for those payment system settlement operators subject to the Federal Reserve Policy Statement on Payment System Risk, the Policy Statement requires that such payment systems implement a risk management framework approach to address risks the system poses to its participants. One element of this risk management framework is establishing "clear and appropriate rules and procedures," and specifying the respective responsibilities of the system participants. Check Image Rules are an important part of this risk management framework.
- F. *Uniformity and Efficiency Of Check Image Rules.* Check Image Rules allow for broad and uniform application across the industry. Different check image exchange networks have required that their participants are also ECCHO members to use the ECCHO Rules, and the Federal Reserve Banks mandate the use of their Operating Circular 3 and Regulation J for their exchanges with all depository institutions. This broad application of a limited number of Check Image Rules sets increases efficiency of check image exchange programs and removes uncertainty among financial institution participants as to the applicable rules for a particular check image exchange. This uniformity is particularly relevant when a check image may pass through multiple collecting banks before final presentment to the paying bank. Given the decentralized nature of check collection, it would be expensive and time consuming for individual financial institutions to address all the issues, described above for Check Image Rules, by means of separate agreements between and among the parties.

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