

**PERMANENT EDITORIAL BOARD
FOR THE UNIFORM COMMERCIAL CODE**

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May 3, 2005

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

(Sent via email to: regs.comments@federalreserve.gov)

Re: Amendments to Regulation CC, 12 C.F.R. Part 229
Docket No. R-1226

Dear Ms. Johnson:

The Permanent Editorial Board for the Uniform Commercial Code welcomes this opportunity to comment on proposed amendments to Regulation CC that cover “remotely created checks.” As you may know, the Permanent Editorial Board (“PEB”) is a body of representatives of law practice and the academy and is sponsored jointly by the American Law Institute and the National Conference of Commissioners on Uniform State Laws.¹ Its functions include advising both sponsoring groups on developments in the law that require study or action and providing guidance on the provisions of the Uniform Commercial Code in the form of PEB Commentaries.

Pursuant to our responsibilities to advise our sponsors on developments that require study or action, we have reviewed the Board’s proposed amendments to Regulation CC to cover “remotely created checks.” Our focus has been to identify parts of the proposal that may require clarification for the smooth functioning and transparency of the check collection system and that may produce optimal allocation of risks between depositary and payor bank participants in this specialty arena. In our review of the proposed amendments, we have identified a small number of issues that we believe require further attention.

You will recall that, by letter dated March 21, 2004, in response to the Board’s request for comments as to whether it would be appropriate to incorporate into Regulation CC the 2002

¹ The current members of the Permanent Editorial Board are listed on the website of the American Law Institute: www.ali.org; click on Projects and Participants, then Current Projects, then UCC-PEB Members to retrieve the listing.

revisions to the U.C.C. regarding remotely-created consumer items, the PEB answered in the affirmative. We continue to maintain that view, and our comments today do not revisit that basic policy decision. Rather, our comments are directed to the effectuation of that policy decision in the proposed amendments.

Turning our attention to the specifics of the proposed amendments, we have the following comments:

1. The Proposed Definition of “Remotely Created Check.”

As noted above, we support the goal of the proposed amendments – to ultimately shift liability for the loss created by an unauthorized remotely created check to the depository bank. Although the operative provision of the proposed amendments, § 229.34(d), is quite straightforward, its applicability is dependent on the definition of its key term – “remotely created check.” We have two concerns about this definition as it appears in the proposed amendments.

First, under the proposed definition, a remotely created check must be “created by the payee.” This will add a factual element to any warranty claim under the proposed rules that will, in most cases, be nearly impossible for the transferee bank, collecting bank, or paying bank to demonstrate. Yet, if the bank cannot demonstrate that the check was created by the payee, the check will not constitute a remotely created check and, thus, the warranties in § 229.34(d) will be inapplicable. Moreover, this criterion will not be satisfied in cases in which an unscrupulous payee utilizes a confederate who does not qualify as an agent to create the check.

Second, the proposed definition of “remotely created check” also excludes a check bearing a signature in a “format approved by the bank-customer agreement.” Although we understand that the intent of this portion of the definition is to prevent a “typical forged check” from being treated as a remotely created check, we are concerned that this method of distinguishing “typical” forged checks from the checks sought to be covered by the proposed amendments does not convey the concept with sufficient clarity and may create perverse incentives. For one thing, an unscrupulous payee, creating a check without authorization from the purported drawer, might accidentally employ a signature *format* approved in the bank-customer agreement. It is not clear to us why this fortuity should result in a different loss allocation. Moreover, because the proposed amendments ultimately place the risk of bad behavior by remote payees on depository banks, we can expect that some depository banks may refuse to take remotely created checks for deposit from some of their customers (just as some depository banks at one time refused to take double-indorsed checks from some customers for deposit and collection). As a consequence, remote payees (including those proceeding with authorization from the drawer) will have incentives to create checks in a form that will not qualify as remotely created checks under the proposed definition so their depository banks will not refuse to take these checks for deposit and collection. Because the bank-customer agreements for most individual accounts require handwritten drawers’ signatures, there will, therefore, be incentives for remote payees (even honest remote payees) to create such checks

with *handwritten* legends indicating that the account owner authorized creation of the check so that the check will not qualify as a remotely created check.

Thus, although we recognize that the Board's proposal does not contemplate a repeal of the *Price v. Neal* rule in the context of typical forged checks and endeavors to distinguish those cases from the checks to be covered by the proposed amendments, we do not believe that the proposed definition of "remotely created check" is sufficient for that purpose.

As an alternative, we recommend that the term "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 customer or the paying bank,² (iii) does not bear a signature that purports to have been applied by the customer or another person identified in the paying bank's records as an authorized signatory on the account, and (iv) is purportedly drawn under authority granted by the customer.

2. Extent of Preemption of State Law on Remotely Created Checks.

As noted in the Supplementary Information accompanying the request for comments on the proposed amendments, 14 states have addressed issues raised by remotely created checks. Moreover, many of those states define the type of checks that are subject to their rules differently than the proposed regulations define "remotely created check." As a result, if the proposed amendments are promulgated, there will be some checks that qualify as "remotely created checks" under Regulation CC but not under analogous state law and other checks that will not qualify as "remotely created checks" under Regulation CC but which will qualify as such checks under analogous state law. Thus, federal rules as embodied in the proposed amendments (i) will create a warranty of authorization by the depository bank in some cases in which applicable state law would not otherwise do so, and (ii) will not create a warranty of authorization by the depository bank in some cases in which the laws of at least some of the 14 states do create such warranties. In the first situation, it is clear that the federal rule will preempt inconsistent state law, resulting in risk allocation as set forth in the proposed amendments. It is not so clear, though, what will happen in the second situation – when the check in question does not qualify as a "remotely created check" under Regulation CC but does qualify for analogous treatment under state law. Does the Board intend that the proposed amendments preempt this entire field, so that, notwithstanding state law, there would be no warranty of authorization or the like by the depository bank in cases not covered by §§ 229.2(ff) and 229.34(d)?

We recommend that the proposed amendments contain a provision explicitly stating whether those amendments preempt the field so that there is no warranty of authorization in cases in which the proposed amendments do not create such a warranty (or whether, alternatively, there is no preemption so that such a warranty may exist when it is supplied by

² One suit is pending in which a payor bank was induced by someone who works for the bank's customer but allegedly did not have authority to sign or "responsibility" for purposes of UCC § 3-405 to create one or more checks based on a telephone instruction to the payor bank. In our view, payor banks should continue to be responsible for payments based on checks that they themselves "create" and should bear their share of the loss for payments that are covered by an existing UCC "comparative negligence" rule.

state law). As between those two choices, we would recommend that the Board explicitly indicate that the proposed amendments preempt state law in this area. The result would be a uniform national standard that determines when the risk of non-authorization is allocated to depository banks, thus avoiding conflict of laws issues and market distortions that could arise from the applicability of different standards in different states.

3. Response to Additional Request for Comment.

The Board has also requested comment on several issues. One issue is whether, as an alternative to the use of warranties, the rule should allow a paying bank to return an unauthorized remotely created check through the check system by extending the U.C.C. midnight deadline for a period of time (such as 60 days).

We think that this alternative should not be adopted. For one thing, as the Board's request for comment notes, extension of the midnight deadline will delay finality of payment and discharge for these transactions. Finality of payment and discharge is an important value for our payments system, and we see no good reason to undermine that value in this context. Moreover, the return scheme for unauthorized automated clearing house ("ACH") transactions, to which the Board's proposal alludes, differs from the regime proposed by the Board for "remotely created checks" in an important respect.

In order to understand the nature of the ACH return scheme, one must start with Section 8.6.1 of the 2005 edition of the ACH Rules of the National Automated Clearing House Association ("the NACHA rules"), which provides (in the context of consumer transactions) that the Receiver of a debit entry (analogous to the drawer of a check) has an automatic right to recredit if the Receiver delivers to its bank (the Receiving Depository Financial Institution, or "RDFI"), within 15 calendar days after the RDFI sends or makes available to the Receiver information pertaining to the transaction, a written statement under penalty of perjury that the debit entry was not authorized. Thus, the RDFI must recredit its customer's account without regard to whether the customer's statement is shown to be true. In this context, a warranty claim might not be available for the RDFI to pass its loss back through the ACH system, since there is no proof that the ACH equivalent of a warranty of authorization has been breached. Accordingly, in cases in which the Receiver sends such a statement to its RDFI, Section 8.7.1 of the NACHA rules gives the RDFI the right to transmit an adjustment entry – essentially the ACH equivalent of returning the item. Thus, just as the Receiver is entitled to recredit from the RDFI even in the absence of proof of non-authorization, the ACH return scheme allows the RDFI to pass this loss back through the system even in the absence of such proof.

In the check system, by way of contrast, a customer does not have an automatic right of recredit based solely on the customer's allegation that it did not authorize the check. There is a right to recredit only if the check was, in fact, not authorized. If the check was not authorized, though, the payor bank would be able to use the warranty created by the proposed amendments to reallocate its loss back through the collection system and ultimately to the depository bank. Thus, unlike the ACH system, the warranty mechanism can bring about the desired result without the need for a return regime that sacrifices finality.

If you have questions about these comments, please contact Professor Sarah Jane Hughes at (812) 855-6318 (or by email at sjhughes@indiana.edu), or Professor Neil B. Cohen at (718) 780-7940 (or by email at neil.cohen@brooklaw.edu).

Sincerely,

A handwritten signature in black ink that reads "Lance Liebman". The signature is written in a cursive style with a horizontal line at the end.

Lance Liebman
Chair
Permanent Editorial Board for the Uniform Commercial Code