2007

Legislative and Regulatory Developments Affecting Deposit Accounts and Payment Transactions

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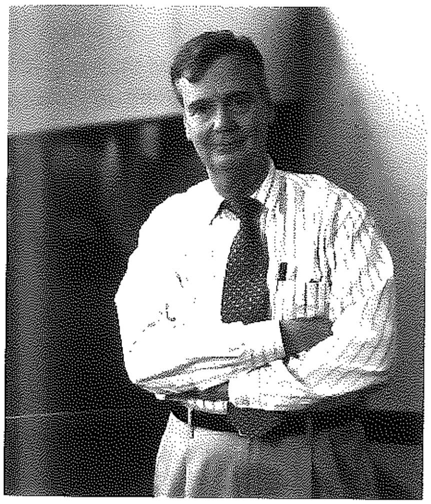

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I. The 2005 and 2006 FRB Amendments

In 2005 and 2006, the Federal Reserve Board (FRB) finalized various regulatory amendments that affect common deposit account transactions.[1] The first 2005 FRB amendment focused on Regulation DD,[2] which implements the Truth in Savings Act,[3] clarifying the treatment of certain overdraft payment services (sometimes called "bounce protection programs").[4]

Overdraft protection (or "bounce protection") programs were already subject to extensive state and federal law coverage.[5] The May, 2005 FRB amendments addressed the Truth in Savings Act and Regulation DD disclosures, and also the impact of the Truth in Lending Act (TILA) and Regulation Z on the credit aspects of bounce protection programs.[6] Generally these 2005 rules require banks to disclose their overdraft and returned-items charges to the customer when a deposit account is opened (including the categories of transactions on which the charges may be imposed), and additionally require disclosure of the aggregate charges for overdrafts and returned-items by banks that advertise overdraft protection services.[7]

The second 2005 FRB amendment was to Regulation CC,[8] governing the collection of checks and other items through the banking system. This November, 2005 amendment modifies the effect of *Price v. Neal*[9] for "remotely created checks."[10]

Then in January, 2006 the FRB amended Regulation E, governing electronic check conversion; this was followed in August, 2006 by a revised interim rule and ultimately by publication on December 1, 2006 of a revised final rule amending Regulation E.[11]

In addition, as described in a previous article,[12] in 2002 the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved amendments to the uniform text of Uniform Commercial Code(UCC) Articles 3 and 4.[13] These amendments address various matters, including the remotely-created consumer items that are also subject to the November, 2005 FRB regulatory amendments.

1. *See also* Alvin C. Harrell, Price v. Neal *Revisited: UCC and FRB Revisions Impact Bank Accounts and Transactions*, 60 Consumer Fin. L. Q. Rep. 309 (2006). The term "bank" is used here, as in the Uniform Commercial Code (UCC) and many federal regulations, essentially to mean any depository institution. *See, e.g.*, UCC § 4-105 (and revised § 1-201(a)(4)). However, while credit unions are banks for purposes of the UCC they are regulated primarily by the National Credit Union Administration (NCUA) rather than the FRB, and therefore are not "banks" within the scope of some FRB regulations. Generally in these circumstances credit unions are subject to equivalent regulations issued by the NCUA. *See, e.g.*, Truth in Savings, 70 Fed. Reg. 29582 (May 25, 2005).
2. 12 CFR pt. 230.
3. 12 U.S.C. §§ 4301-4313.
4. Final Rule, FRB, 12 CFR pt. 230; 70 Fed. Reg. 29582 (May 24, 2005). *See infra* Part III.
5. *See, e.g.*, Harrell, *supra* note 1; and Sam Davis and Stanley D. Mabbitt, *Checking Account Bounce Protection Programs*, 57 Consumer Fin. L.Q. Rep. 26 (2003). *See also* Hernandez v. Wells Fargo Bank New Mexico, 128 P.3d 496 (N.M. App. 2005) ($30 per transaction overdraft charge was not unconscionable under state and federal law).
6. *See supra* note 4.
7. *Id.*
8. 12 CFR pt. 229.
9. 97 Eng. Rep. 871 (K.B. 1762).
10. Final Rule, FRB, 12 CFR pts. 210 and 229; 70 Fed. Reg. 71218 (Nov. 28, 2005). *See also* Harrell, *supra* note 1, and *infra* Part II.
11. *See* FRB Final amendments to Regulation E and the Official Staff Commentary to Regulation E concerning electronic check conversion transactions, 71 Fed. Reg. 69430 (Dec. 1, 2006), discussed in more detail *infra* at Part IV.
12. *See, e.g.*, Harrell, *supra* note 1.
13. *See infra* Part II.

At this writing the Article 3 and 4 amendments have been enacted (with some nonuniform changes) in five states.[14]

II. FRB Regulation Governing Remotely Created Checks[15]

A. Scope

The Novembr, 2005 FRB amendment to Regulation CC[16] (with conforming amendments to FRB Regulation J[17]), covering remotely-created "telephone" drafts, is generally consistent with but differs slightly from the equivalent 2002 revisions to the uniform text of UCC Articles 3 and 4. The UCC revisions apply to "remotely-created consumer items," thereby making clear that such are items under UCC Article 4[18] and are therefore subject to the Article 4 bank collection rules, even though they are not negotiable instruments or checks under Article 3 section 3-104 (because they are not signed by the drawer). The UCC definition of "remotely-created consumer item" at section 3-103(a)(16) also specifies that the applicable rules are limited to items drawn on consumer accounts.

The 2005 FRB amendments to Regulation CC, in contrast, apply to "remotely created checks." These are defined in Regulation CC as "checks," even though they are not checks under the UCC or traditional commercial law standards (*e.g.*, UCC section 3-104(f)) because they are not signed.[19] Nonetheless, under Regulation CC these unsigned drafts are deemed "checks" because they are drawn on an "account," which is defined as an arrangement that allows "a person" (apparently including the payee) to draw on funds held by a bank.[20] In addition, the FRB amendments are not limited to items drawn on consumer deposit accounts, the FRB having concluded that there is no reason to distinguish consumer from non-consumer accounts for this purpose, in response to banker concerns that such distinctions are often difficult to make.[21]

The FRB amendments also define a remotely created check as one "not created by the paying bank" and not drawn or purported to be drawn by the account holder.[22] Thus, Regulation CC does not distinguish between items drawn by the payee upon a telephone authorization and those drawn by a bill payment service on behalf of the deposit account holder.[23] This language referencing the definition (and thus the scope of the Regulation CC rule) to items not purportedly drawn by the account holder is basically similar to the equivalent UCC Article 3 definition of "remotely-created consumer item" at section 3-103(a)(16) ("an item...not created by the payor bank and [not bearing] a handwritten signature purporting to be the signature of the drawer"). The FRB abandoned its earlier proposal to define remotely created checks by reference to "the format" agreed to by the bank and its account holder, recognizing that this would have created a seriously unclear standard.[24]

The FRB also expanded the scope of the new rule, for purposes of warranties, beyond the normal Regulation CC coverage of "consumer accounts," because the latter coverage does not include all deposit accounts on which checks can be drawn. The FRB did not want the rules governing remotely created checks to be so limited, and thus defined the applicable accounts as including any account on which "checks" (broadly defined, as noted above) can be drawn (including line-of-credit accounts, money market accounts, etc.).[25] The FRB also made clear that the new rules apply to "checks" payable through or at a bank (rather than being limited to those payable by the bank[26]), and to "substitute checks" created pursuant to the Check Truncation Act.[27]

B. Impact on the Midnight Deadline

As discussed in a previous article,[28] the 2005 FRB amendments governing remotely created checks override the effect of *Price v. Neal* by providing new warranty remedies for the payor bank (called the paying bank in Regulation CC), allowing unauthorized remotely created checks to be returned after final payment and expiration of the midnight deadline. The new rules do not directly override the UCC midnight deadline, but create a new warranty remedy not subject to those rules and deadlines.[29] Thus, as under the 2002 amendments to UCC Article 4, the new Regulation CC remedies for breach of warranty are not barred by the finality of payment and midnight deadline rules at sections 4-215, 4-301 and 4-302 of Article 4.[30]

C. The New Warranties

As noted in a previous article,[31] the 2005 FRB amendments to Regulation CC impose new transfer and presentment warranties on presenting and depositary banks, which now warrant that

14. Arkansas, Kentucky, Minnesota, Nevada, and Texas. The revisions are under consideration in Oklahoma and other states. However, the relatively slow pace of enactment of these revisions was cited by the FRB as a reason for federalizing some of the issues. *See* 70 Fed. Reg. at 71221.

15. *See also* Harrell, *supra* note 1.

16. *See supra* notes 8-10.

17. 12 CFR pt. 210.

18. *See* § 4-104(a)(9) (definition of "item").

19. *See* UCC §§ 3-103(a)(6), 3-104(a).

20. *Id.*; *see also* revised 12 CFR § 229.2(fff); 70 Fed. Reg. at 71225. Thus Regulation CC defines "checks" very differently from the UCC. *Cf. id. with* UCC § 3-104(f). Note that under both state and federal law these items are not properly payable (*see* UCC § 4-401) unless authorized by the customer.

21. 70 Fed. Reg. at 71221.

22. 12 CFR § 229.2(fff); 70 Fed. Reg. at 71222 and 71225.

23. 70 Fed. Reg. at 71222.

24. *Id.*

25. *Id.*

26. 12 CFR § 229.34(d)(1). *See also* UCC § 4-106.

27. 70 Fed. Reg. at 71222, citing the Check Clearing for the 21st Century Act, 12 U.S.C. §§ 5001-5018 (the Check Truncation Act). The Check Truncation Act is also sometimes called "Check 21." *See generally*, *Check 21*, 58 Consumer Fin. L.Q. Rep. 362 (2004).

28. *See* Harrell, *supra* note 1, at 310-313.

29. The UCC midnight deadline rules are at §§ 4-301 and 4-302. *See also* § 4-215 (final payment); Fred H. Miller and Alvin C. Harrell, The Law of Modern Payment Systems and Notes ¶ 8.02 (2002).

30. *See id.*, and in particular § 4-302(b) (midnight deadline does not bar a breach of warranty claim).

31. *See* Harrell, *supra* note 1, at 312.

remotely created checks are authorized by the customer of the payor bank on whose account the check is drawn.[32] If an unauthorized remotely created check is presented and paid, this is a breach of warranty that can be asserted by the payor bank as a means to recover the payment from the presenting or depositary bank, notwithstanding final payment of the item and expiration of the midnight deadline.[33] However, this is specifically made subject to UCC section 4-406: The payor bank cannot assert the new warranty against the presenting bank or depositary bank if the payor bank's customer is precluded under section 4-406 from asserting against the payor bank that the check is unauthorized. This places some outer limits on assertion of the breach of warranty claim. All in all, it is an elegant solution to the problem of telephone drafts, which leaves in place the principle of *Price v. Neal* in other common scenarios (where the depositary bank has no means to police the drawer's signature).

As noted, the November, 2005 FRB language largely tracks the warranty language in the 2002 amendments to the UCC.[34] This avoids various pitfalls presented by other proposals, and provides welcome symmetry between state and federal law.[35] This language and the related FRB Supplementary Information also make clear that the new warranties do not cover forged indorsements.[36]

An interesting difference between the 2002 UCC Article 3 and 4 warranties and the 2005 FRB amendments is that the former extend the warranty (the representation that remotely-created consumer items are authorized) to the depositor and other non-bank transferors who received consideration for the item, who transferred the item outside the banking system.[37] Thus, under the UCC revisions the payor bank can recover directly from such parties. In contrast, the new Regulation CC warranties created by the 2005 FRB amendments are imposed only on banks.[38] A primary reason is that the scope of FRB authority extends only to banks.[39] However, this distinction is likely to make little difference, as depositary banks generally have ample means of legal recourse against depositors who deposit unauthorized items.[40] Probably the real problem for depositary banks is economic, *i.e.*, collecting from a depositor who may have withdrawn the funds and fled the area, or is unable or unwilling to repay. In this respect, the limitation on the payor bank's warranty claim at 12 C.F.R. section 229.34(d)(2), effectively allowing the depositary bank to assert the payor bank's preclusion against the payor bank's customer under UCC section 4-406 as a defense, may be the most important legal remedy provided to depositary banks in the new regulation.

Two other points addressed in the FRB Supplementary Information are worthy of note: First, the new warranty could cover the scenario where the payor bank's customer authorizes a remotely created check payable to, *e.g.*, the payee's trade name, but instead the check is made payable to the payee's legal name, to the extent that the result is deemed an unauthorized check. The FRB Supplementary Information indicates that this will have to be handled on a case-by-case basis.

Second, the FRB noted the problem of "buyer's remorse," *e.g.*, where a bank customer authorizes a remotely created check and then asserts that it was unauthorized because the customer has changed his or her mind about the underlying transaction. The FRB noted that the Federal Trade Commission (FTC) Telemarketing Sales Rule[41] requires telemarketers to obtain the customer's "express verifiable authorization" for any remotely-created check. That evidence would be available to rebut the customer's assertion that the check was unauthorized, and the "paying bank would not prevail on a warranty claim if the customer had, in fact, authorized the transaction but later suffered 'buyer's remorse'."[42] The payor bank could then charge its customer's account, as the item would be properly payable.[43]

III. Overdraft Protection Programs

A. Guidance on Overdraft Protection

The 2005 Interagency Guidance on Overdraft Protection Programs (the Guidance) was released in final form by the FRB, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration on February 18, 2005.[44] The Office of Thrift Supervision released a separate guidance on February 14, 2005.[45] These address a number of advertising and Truth in Savings Act (TISA) issues and stipulate certain "Best Practices," *e.g.*, relating to "Marketing and Communications with Consumers" and "Program Features and Operation." These matters impact small business as well as consumer deposit accounts.

The Guidance notes that these programs should be reviewed by qualified legal counsel for compliance with applicable laws and regulations. The Guidance addresses various other issues, including safety and soundness considerations, loan documentation, charge-off policies, accounting matters, the allowance for loan

32. 12 CFR § 229.34(d); 70 Fed. Reg. at 71222-223 and 71225.

33. *Id.*; *cf.* UCC §§ 4-301 and 4-302(b). *See generally* Charles Cheatham, *Telephone Drafts - The Federal Reserve Board's Warranty of Authorization*, 77 Okla. Bar J. 2225 (2006); Harrell, *supra* note 1.

34. This was intentional. *See* 70 Fed. Reg. at 71222; *cf.* UCC §§ 3-417(a)(4), 4-208(a)(4). *But see infra* this text and notes 37-39.

35. *Id.*

36. 70 Fed. Reg. at 71222. Indorsements are covered elsewhere. *See, e.g.*, UCC §§ 4-207(a)(1), (2), and 4-208(a)(1).

37. *See* UCC §§ 3-416(a), 3-417(a), 4-207(a), 4-208(a).

38. *See* 12 CFR § 229.34(d)(1).

39. *See* 70 Fed. Reg. at 71222. This is also something of an issue with regard to check truncation. *See* Miller and Harrell, *supra* note 29, at ¶ 9.03[7].

40. *See, e.g.*, 70 Fed. Reg. at 71222. *See also* UCC §§ 4-201, 4-202, 4-214; §§ 3-415, 3-416; § 3-403 - 3-407.

41. 16 CFR § 310.3(a)(3).

42. 70 Fed. Reg. at 71223.

43. *Id.*, citing UCC § 4-401.

44. *See* Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 9127 (Feb. 24, 2005). This discussion is indebted to Laura N. Pringle, *Overdraft Protection Programs and Related Issues*, 77 Okla. Bar J. 2221 (2006).

45. *See* Guidance on Overdraft Protection Programs, 70 Fed. Reg. 8428 (Feb. 18, 2005).

and lease losses, and third-party technology-related risk management concerns.[46]

B. New Account Disclosures for Overdraft Protection Services

In addition to the Joint Guidance on Overdraft Protection Programs,[47] the FRB issued amendments to Regulation DD, implementing the TISA,[48] to clarify certain required disclosures relating to overdraft protection services.[49]

The account-opening disclosures for overdraft protection fees and services, as provided in revised Regulation DD, apply to all depository institutions, regardless of whether the institution actively promotes its overdraft protection services. Expanded prohibitions on misleading advertisements also apply to all depository institutions. Additional disclosure provisions for periodic statements (*see infra* Part III.C.) and advertisements apply only to institutions which promote the payment of overdrafts (examples of such promotion include, *e.g.*, stating the overdraft limit for an account on a periodic statement or stating an account balance that includes available overdraft funds on an automatic teller machine (ATM) receipt; these would be considered advertisements triggering the additional disclosures). The disclosure requirements for periodic statements include a separate disclosure of the total dollar amount of fees and charges imposed on the account for paying overdrafts, and the total dollar amount for returning items unpaid (for the statement period and for the calendar year-to-date for each account promoted). Regulation DD includes examples of advertising practices which could be misleading, so as to require additional disclosures in the advertisements of overdraft services.

C. Customer's Statement of Account

As noted above, the 2005 revisions to FRB Regulation DD require new disclosures with each periodic statement of account (*e.g.*, the monthly bank statement), if the bank promotes overdraft protection services.[50] Under revised 12 CFR section 230.11(a), each banking institution which promotes the payment of overdrafts must provide the following required disclosures for each periodic statement of account covering an account for which the bank has promoted the payment of overdrafts: (1) a separate disclosure of the total dollar amount for all fees or charges imposed an the account for paying checks or other items when there are insufficient funds and the account becomes overdrawn; and (2) the total dollar amount for all fees imposed on the account for returning items unpaid.

These disclosures must be provided for the statement period and for the calendar year-to-date, by aggregating the fees imposed since the beginning of the calendar year or since the beginning of the first statement period for that year for which such disclosures are required. The disclosures must be made beginning in the first statement period that begins after such a promotion and must continue until two years after the date of the last such promotion applicable to that account. If a promotion does not specify the types of accounts to which it applies, the additional disclosures are required for all periodic statements covering the institution's deposit accounts. As noted, an institution triggers the periodic statement disclosure requirements if it promotes the institution's policy or practice of paying overdrafts by means of any of a variety of advertising media, *e.g.*, by including a message on a periodic statement informing the consumer of an overdraft limit or including a notice of the amount of funds available for overdrafts.

IV. Electronic Check Conversion Under Regulation E[51]

A. Introduction

The FRB amended Regulation E in 2006, in ways that affect deposit accounts and checking transactions as well as retail sales by merchants who accept payment via electronic check conversion (ECK).[52] Checks converted to electronic funds transfers (EFTs) by merchants at the point-of-sale (POS), or by companies receiving check payments in the mail, are subject to new disclosure requirements for ECK and the Regulation E error-resolution procedures. The new requirements were effective February 9, 2006 on a voluntary basis, with compliance mandatory as of January 1, 2007.[53] As noted *supra* at Part I., and discussed further below, additional revisions during 2006 resulted in publication of a revised final rule on December 1, 2006.[54]

Modified Regulation E "initial disclosures" are required for new bank customers, effective January 1, 2007, but a bank could switch to the new disclosures sooner, whenever it reprinted its forms. Each bank was required to deliver the revised Regulation E disclosures to existing customers on or before January 1, 2007.

The statements of account (*i.e.*, monthly bank statements) sent to customers increasingly include numerous line-item EFTs, representing ECK, in lieu of cancelled checks that the customer has written. Customers may wonder why they

46. *See also* Final Rule, Federal Reserve System, 70 Fed. Reg. 29582 (May 24, 2005), 12 CFR pt. 230 (revisions to Regulation DD, implementing the TISA, 12 U.S.C. §§ 4301-4313, to clarify the required TISA disclosures for certain overdraft protection services); Davis and Mabbitt, *Checking Account Bounce Protection Programs*, *supra* note 5; *Hernandez*, 128 P.3d 496 ($30 per item overdraft charge was not unconscionable, due in part to federal preemption). For discussion of related "check-kiting" issues, *see* Alvin C. Harrell, *Some Surprising New (and Old) Perspectives on Check-Kiting*, 57 Consumer Fin. L.Q. Rep. 214 (2003).

47. 70 Fed. Reg. 9127 (Feb. 24, 2005) (describing various "best practices" as defined by the federal bank regulatory agencies).

48. 12 U.S.C. §§ 4301-4313.

49. *See* Final Rule, 70 Fed. Reg. 29582 (May 24, 2005), amending 12 CFR pt. 230 (Regulation DD).

50. *Id.*

51. This discussion is indebted to materials provided by Charles Cheatham, Vice President and General Counsel of the Oklahoma Bankers Association. Our thanks to Charles for his assistance. *See also* Charles Cheatham, *Electronic Check Conversion under Regulation E*, 77 Okla. Bar J. 2245 (2006); Mark Budnitz, *Payment Systems law 2005-2006*; 10 J. Consumer and Comm. L. 2 (2006).

52. 71 Fed. Reg. 1638 (Jan. 10, 2006), revising 12 CFR pt. 205.

53. *Id.*

54. *See supra* note 11 and discussion *infra*.

don't receive cancelled checks in their deposit account statement (or even a check image), or why they have overdraft charges when EFTs pay faster than the check would due to ECK. The new Regulation E disclosures are designed in part to alert customers to these issues.

B. Overview of Regulation E and Comarison to the UCC

1. Introduction

Regulation E implements the federal Electronic Fund Transfer Act.[55] Because the scope of Regulation E is keyed to the scope of other, mutually exclusive laws,[56] and because Regulation E provides disclosure, liability, and error resolution rules that are very different from those other laws, coverage by Regulation E is a handy means to distinguish between two primary "worlds" of payment systems law.

While this division of legal rules quite naturally seems confusing at first glance, and therefore is an easy target for those advocating change, upon reflection it is logical and simple: As discussed below, Regulation E applies to consumer(retail) electronic payments, *e.g.*, payments by debit card from a deposit account, or automated clearing house (ACH) transfer, including the ECK discussed here. Regulation E does not apply to the UCC-based payment systems (which have their own legal frameworks and error-resolution rules), *e.g.*, checks and other negotiable instruments are governed by UCC Article 3, "items" are governed by UCC Article 4, and "wholesale" funds transfers are governed by UCC Article 4A.

2. Scope of Regulation E

Regulation E applies to "any electronic fund transfer that authorizes a financial institution to debit or credit a consumer's account."[57] As noted, while there are a number of specified examples and exclusions in Regulation E,[58] the basic dividing line established by this scope provision is that Regulation E applies to "retail" (*i.e.*, consumer) electronic funds transfers, *e.g.*, transfers by: (1) debit card; (2) automated clearing house (ACH); and (3) ACH variations such as electronic check conversion (ECK), discussed in more detail below. Regulation E does not apply to more traditional, UCC-based payment systems governed by: (1) UCC Article 3 (negotiable instruments); (2) UCC Article 4 (bank deposits and collections (and FRB Regulation CC); (3) UCC Article 4A (wholesale wire transfers); and "Check 21" (the Check Truncation Act[59]).

While concern has been expressed about the potential for consumer (and lawyer) confusion from this multiplicity of alternative payment systems and sources of law, and there has even been some talk of reviving the ill-fated uniform payments code from the 1980s (to comprehensively cover all of these transactions), the fact is that the current scope arrangements make considerable sense. Regulation E covers retail consumer electronic fund transfers, and provides liability rules and error resolution procedures appropriate to that context.[60] The UCC (Articles 3 and 4) and FRB Regulation CC (including the regulations implementing Check 21) cover more traditional payment transactions based largely (though not entirely) on negotiable instruments law,[61] with the risk and loss allocation rules appropriate to that environment, as developed over roughly the past 300 years.[62]

This division of legal rules makes considerably more sense than many commentators seem to recognize, and is likely to be preserved to a large degree even if there is comprehensive overhaul of the system. The only real alternative to this dual system (since electronic find transfers are clearly ascendent) is to abolish negotiable instruments law; while some may favor this, it would be a grave error given the fundamental role of that law in our economic system and the fact that, even today, paper instruments account for something like 40 billion payment transactions annually and roughly half of such transfers (not to mention credit transactions).

3. So, What Does Regulation E Do?

Among the many details, there are three primary categories of law imposed by Regulation E: (1) disclosure requirements; (2) liability rules; and (3) error resolution procedures.

The disclosure requirements are at 12 C.F.R. sections 205.7–205.10, and include both initial and periodic required disclosures, as well as requirements for periodic statements, electronic terminals, and preauthorized terminals. Model disclosure forms and language are provided. These disclosures and notices are a subject of the 2006 revisions to Regulation E, and some additional rules, as noted below.

4. Liability Provisions and Comparison to the UCC

The Regulation E rules at 12 C.F.R. section 205.6 governing consumer liability are substantive law provisions that vary considerably from the UCC-based rules for more traditional payment transactions. But there are good and obvious reasons for this divergence.

Under Regulation E, a consumer's liability for an unauthorized electronic fund transfer from the consumer's account is governed by 12 C.F.R. section 205.6(b), if the financial institution has made the required disclosures as

55. Title IX of the Consumer Credit Protection Act, 15 U.S.C. §§ 1693 *et seq*, implemented by FRB Regulation E, 12 CFR pt. 205.

56. *See, e.g.*, UCC Article 4A, § 4A-107; Regulation E, 12 CFR § 205.3(c) (exclusions from coverage).

57. 12 CFR § 205.3(a).

58. *See id.* § 205.3 (b), (c).

59. *See supra* note 27.

60. *See, e.g.*, 15 U.S.C.A. §§ 1693a.(6), 1693f., 1693g., and 1693h.; 12 CFR §§ 205.3, 205.6, and 205.11.

61. *See* UCC §§ 3-103, 3-104 (scope of Article 3); *id.* §§ 4-102 - 4-104 (scope of Article 4); 12 CFR § 229.1 (scope of Regulation CC). *See generally* Miller and Harrell, *supra* note 29, ¶¶ 1.02[1], 1.04, 8.01, and 8.04.

62. *See, e.g.*, Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 Creighton L. Rev. 441, 446–450 (1979).

noted above.[63] Under 12 C.F.R. section 205.6(b), the consumer's liability is limited to $50 if the consumer notifies the financial institution within two days after learning of the loss or theft of the electronic fund transfer access device.

While this Regulation E remedy is sometimes touted as more beneficial to the consumer than the equivalent UCC Article 4 liability rules, it should be noted that Article 4 imposes no liability whatsoever on the payor bank's customer for unauthorized items (absent a preclusion for customer negligence, *e.g.*, under UCC sections 3-406 or 4-406), and the UCC has no direct equivalent to the somewhat onerous two-day notice requirement in Regulation E. In addition, in transactions subject to Regulation E the requirements for licensed technology at the point of sale means there is usually a responsible merchant who is in a position to prevent the fraud, who can be held liable to the consumer's financial institution for an unauthorized electronic fund transfer. There is no comparable safeguard for the financial institution in many traditional payments by check; hence, there are good reasons for the differing loss allocation rules in the UCC and Regulation E.

Under Regulation E, if the consumer fails to notify the financial institution of his or her loss of the access card within two days, the consumer's liability is limited to $50 or the loss within this two day period (whichever is less), plus the resulting loss that occurs before such notice is given, up to a maximum of $500. This effectively limits the consumer's risk of loss to $500, compared to the much greater loss that can occur in forged check scenarios under the UCC.[64] But as noted, under the UCC the loss will fall entirely on the bank, unless the customer is at fault; so again, this difference is logical, given the relatively small and routine nature of Regulation E electronic fund transfers, and the availability of recourse against the merchant who accepted the unauthorized fund transfers. Under the UCC, a much greater loss is possible, and there is often no POS merchant to serve as gatekeeper; hence, there is little practical alternative but to allocate the risk of loss between the two innocent parties according to their fault and contribution to that loss. Thus, the loss is attributed to the customer to the extent that the customer is negligent and that negligence contributed to the loss. There is an offset for comparative negligence where the customer's bank has failed to exercise ordinary care.[65]

Finally, under 12 C.F.R. section 205.6(b)(3), Regulation E requires that the consumer notify the financial institution of any unauthorized electronic fund transfer that appears on the periodic account statement sent to the consumer by the financial institution. If the consumer fails to do so within sixty days of the transmittal of the statement, the consumer may be liable to the financial institution for subsequent losses from unauthorized transfers resulting from that failure. This is roughly comparable to the UCC Article 4 obligation of the customer to examine his or her monthly bank statement and notify the bank of any forged or altered items paid on the customer's checking account.[66]

5. Error Resolution Procedures

Regulation E section 205.11[67] provides procedural requirements for a financial institution faced with a notice of alleged error in an electronic fund transfer. This includes notice of alleged: unauthorized transfers; errors and omissions; computational and accounting mistakes; incorrect amounts; and insufficient identification and transactions.[68] It does not cover: routine balance inquiries; information requests for tax or other record-keeping purposes; or requests for duplicate copies of documentation.[69]

To qualify as a notice of error subject to the Regulation E requirements, the consumer's notice to the financial institution: (1) can be oral or written; (2) must be received by the financial institution within sixty days after the relevant periodic statement (or other documentation required by 12 C.F.R. section 205.9) is sent;[70] (3) must be sufficient to allow the financial institution to identify the consumer and account number; and (4) must indicate why the consumer believes an error exists, including as possible the date, type, and amount of error (except for a documentation request under 12 C.F.R. section 205.11(a)(1)(vii)).[71] If the consumer's notice is oral, the financial institution may require written confirmation within ten business days.[72]

Upon receipt of such notice from the consumer, the financial institution must investigate "promptly" and determine whether the alleged error occurred, within ten business days of receiving the consumer's notice unless the forty-five day rule noted below applies. The financial institution must report the results within three business days of completing the investigation, and must correct the error within one business day after determining that the error occurred.

There are no equivalent timing requirements for resolution of alleged checking account errors under UCC Article 4, as investigations of checking transaction problems often cannot be completed in such a short time frame (often checking account problems involve forgery or alteration scenarios that, unlike an electronic transaction authorization, require extensive auditing by third persons, and cannot be resolved quickly). There is, however, an incentive in Article 4, for the bank to act quickly that does

63. *See* 12 CFR § 205.6(a), referencing disclosure requirements at 12 CFR § 205.7(b)(1), (2), and (3).

64. *See, e.g.*, Miller and Harrell, *supra* note 29, ¶¶ 4.03, 7.03, 9.01.

65. *See, e.g.*, UCC Article 3, Part 4; and Article 4, Part 4.

66. *See* UCC Article 4 § 4-406.

67. 12 CFR § 205.11.

68. *Id.* § 205.11(a)(1).

69. *Id.* § 205.11(a)(2).

70. *See also id.* § 205.11 (b)(3) (when the consumer's notice of an error is based on documentation requested by the consumer, notice is timely within 60 days after the documentation is provided).

71. *Id.* § 205.11(b)(1).

72. *Id.* § 205.11(b)(2).

not exist in Regulation E: A failure to promptly recredit the customer's checking account for the erroneous payment of an improper item is likely to result in the wrongful dishonor of other items drawn on that account, with bank liability under UCC Article 4 section 4-402.

Under Regulation E, the financial institution that is unable to complete its investigation within the ten day period noted above can take up to forty-five days (from receipt of the consumer's notice) to do so, if the financial institution: (1) provisionally credits the consumer's account (including interest where applicable) within the ten-day period; (2) informs the consumer within two days that the provisional credit has occurred (the consumer must have full use of the funds); (3) corrects any error within one day of determining it; and (4) reports the results of the investigation within three business days of its completion (including, if applicable, that the provisional credit has been made final).[73] There are some additional extensions of these time limits for new accounts, point-of-sale debit card and out-of-state transactions, etc.[74] There are no equivalent time periods in UCC Article 4, although as noted the wrongful dishonor provisions at section 4-402 provide an effective counterpart.

There are also provisions in Regulation E governing the required response of the financial institution where no error is found.[75]

C. Electronic Check Conversion

Regulation E was revised in 2006 in several ways to deal more specifically with ECK transactions. For example, 12 CFR section 205.3,[76] listing the types of transactions Regulation E covers, now has a scope provision at section 205.3(b)(2)(I) providing as follows:

"(2) Electronic fund transfer using information from a check. (I) This part applies where a check, draft or similar paper instrument is used as a source of information to initiate a one-time electronic fund transfer from a consumer's account. The consumer must authorize its transfer."[77] This expands the scope of Regulation E to cover ECK transactions.

Generally under prior law, if a transaction started out as a check, it was not subject to Regulation E, no matter how that check was later transformed--for example, converting a check to an image before presentment, or re-presenting a returned check electronically did not trigger Regulation E. On the other hand, a transaction that starts out as an EFT has always been covered by Regulation E. Before the 2006 changes, there was some uncertainty in deciding whether a mixed transaction was covered by Regulation E, *e.g.*, when the customer presented a check to the merchant but instead of sending the check through the UCC Article 4 check collection channels the merchant elected to scan the check's magnetic information (the "MICR" line) for the payor bank's routing number, the customer's account number, and the check number, in order to originate an EFT from the customer's bank account (an ECK). In this transaction, the merchant may then hand back the consumer's check, along with a copy of the EFT transaction slip, stating, *e.g.*: "Keep this for your records."

In this situation (an ECK), where the check is used to initiate an EFT, revised Regulation E treats the check as merely a "source of information" for originating the EFT. Under the 2006 changes to Regulation E, this transaction is treated as an EFT from the beginning, and is never treated as a payment by check.

Although it may seem odd to say that an ECK transaction resulting from issuance of a check is entirely an EFT transaction and is never a check, from the standpoint of processing the payment there isn't any check or even an image of a check that is deposited with, sent through, or presented to any banking institution. Thus the FRB concluded that it would be hard to apply the UCC Article 4 rules governing items, and since there is never an "item" under Article 4 it is clear that Article 4 does not apply. Of course the same could be said of the check imaging information that is transmitted between banks under Check 21, but as noted below those transactions remain subject to the check collection regime. Moreover, it should be noted that, even though in this scenario there is never an Article 4 "item," the check used to initiate the ECK remains an instrument under UCC Article 3; but, if it is returned to the drawer or destroyed by the merchant, normally it will not be negotiated to a subsequent holder or create additional liability against the drawer, *e.g.*, under Article 3 sections 3-302, 3-305(b), and 3-414.[78]

D. Regulation E Initial Disclosures

For new accounts opened on or after January 1, 2007, a bank's disclosures under Regulation E must be modified to list an additional type of EFT--onetime EFTs from a consumer bank account using ECK information derived from the consumer's check. Sample language appropriate for this new disclosure is set out in model clause (d)(2) in Form A-2 of Appendix A to Regulation E. Two other minor, conforming changes were made to clauses (a) and (b) of Form A-2. A bank's existing deposit customers were required to receive a disclosure about the new type of EFT on or before January 1, 2007.

E. Distinguishing Check 21, Check Re-Presentment, and Pre-Authorized Transfers

A new paragraph 3(b)(2)(iv) of the FRB Official Staff Commentary

73. *Id.* § 205.11(c)(2).

74. *Id.* § 205.11(c)(3).

75. *Id.* § 205.11(d).

76. *Id.* § 205.3.

77. *Id.* § 205.3(b)(2).

78. Interesting questions may arise, however, if the check is deposited through Article 4 check collection channels and is presented to the payor bank and paid, in addition to the ECK. Assuming the check is properly indorsed, it would appear that both the check and the EFT generated by the ECK are properly payable, and the customer would be limited to recourse against the merchant for overcharging on the underlying transaction. *Compare* the warranty remedies under Check 21.

to Regulation E, at 12 C.F.R. section 205.3, clarifies that the transmission of an electronic check image for collection (*e.g.*, as allowed by Check 21[79]) is not an ECK, nor an EFT, but merely an electronic method for collection and presentment of the check itself. The image that passes through the payment system is still treated as a check and is an Article 4 "item," and is governed by UCC Articles 3 and 4 as well as Check 21 and Regulation CC, not Regulation E.

A new paragraph 205.3(c)(1) of the FRB Official Staff Commentary to Regulation E advises that electronic re-presentment of a returned (dishonored) check is also not covered by Regulation E (and is not considered an ECK transaction), because the original presentment was in check form, not an EFT (and the item has already been through the payment system once as a check). However, the electronic collection of a returned-item charge imposed by the payee in this scenario is an EFT subject to Regulation E; the returned-item charge was never an item in written form, so it was originated as an EFT. This is one of the issues further clarified in the revised final rule published December 1, 2006: The Regulation E requirements apply to any returned item fee, not just fees for items returned for insufficient funds.[80]

The new rules bringing ECK into Regulation E apply only when information from a check is used as a source of information for a "one time" EFT transfer from a consumer account. Regulation E has a different rule (in 12 CFR section 205.10) for "pre-authorized transfers," which means a series of debits to the customer's account occurring at least once every sixty days. Pre-authorized transfers might involve insurance premiums, utility bills, mortgage payments, etc. The deposit account customer typically provides a deposit slip or voided check to the service provider who is establishing the pre-authorized transfers. Although a check may be used as a "source of information" to originate a pre-authorized transfer, these transactions are not covered by the new ECK provisions because the check information is not used to initiate a "one time" EFT.

F. Check Conversion by Merchants

Previously, Regulation E applied only to financial institutions. ECKs occurring at the point of sale (POS), or when the customer mails a check in response to a periodic billing statement such as a utility bill (*i.e.*, check conversions by merchants and other payees) have been outside the scope of Regulation E--although governed by the National Automated Clearing House Association (NACHA) rules requiring authorization for originating an EFT. As an increasing number of merchants and other commercial payees (including those receiving check payments by mail) began collecting checks via ECK, instead of depositing the actual checks, the FRB contemplated an expansion of Regulation E to cover these transactions. The 2006 Regulation E revisions were a culmination of these efforts, and are designed to help consumers understand the nature and potential consequences of these ECK transactions.

Thus the 2006 Regulation E revisions bring merchants and other payees under the coverage of Regulation E for the first time, for the limited purposes of standardizing the disclosure notices that consumers must receive and determining what constitutes authorization to originate an EFT. Merchants and other payees are now required to make certain disclosures available to the consumer and to obtain the customer's authorization before an ECK occurs, although (as noted below) the December 1, 2006 final rule provided for the new notice of a returned item charge to be delayed.

G. Required Notice at POS Locations

1. Types of Notices

Regulation E, at 12 CFR section 205.3(b)(2)(ii), now requires that a specified ECK notice be provided by the merchant to the consumer at the POS location, in order to authorize the merchant to electronically convert the consumer's check (an ECK). The consumer must receive notice in two ways (both involving basically the same disclosures) in a POS transaction. First, the POS notice "must be posted in a prominent and conspicuous location" (*e.g.*, at the cash register). Second, "a copy of the notice must be provided to the consumer at the time of the [POS] transaction." This notice might be printed on the consumer's copy of an authorization slip signed by the consumer in connection with the ECK. The notice also could be printed on a cash register receipt, or on a separate piece of paper handed to the consumer at the time of the POS transaction.

2. The ECK Notice

Model clause (a) of new Form A-6 in Appendix A of Regulation E has sample language for this required notice to consumers. Disclosures from two separate paragraphs in clause (a) must be given, as applicable, to alert the consumer: (1) that his or her check may be electronically converted (an ECK); and (2) that a returned-item fee of a stated amount may be charged to his or her bank account by EFT if the ECK is dishonored. However, as noted below, the December 1, 2006 final rule allowed the latter disclosure to be deferred.

The model notice for the ECK (as noted above) states: "When you provide a check as payment, you authorize us either to use information from your check to make a one-time electronic fund transfer from your account or to process the payment as a check transaction." This notice gives the merchant or service provider sufficient flexibility either to process the consumer's check as a check, through the UCC Article 4 bank collection system, or to use ECK. For example, some merchants may decide to process local checks in paper form, while converting out-of-town checks to EFT for faster settlement. Although the model language allows this combination of approaches, the model language

79. *See* 12 CFR §§ 229.51 *et seq.*

80. *See supra* note 11.

can be used even if, for example, the merchant knows that it will process all check-based payments by EFT and none as actual checks, or vice versa. Moreover, for checks received in a POS situation, the model language quoted above is appropriate if ECK will occur at the register, but also works if the merchant's office personnel might convert the check later. Of course, a merchant who never uses ECK is not covered by Regulation E and need not make the disclosure.

3. Returned-Items Charges

The second required paragraph in clause (a) of Form A-6 relates to returned-item charges posted directly to the customer's account by EFT, and was a subject of the revisions in the December 1, 2006 final rule. The disclosure in the second paragraph must be given if the merchant (or other payee) imposes returned-item fees that are charged electronically to a consumer's account. This disclosure reads: "You authorize us to collect a fee of $_____ through an electronic fund transfer from your account if your payment is returned unpaid."

As with the disclosure that the consumer's check may be electronically converted (in an ECK), this notice that a returned-check charge may be originated by EFT is to be given both by posting it prominently and conspicuously on a sign at the POS and by giving the customer a copy in a form that he or she can keep. For example, it could be printed automatically on each cash-register receipt.

Many merchants were already providing a clear and conspicuous posted notice that a returned-item charge of a certain dollar amount would be originated by EFT. However, beginning in January, 2007, a merchant also is required to give the consumer a copy of the notice with every transaction, in a form that the consumer can keep. This requirement apparently created potential operational problems that resulted in the December 1, 2006 revised final rule, and the deferral of the effective date to January 1, 2008, as noted below.

Many merchants still process checks through the normal check collection process, not by ECK. If such a check bounces, the merchant may use a collection service that re-presents the dishonored check by EFT instead of processing the paper check a second time. Electronic re-presentments of returned checks are called "RCK" entries in Automated Clearing House (ACH) terminology. Under revised Regulation E, if a returned check was not processed the first time as an EFT (*i.e.*, if there was no ECK), an electronic re-presentment of that dishonored check will not be an EFT subject to Regulation E. However, the returned-item charge is a different matter. If a returned-item fee will be originated by an EFT, this additional charge (not part of the original check presentment) is an EFT subject to the new Regulation E notice requirements.

Accordingly, under the original (January, 2006) rule, effective January 1, 2007, any merchant who imposed an electronic returned-item charge (even if the merchant does not engage in ECK) was required to prominently and conspicuously post the notice provided in the second paragraph of model clause (a), and also was required to provide that notice in a form the customer can keep, such as by printing the notice on each cash register receipt. This is a significant change from standard industry practice, which previously included a posted notice at the register but not an electronic returned-item charge notice for the consumer to keep with respect to each check-based POS transaction. Apparently, many merchants' systems were not able to accommodate this change, leading to the December 1, 2006 revised rule delaying this requirement.

In the revised final rule published December 1, 2006,[81] the FRB (in addition to clarifying that the 2006 rule applies to all returned-item charges, not just NSF charges) provided that if the merchant could not provide notice of the EFT returned-item charge in a form the consumer can keep prior to the transaction (as initially required, in the January, 2006 rule), this notice may be given later. The notice still had to be posted prior to the transaction. However, the original requirement was merely deferred for one year, to permit the needed update of merchant processing systems. Thus, as of January 1, 2007 all of the Regulation E revisions were effective except the requirement to give notice before the transaction of the EFT returned-item charge, in a form the consumer can keep; this requirement became effective January 1, 2008.

A third provision, new model clause (c) in Form A-6 in Appendix A, must be given by all merchants who will engage in ECK, but also must be given by merchants who will only originate EFTs for returned-item charges. This model clause (c) must be posted in a "prominent and conspicuous" location (*e.g.*, at the cash register), but a copy does not have to be given to the consumer. Model clause (c) states: "When we use information from your check to make an electronic fund transfer, funds may be withdrawn from your account as soon as the same day [you make] [we receive] your payment [, and you will not receive your check back from your financial institution]."

This model clause (c) addresses two possible misunderstandings: (1) a consumer may not recognize that an electronically-converted check (an ECK or an EFT for returned-item charges) could be paid as early as the same day; and (2) a consumer may be expecting that his or her check (or an image) will be returned to him or her with the periodic bank statement--particularly if he or she mails a check as payment, or the check for some reason is not handed back at the time of a POS transaction. The first half of model clause (c) must be given even by a merchant who originates EFTs for returned-item charges but never converts checks electronically in an ECK. If the only EFTs will be for returned-item charges, the second half of model clause (c) will not apply, because the customer will never give a check for the returned-item charge.

81. *Id.*

4. Related POS Requirements

In a POS transaction, the notice should indicate that the EFT could be paid from the consumer's account as early as "the same day you make your payment," not "the same day we receive your payment." The "same day we receive your payment" language applies to payees that receive payments by mail.

The second half of model clause (c) ("and you will not receive the check back from your financial institution") can be deleted in POS transactions where the merchant always hands the consumer's check back to the customer. Regulation E, however, does not assume that a check always will be handed back to the consumer. For example, the merchant's back office might convert a check to an EFT later, and then destroy the check.

The requirement to include model clause (c) currently applies only from 2007 through 2009. After 2009, the FRB indicates that this clause may be unnecessary, because consumers will be more familiar with the nature of these transactions. Presumably these issues will be revisited before then.

H. Notice for Billing Statements--ARC Transactions

In an accounts receivable conversion (ARC) transaction, the consumer mails a payment to a payee, such as a utility company or mortgage company. The company receiving the check electronically converts it to an EFT. The posting on the consumer's monthly checking account statement is a line-item entry for the EFT. No check or image is included in the customer's checking account statement from his or her bank.

In the past, ARC transactions were processed based on section 3.6.1 of the NACHA rules, which requires the payee to "clearly and conspicuously" state that, if the consumer provides a check to the payee, receipt of that check will authorize the payee to use the check to originate an EFT on the consumer's account. This disclosure, usually appearing on the payee's regular billing statement, has sometimes not been very conspicuous, although the NACHA rules require it to be stated prominently. Many consumers have apparently not paid attention tho this disclosure, and some have been surprised (or even dismayed) by the resulting ARC.

The 2006 Regulation E provision now governs this issue, and goes beyond the NACHA rule by providing model disclosure language instead of just requiring that the disclosure be conspicuous. The FRB also suggests that payees consider using headings preceding the model notice, to call attention to the information presented, and use a print size that is large enough to be noticed.

Notice in a billing statement or invoice that authorizes ECK should include all of the three model clauses described above, as applicable to the particular situation, *e.g.*: (1) the ECK notice; (2) the notice that an EFT will be originated in a specific amount for any returned-item charge; and (3) the notice that the EFT may be paid quickly and that the consumer's check will not be returned by his or her bank. In contrast to a POS transaction (where the consumer will receive two forms of notice), the consumer receiving a notice on a billing statement or invoice will get just one notice, so it needs to be clear.

As with POS transactions, it is not necessary for the billing statement to give notice that an EFT may be originated for a returned-item charge if the company does not impose such a charge, or simply adds any such charge to the next invoice. If a company does not electronically convert checks (*i.e.*, does not use ECK), but does originate EFTs for returned-item charges, the ECK disclosure would not be required on a billing statement, but the FRB model returned-item charge notice and the first half of model clause (c) would be required.

As with POS disclosures, the requirement to include model clause (c) on billing statements or invoices is currently set to expire at the end of 2009.

I. Coupon Books

The new Regulation E disclosures for billing statements and invoices must be provided in connection with each payment (in other words, for each statement period). If a payee furnishes payment coupon books, there won't be monthly mailings of a billing statement to the consumer in which to include the ECK disclosures. Coupon books are common for closed-end mortgage loans and installment vehicle loans. A coupon book is mailed in advance, often including twelve months' payment coupons or more.

The FRB concluded that it should not be necessary to print the required ECK and other EFT disclosures on each coupon in a coupon book. Instead, the Regulation E disclosures can be given in a noticeable location, such as on the first page, or inside the front cover of the coupon book. In this way, a consumer can retain the disclosures, even after coupons are torn out.

Many creditors already had coupon books outstanding as of the mandatory effective date of the Regulation E changes (January 1, 2007). These creditors were permitted to comply with the new requirements by mailing a one-time notice to coupon-book customers, providing the required Regulation E disclosures.

J. Authorization at the POS

The FRB considered whether a merchant should be required to obtain the consumer's signed authorization before an ECK would be considered "authorized" for purposes of Regulation E. The FRB decided not to require a signature.

Instead, Regulation E, at 12 CFR section 205.3(b)(2)(ii), provides: "A consumer authorizes a one-time electronic fund transfer (in providing a check to a merchant or other payee for the MICR encoding, that is, the routing number of the financial institution, the consumer's account number and the serial number) when the consumer receives notice and goes forward with the transaction."

Thus, simply going forward with the transaction, after notice, constitutes "authorization." Under Regulation E, consumers can subsequently dispute an ECK, as well as EFTs originated to collect returned-item charges, just like other EFTs can be disputed; but these ECKs will be considered "authorized" (and not reversible for non-authorization) if the appropriate notice has been given.

However, in order to prevent consumers from successfully disputing these transactions as unauthorized under Regulation E's dispute resolution procedures, merchants must comply with Regulation E's disclosure requirements. The same is true for the notices that ARC payees must give on periodic billing statements and invoices: If the ARC payee, such as a utility company or a mortgage company, gives proper notice in its billing statements, then its ECK and EFTs for returned-item charges will be "authorized" for Regulation E purposes, and thus cannot be disputed on that basis. Therefore, in expanding the scope of Regulation E to include ECK transactions and EFTs for returned-item charges, the FRB was seeking to ensure that consumers understand these types of transactions and won't be surprised by electronic items and fees charged to their accounts.

For POS transactions, subject to the exceptions as noted above, the FRB essentially requires the merchant to post notice at the cash register and give the consumer a copy that he or she can keep. If the consumer declines to go forward with the transaction because of the notice, the merchant will have to cancel the EFT as being unauthorized. But if the consumer says "no" to the ECK, that doesn't require the merchant to accept the consumer's paper check. If the consumer objects to an ECK, and the merchant then declines to accept the consumer's check, the consumer won't be able to complete the transaction (*e.g.*, a purchase of goods or services) unless the consumer can pay by an acceptable alternative means, such as cash or a credit or debit card.

K. Authorization on Billing Statements

When consumers mail checks to pay monthly billing statements, invoices, etc., the FRB's approach is much the same as for authorization at the POS: If the ARC payee gives the proper Regulation E notice on the billing statement (as described above), and the consumer proceeds with the transaction (by mailing a check to the ARC payee), the required disclosures together with the mailed check constitute authorization for the ECK or other EFT for purposes of Regulation E. Of course, in the billing statement scenario, the consumer may perceive that he or she has little choice but to mail a payment check along with the tear-off portion of the periodic billing statement. But, after this initial payment, if the consumer does not like the ARC, there is usually the option for the consumer to do business elsewhere.

With mailed payments that are converted via ARC, the consumer will not receive the check back, will not see a prominently posted notice such as exists at the check-out counter in a POS transaction, and will not be handed a copy of the required notice at the time the check is presented (all of which are supposed to occur in a POS transaction). Instead, the customer mailing a payment will receive only the notice that is printed on his or her periodic billing statement. The consumer may not realize that ECK or another form of EFT is occurring until the consumer reviews his or her bank statement. The payor bank may then bear the brunt of any resulting questions or complaints, but as noted, if the customer objects to the ECK or EFT, the consumer's remedy is to do business with a payee that does not (or agrees not to) use ECK.

V. Terminal Receipts for Small Transactions

An additional proposed amendment to Regulation E was also published on December 1, 2006.[82] Previously, Regulation E required a written customer receipt to be provided for all EFT transactions at the electronic terminal (*e.g.*, the POS or an automated teller machine (ATM)). The purpose of this requirement was to serve as a substitute for the checkbook record in a checking transaction, *i.e.*, to allow the consumer to keep track of his or her transactions and to give the consumer a record to cross-check against the consumer's periodic account statements (much like checking account customers can reconcile their checkbook records with the monthly account statement). However, over time it has become apparent that relatively few consumers retain and use these receipts (though, in your author's experience, some do, particularly for larger transactions).

A related reason for this Regulation E change is that EFT transactions (*e.g.*, credit card and debit cards) increasingly are being used as a substitute for cash in small dollar amount transactions. It has become as easy (or more so) to swipe the card to pay for a cup of coffee as to dig out the cash, and when there is a line at the cash register such speed is appreciated by all. But waiting for the paper receipt to print significantly slows the process, and is commonly viewed as inconvenient, redundant, and unnecessary.

Hence the FRB proposed on December 1, 2006 to eliminate the Regulation E requirement for a written terminal receipt in transactions under $15. The theory is that the monthly deposit account statement provides a sufficient record and confirmation of the transactions, and if the consumer wants more he or she can keep a running tally equivalent to a checkbook record. Even without such a record, the monthly deposit account statement provides the consumer more documentation than the consumer receives in a cash transaction, so the written terminal receipt requirement involved an element of overkill for very small transactions. Some argued that the trigger for the new rule should be even higher, *e.g.*, $25 or $50.

Some consumer advocates opposed the proposal on grounds that it will make it harder for consumers to keep track of their deposit account balances while using debit cards, thereby creating more checking account overdrafts and generating more bank NSF charges. Interestingly, the FRB revision goes beyond what the industry requested in one

82. Proposed amendments to exempt certain small transactions from the terminal receipt requirements of Regulation E, 71 Fed. Reg. 69500 (Dec. 1, 2006). The final rule was published July 5, 2007. *See* 72 Fed. Reg. 36589 (July 5, 2007).

respect, in that it covers all EFT transactions (including ATMs) rather than merely POS transactions. As noted, the final rule was published July 5, 2007.[83]

83. *Id.*

APR Tolerances for Regular and Irregular Transactions

By Stephen F.J. Ornstein, Matthew S. Yoon, and Richard B. Horn*

I. Introduction

This article addresses the Annual Percentage Rate (APR) tolerances for "regular" and "irregular" transactions under the federal Truth-in-Lending Act (TILA) and its implementing regulation, Regulation Z.[1] This distinction is important because, depending on how the transaction is characterized, the transaction may be subject to the more stringent .125 percent tolerance for "regular" transactions or the more lenient .25 percent tolerance for "irregular" transactions.[2]

Regulation Z states that, for purposes of determining whether to apply the more lenient .25 percent tolerance, an "irregular" transaction is a transaction that includes one or more of the following features: (1) multiple advances; (2) irregular payment periods; or (3) irregular payment amounts (other than an irregular first period or an irregular first or final payment).[3] The Official Staff Commentary to Regulation Z (Commentary) further explains that this more lenient .25 percent tolerance is intended for more complex transactions that do not call for a single advance and a regular series of equal payments at equal intervals.[4]

For instance, the Commentary indicates that the more lenient tolerance may be used in a construction loan where advances are made as construction progresses, or in a transaction where payments vary to reflect the consumer's seasonal income. It may also be used in loans with graduated payment schedules where the contract commits the consumer to several series of payments in different amounts. The Commentary observes, however, that the more lenient .25 percent tolerance would *not* apply to loans with variable rate features where the initial disclosures are based on a regular amortization schedule over the life of the loan, even though payments may later change because of the variable rate feature.[5]

Conversely, a "regular" transaction is one in which the consumer is given a single advance of funds and is required to make a regular series of equal payments at equal intervals. A "regular" transaction also includes transactions that have irregular first periods, irregular first payments, and irregular final payments.[6] As a result, "regular" transactions that would remain subject to the more stringent .125 percent tolerance would include fixed-rate mortgages with one advance, regular payment periods, and regular payment amounts, as well as adjustable-rate mortgages (ARMs) where the initial disclosures are based on a regular amortization schedule over the life of the loan. Balloon payment loans with otherwise regular payment amounts and periods would also be included in the "regular" transaction category.

II. Application to Discounted Variable-Rate Transactions, Option ARMs and I/O Loans

With respect variable-rate mortgages where creditors may set initial interest rates that are *not* determined by the index or formula used to make later interest rate adjustments (*i.e.*, discounted and premium variable-rate transactions), Regulation Z states that because these transactions involve irregular payment amounts, other than irregular first or last payments, these transactions would be considered "irregular" and therefore subject to the more lenient .25 percent tolerance.[7] Significantly, this means that because most current ARM products have a discounted rate, these products qualify as "irregular" transactions and therefore are subject to the more lenient .25 percent of one percent tolerance.

It appears that this would be the case as well with respect to some of the more current "exotic" products in the marketplace, such as option payment ARMs or "interest-only" loans (I/O Loans). For instance, with respect to option payment ARMs, in order to ensure that the borrower is aware of the risk of payment shock that is associated with the products, the disclosed payment schedules should be based on the largest possible finance charge. In an option payment ARM, this would initially be the negative amortization payment option. Once the principal amount of the loan had increased to the negative amortization cap set by the loan documents (*e.g.*, 110 percent or 115 percent of the original loan amount), and the loan recasts, the negative amortization payment option would no longer be permitted and the disclosed payment schedule under the TILA would then reflect the next largest possible finance charge disclosure, which would either be an interest-only payment option or an amortizing payment option. As a result of these multiple disclosed payment schedules, option payment ARMs can contain irregular payment amounts other than the first and last payments and therefore can be considered "irregular" transactions subject to the more lenient tolerance.

With respect to an I/O loan, these products also qualify as "irregular" transactions given the Commentary position on discounted variable-rate transactions. This is because there are two different payment streams that are disclosed with different payment amounts between the I/O period and the fully amortizing period of the loan. As a result, an I/O loan contains irregular payment amounts and therefore qualifies as an "irregular" transaction.

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1. 12 CFR pt. 226.

2. 12 CFR § 226.22(a).

3. 12 CFR § 226.22(a)(3) n. 46.

4. Commentary to 12 CFR § 226.22(a)(3)-1.

5. Commentary to 12 CFR § 226.22(a)(3)-1.

6. 12 CFR § 226.22(a)(3) n. 46.

7. Commentary to 12 CFR § 226.17(c)(1)-10(iv).