Current Issues in Negotiable Instruments Law, Deposit Accounts and Payment Transactions

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I. Rights of the Holder — Mortgage Foreclosure

Generally, the right to enforce a negotiable instrument depends on holder status, not ownership of the debt or assignment of the mortgage. This is fundamental to the law of negotiable instruments, under the Uniform Commercial Code (UCC) and other law, whether the holder is a financial institution or other creditor, a securitization trust, the loan servicer, or a nominee such as the Mortgage Electronic Registration System, Inc. (MERS), and whether or not the mortgage has been assigned or even if the instrument has been lost or stolen. Moreover, if the holder is a holder in due course under section 3-302, ownership claims adverse to the holder are essentially cut off under the principles codified at section 3-306. Thus, ownership of a loan evidenced by a negotiable instrument (as opposed to holder status) is generally irrelevant to its enforcement.

Nonetheless, in Ross v. Huntington Bank a mortgage loan was securitized to a securitization trust, which could be foreclosed only by the securitization trust (as the owner and real party in interest, pursuant to Rule 17 of the Federal Rules of Civil Procedure), even though the trustee was not the holder of the note. The court concluded that having a plaintiff who was the holder and party entitled to enforce the note and mortgage under state law was not enough to satisfy this federal procedural requirement. The holder of the note was deemed to have assigned back the note and mortgage to the seller, and the note and mortgage under state law was not enough to satisfy this federal procedural requirement.

II. Cashier’s Checks

A. Case Law on Reform 1990 Revisions

The 1990 revisions to the uniform text of UCC Articles 3 and 4 have been enacted in every state except New York, and include significant clarifications relating to the cash management of a bank’s cashiers’ checks (and other bank-obligation checks), e.g., at sections 3-312 ("Lost, Destroyed, or Stolen Cashier’s Check, Teller’s Check, or Certified Check") and 3-411 ("Refusal to Pay Cashier’s Checks, Teller’s Checks, and Certified Checks"). For many of these purposes, all bank-obligation checks (see the definitions of cashier’s checks, teller’s checks and certified checks at sections 3-104 and 3-409) are treated the same; however, for simplicity of reference the discussion below is focused on cashier’s checks.

An excellent recent case illustrating the application of the 1990 revisions to the uniform text of UCC Articles 3 and 4, as to the enforcement of cashier’s checks under section 3-411, in S. Cert. Bank of Desoto County v. Lynnette Nettles Bank v. Lynnette Nettles, was issued. The issuing bank issued a cashier’s check (the first cashier’s check) payable to a manufactured home dealer, as payment for a manufactured home being purchased by the issuing bank’s customers (the "remitters") — see section 3-103(a)(15). This is essentially the scenario described in the automated stay — see section 3-411. In S. Cert. Bank, the dealer (payee of the first cashier’s check) deposited it at the depository bank and the next day withdrew the funds by obtaining a second cashier’s check issued by the depository bank (which thereby gave value and became a holder in due course (HDC) of the first cashier’s check). The dealer subsequently defaulted on its contract to deliver the manufactured home, and the depository bank deposited the issuing bank that the issuing bank did not intend to honor the first cashier’s check. The depository bank nonetheless honored the second cashier’s check when it was presented for payment (as it was obligated to do under sections 3-411 and 3-412). The first cashier’s check was then dishonored upon presentment to the issuing bank, leaving the depository bank with the unpaid cashier’s check.

The depository bank’s failure to honor the dishonored first cashier’s check then sued the issuing bank on the obligation of the issuing bank to pay the first cashier’s check, under section 3-412. The issuing bank asserted a right to refuse payment under section 3-411, and the S. Cert. Bank court considered the statutory defenses for doing so without risking liability for the holder’s legal expenses and consequential damages (including, pursuant to section 3-411(c)(3), a defense of the issuing bank, separate from the claims of its customer). Here, the issuing bank had no such defense, and in such circumstances is precluded from asserting the rights of another person (such as its customer). Moreover, as noted above, the depository bank was a HDC, and therefore was subject only to the limited defenses and restrictions allowed under sections 3-305(b) and 3-306, which were not available in this case.

B. Stopping Payment on a Cashier’s Check

As noted, the 1990 revisions at section 3-411 related to only the automatic stay, but did not allow the depository bank to refuse payment of its cashier’s checks, but no amount of clarification can prevent its misapplication by every court. The court of appeals decision in Mid America Bank v. Charter One Bank illustrates a variety of potential errors. A bank’s customer (the remitter) purchased a cashier’s check payable to a corporation, using funds in her account at the issuing bank. She nego-

quently closed that the payee corporation, which deposited it in a corporate account at the depository bank. In the meantime, the remitter determined that the corporate payee had defrauded her, requested the issuing bank to dishonor the cashier’s check, which it did upon presentment by the depository bank.

The trial court correctly held that the issuing bank wrongfully dishonored the cashier’s check because it had no defense against the presenting depository bank. However, a panel of appeals held that the depository bank stood in the shoes of its depositor, the corporation that obtained the check by fraud, and that this provided the issuing bank a defense against the depository bank. Even aside from the question of whether the depository bank was a HDC (and therefore relieved to the remitter’s defense of fraud in the inducement, under section

11. See 15 U.S.C. § 1601(a)(2)(A) ("person who at the time is the owner of the note or security").
C. Discrepancy in Indorsement

In Seraf v. National City Bank,16 the plaintiff and others wrote checks payable to "M.B. S Clearing" for the purchase of bank certificates of deposit (CDs), and mailed the checks to an intermediary ("BankAmerica") for endorsement and collection. At least one of the checks indicated that it was for the purchase of a CD. The checks were subsequently delivered to the defendant bank, which deposited the checks on its books. The plaintiff asserted ten counts of breach of fiduciary duty, bad faith, negligence, conversion, unjust enrichment and a lack of ordinary care against the bank, but the bank either owed or breached no such duties to the plaintiffs.

D. Forged Indorsement

In Simmons v. AmSouth Bank,17 the bank's customer deposited a check with forged indorsements, then withdrew the funds. The court upheld the bank's right to charge-back the deposit and recover the funds from its customer. In Simmons v. AmSouth Bank, the bank customer's claim for breach of contract was dismissed.

E. Ambiguous Payee

Section 3-101 is again illustrated by New Wave Technologies, Inc. v. Legacy Bank of Texas.18 In New Wave, the check was payable to payee whose names were separated by a virgule: "Maxim Solutions Group/New Wave Tech." The check was indorsed by one of the payees (Maxim) but not the other (New Wave), and deposited in the bank account. New Wave sued the depositing bank for conversion under section 3-420.

The New Wave court relied on section 3-110 and also concluded that a virgule means "or." To the extent there was an ambiguity (with language on the back of the check), the bank properly construing the payee line by stating that "Each Payee Must Endorse Exactly as Drawn," under section 3-110 it was resolved by permitting either payee to indorse the check. Therefore, the check was properly indorsed, and there was no conversion under section 3-420. Summary judgment was granted for the depository bank.

IV. Checks Paid After a Bankruptcy Filing

If the drawer of a check (the deposit account customer) files bankruptcy before the bank's deposit account becomes property of the bankruptcy estate and subject to the automatic stay that prohibits any action to collect against estate property.20 In Bucky Check Cashing, Inc. v. Meadow,21 a payday lender took a post-dated check as collateral for a short-term loan. Upon maturity of the loan, pursuant to the loan agreement and after receiving notice of the debtor's Chapter 13 bankruptcy filing, the lender presented the check for payment. The lender then sued the lender, alleging violation of the automatic stay. The Fifth Circuit Bankruptcy Appellate Panel held that the payday lender did not violate the automatic stay, because the debtor's check was property transferred prior to the filing of the bankruptcy. The court noted that the payee did not seek avoidance of the transfer under any section of the Bankruptcy Code (postpetition transactions), but the court nonetheless decided on policy grounds to deny the bankruptcy estate's claim under section 549 (liability of transferor for avoided transfer). Section 506(a) requires avoidance under another section, and there are exceptions to the automatic stay and avoidance rules that might protect this type of transaction.22

V. No Set-Off Against HDC

In Heart Easters v. Crawford,23 a check was negotiated by the payee to a check cashing service, which thereby became a holder in due course (HDC). The drawer subsequently asserted a claim or defense against the payee for an improper set-off on the check. The check cashing service drew the check under section 3-414, but the drawer wanted to use the check cashing service as a payee as setoff. The trial court recognized that the check cashing service was a HDC under section 3-302, but allowed the drawer to set-off its claim against the payee pursuant to section 3-302, which limits HDC status to a proportionate amount when the value paid by the HDC was only partially performed. The trial court reasoned that the value paid to the drawer by the payee was only partially performed, but the ap-}
the bank for misappropriation, under the Uniform Fraud Act. The court refused the claim as to the deposited funds, because there was no evidence of actual knowledge or bad faith on the part of the bank. As to the checks payable to the bank, the case was remanded to determine if there was sufficient evidence to overcome a presumption that the bank received an improper benefit.

VI. Limitations on Recovery

A. Limitations Period

A non-negotiable instrument is subject to the general statute of limitations period for contracts, rather than the UCC Article 3 limitations period.

B. Rights Not Assignable

In Trifino v. Wachovia Bank, the assignor of a discharged check sought recovery for breach of warranty under the Check Truncation Act ("Check 21") statutory warranty at 2 U.C.S. Section 5001(1). The court held that a statutory warranty claim is not assignable. See also Trifino v. TD Banknorth, holding that a UCC Article 4 section 4-202 accountability claim is a non-assignable statutory duty.

C. Custodial Account was Transferred

In Orin Capital Mgmt., LLC v. Wash-ington Mutual Bank, the depositor did not violate the money market deposit agree-ment by transferring the custodial role for the account to a third party; under the dual rights agreement, the custodians' role was to maintain the account, not to own it.

D. Collection Items

In Tisdale v. Whitney Nat'l Bank, N.A., the court noted that the Article 4 midnight deadline rule for payor banks does not apply to collection items. Such items are governed by the collection instructions.

The court noted that, by its terms, the midnight deadline rule at section 4-302(b) applies only to "a demand item," sometimes called a "cash item" in banking parlance. The court's opinion includes a good discussion of the distinction between demand and collection items.

E. Negotiable Instrument is a Contract

A negotiable instrument is a contract and the UCC is supplemented by general principles of contract law and equity. Therefore, subject to statutory provisions such as section 3-110, contract law governs the interpretation of the parties' agreement. For example, in Tri-State Fide LLC v. First Dakota Nat'l Bank, a prepayment penalty in a promissory note was not enforceable, on a contract's law analysis and due to a conflicting provision in the note; in Water & Sand Far'l Capital, Ltd. v. Capacitive Deionization Tech. Sys., Inc., a choice of forum clause in the notes was enforced as a matter of contract law; and, in Suhler Co. v. Mass. & So. Conn., a negotiable promissory note was enforceable despite contradictory terms in a related settlement agreement—section 3-117 was not applicable because the separate provision did not expressly modify the note.

F. Warranties

In Mills v. U.S. Bank, investors wrote checks to an investment company, which transferred the checks to its holding company (without indemnification) for deposit to the holding company account. The investors subsequently used the deposit for breach of warranty under sections 4-207 and 4-208, on grounds that the investors were damaged when the checks were taken without a proper indorsement. The court rejected these claims because the Article 4 (and the similar Article 3) warranty protects transferees, not drawers of the check. The investors also asserted negligence under section 4-103, but the court noted that the bank owed no duty to noncustomers (such as investors), as drawers of the deposited checks. It can also be noted that the holding company was a transferee entitled to enforce the instruments, under sections 3-203 and 3-301.

X. Check-Kiting Scheme

In Midamerica Bank & Trust v. Charter One Bank, a bank customer who was a "pawer" in a check-kiting scheme was induced to purchase a cashier's check payable to the check-kiting corporation. When the customer (the remitter—see sections 3-103(a)(15)) requested the issuing bank to dishonor the cashier's check, it did so. Even though the depositor/presenting bank may have been a holder in due course, and under section 3-705 the issuing bank could not assert its customer's defense, the court of appeals held that the issuing bank had a duty to dishonor the check to allow dishonor of the cashier's check. This analysis is incorrect. Regarding the lack of a duty of care to noncustomers, see generally Mills v. U.S. Bank.

XI. Charge-Back by Depository Bank

Section 4-214 allows the depository bank to charge-back to the customer's account any item deposited by the customer that subsequently is dishonored by the payor bank, even if that creates an overdraft and even if the depository bank does not meet its midnight deadline or duty of ordinary care under section 4-202 (though the depository bank is liable for any loss resulting from that delay—see also section 4-102(e)). In Donovan v. Bank of Am., the court relied on a similar provision in the deposit agreement as authorization for the bank to charge-back items dishonored due to alteration and forgery.
C. Creditor Process Served on Receiving Bank; Setoff by Beneficiary's Bank

Section 4-502 governs creditor process served on a receiving bank. Creditors process against a payment order can only be served on the beneficiary's bank. In* Palestine Monetary Auth. v. Strachman,* creditors recovered a judgment against the Palestinian Authority (PA) and a related injunction against a Palestinian bank created by the PA, in an effort to collect the funds. The creditors domesticated the judgment in New York and served an intermediary New York bank with an injunction and restraining order; in response, the New York bank froze various wire transfers including a $30 million payment order from the Palestinian bank. Among other allegations in opposition to this freeze, the Palestinian bank argued that ownership of the funds had passed to a third party beneficiary pursuant to section 4-502. However, the court disagreed, on grounds that the Palestinian bank failed to show that the beneficiary was anything more than a collection agent for the Palestinian bank. Moreover, the court held that section 4-502 does not prohibit an intermediary bank from freezing a payment order pursuant to an injunction.

Importantly, however, the infamous Winter Storm case was reconsidered and overruled as erroneously decided, in The Shipping Corporation of India v. Jalali *Overseas PTE Ltd,* held that funds transfers are not subject to attachment under maritime law while being processed by intermediary banks. The effects of this reversal were immediate. See, e.g., AOSTA Shipping Co., Ltd v. OSL Shipping Corp., Ltd (unpublished order vacating an attachment order); Novel Commodities S.A. v. Aramark Marine

Limited (unpublished Order denying application for a maritime attachment).

XV. UCC Article 4A

A. Restitution for Errors

In HSBC Bank USA, N.A. v. A.T.A. Constr. Corp., a series of corrections caused the receiving bank to erroneously pay the beneficiary twice. The bank then sought restitution of the overpayment from the beneficiary under section 4A-505, and on grounds of unjust enrichment. The court agreed, and also awarded prejudgment interest beginning one month after the beneficiary withdrew the funds.

B. Unauthorized Transfers

In ReAmerica, S.A. v. Wells Fargo Bank Int'l,* a company's employee obtained the company's wire transfer code and made unauthorized wire transfers to his personal account. The company became suspicious and directed the bank to suspend the account. The company also requested account activity information, without stating the purpose. The disclosed transactions had identified at least some of the unauthorized transfers. However, the company did not notify the bank of the unauthorized transfers until nearly two years later. The court held that the one year limitation period at section 4A-505 prevented the company from recovering the unauthorized transfers from the bank. The direction to suspend the account and the request for account information were too vague to qualify as objections to the payments under section 4A-505.

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A financial institution's bond that covered losses while the property was "in an armored vehicle" and "during the loading and unloading thereof" therefore did not cover a loss that occurred after the money was unloaded from the armored vehicle and was in the carrier's office.9

B. Deposit Contracts

A contractual reduction in the time for the customer to report unauthorized signatures under section 4-406(c), e.g., from one year to sixty days, is enforceable, and is true under any current forms of UCC Article 4.

C. Deposit Bank Defenses

A good listing of defenses available to a depositary bank being sued in a check fraud scheme is found in Willert, Inc. v. Harr.10 In this case, a family-owned cattle trading company hired Mr. Hurt (who was dating the company's owner and manager) to manage a part of the company's operations. In this capacity, the company issued checks to Mr. Hurt for the purchase of cattle, with the payee line or amount (or both) left blank. Mr. Hurt apparently embezzled company funds by diverting these checks to his and other accounts at the defendant bank. The court's discussion of the depositary bank's successful defense includes issues covered by: section 3-110 (the intender payee rule); section 3-405 (endorsement by); section 3-420 (conversion); and section 4-101 (items not properly payable).11

D. Direct Deposit to Overdrawn Accounts

A California appellate court held that Bank of America did not act illegally when it accepted direct deposits of government benefits to cover overdrawn customer accounts. When the deposits were accepted, the bank applied the proceeds to overdrawn balances and bank fees. The California Supreme Court upheld the ruling. The Supreme Court discredited its prior holding in Kruger v. Wells Fargo Bank12 on grounds that Kruger involved a set-off for credit card debt against an unrelated deposit account containing exempt public benefits, while in Miller the "transaction [occurred] within a single account and [was] triggered by a customer's overdraw..." 13 The court also noted the public policy in favor of permitting overdrafts as an alternative to dishonor, and the effect of post-Kruger state legislation.14

On a related issue, on April 19, 2010, the U.S. Treasury and four other federal administrative offices proposed new rules to restrict the garnishment of deposit accounts containing federal benefit payments.15

E. Regulation E Notice

The EFTA and Regulation E require a notice to automated teller machine (ATM) customers if they "will be charged a fee for a transaction." A notice on an ATM screen that the consumer "may be charged a fee plus affirmative acceptance of the fee was adequate to comply."16

F. Federal Preemption of State Law

The Home Owner's Loan Act (HOLA) and Office of Thrift Supervision (OTS) regulations permit savings and loan banks to accept public unit deposits notwithstanding a state law to the contrary. The National Bank Act (NBA), authorizing national banks to charge a check cashing fee to non-customers, preempts state law to the contrary.17

XVI. 2002 UCC Amendments

At this writing the 2002 amendments to the uniform text of UCC Articles 3, 4, and 4A have been enacted in Arkansas, Indiana, Kentucky, Minnesota, New Mexico, Nevada, Oklahoma, South Carolina and Tennessee. Several amendments affect deposit accounts.18

Several of the amendments recognize electronic records. The substantive changes also include the following:

- Revised section 3-509 permits a party entitled to enforce the instrument to enforce a lost or destroyed instrument even if another party had possession when it was lost or destroyed;
- revised section 3-419 makes clear that an accommodation party guarantees payment unless there is a clear indication that the accommodation is one of collection. It also specifically provides for exoneration in a "proper case;"
- revised section 3-602 accommodates the practices of real estate mortgage loan servicers by, among other things, permitting payment to a prior holder of the note if the payor has not received notice of the transfer of the loan; and
- revised section 3-603 provides definitions of "principal obligor" and "secondary obligor." Then, under section 3-605 (as to checks), the drawer also releases indorsees.

Revised section 3-605 includes numerous other changes regarding releases of secondary obligors applicable to promissory notes;

- revised section 4-104 makes action or non-action at a bank branch subject to the law of the location of the branch; and
- revised section 4-201 permits the return of an image of a check as a check to the opposition party to whom return has made is agreed to accept an image; and
- revised section 4-205 expressly allows the one year time within which a customer
has cleared solely because the funds are provisionally credited to the depositors' account; and
• the bank work cooperatively with deposit customers that become victims of cashier's check
fraud. In addition to providing assistance to the customer in connection with their claims or other actions against perpe-
trators, it may be appropriate in some circumstances for the bank to convert a resulting overdraft into a more formal
loan that the customer can repay over time, instead of demanding
that the overdraft be repaid im-
mediately.

B. OTS Identity Theft Procedure

The OTS has issued examination procedures relating to identity theft and customer address discrepancies. Pursu-
to these procedures, examiners will be looking for: a written Identity Theft Prevention Program; policies and proced-
ures for scrutinizing requests for a change of address request that is followed closely by a request for an
additional credit or debit card or a replacement card; and policies and procedures for handling notices of address discrepan-
cies received from consumer reporting agencies. A revised OTS Identity Theft Prevention Program was also issued, and the OTS
issued Frequently Asked Questions (FAQs) on the identity theft rules.

C. FDIC Overdraft Study

In November, 2008 the Federal Deposit Insurance Corporation (FDIC) completed a study of the overdraft policies and practices of FDIC-regu-
lated banks, conducted for the purpose of providing policy makers with correct background information. This provided
a basis for subsequent revisions to FRB Regulations E and DD, as noted below.

The FDIC study considered the potential need for new rules and restrictions on:
• automatic enrollment in over-
draft plans;
• the size of usage fees;
• allowing overdrafts in automa-
tated teller machine (ATM) and point of sale (POS) retail transactions without notice of
the overdraft prior to incurring the charge; and
• payment of insufficient funds (NSF) items in the order of
largest to the smallest items, which increases the number of NSF items and maximizes NSF
fees.

D. Revisions to FRB Regulations E and DD

Subsequent to the FDIC overdraft study (noted above at Part XVII.C), and the FDIC’s issuance of its comments on the draft
Final Rule in September, 2009 the FRB issued regulations to Regulations E (Implementing the EFTA and EDD (Truth in Savings), relating pri-
marily to overdraft protection programs.

E. Treatment of Deposits at Failed Institutions

The FDIC finalized a rule establishing the FDIC’s practices for determining de-
posit and other liability account balances at a failed insured depository institution. The final rule also requires insured
depository institutions to prominently disclose to sweep account customers whether the sweep funds are deposits and the status of the sweep funds if the institution were to fail. The rule provides that:
• upon the failure of an FDIC-insured depository institution, the FDIC must determine
the total insured amount for each depositor. The deposit account balance on the day of the fail-
ure is defined as the end-of-day ledger balance. With certain exceptions, the FDIC will use
the cutoff times applied by the failed insured depository institutions in establishing the end-of-
day ledger balance for deposit insurance determina-
tion purposes;
• all checks deposited into and posted to a deposit account by the applicable cutoff time and received as part of the end-of-
day ledger balance will be treated as a deposit for insurance purposes, regardless of whether
these funds have been collected;
• any automated sweep transac-
tion transferring funds internal to the depository institution's operations from one deposit
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on completing Currency Transaction Reports (CTRs) on deposits transferred to the bank by armored car.109

XIX. Overdraft Protection Regulation and Litigation

A. Introduction

As noted above at Parts XVII.C. and D, this past several years have seen an increasing number of regulatory developments relating to the fees charged by banking institutions for paying items that are drawn on insufficient funds (i.e., that overdraft the customer’s account).110 These developments culminated in 2009 revisions to Federal Reserve Regulation E and DD (and clarifying amendments of June 4, 2010), all effective in 2010.111 As noted below, these developments have also been accompanied by litigation on related issues.

B. Scope of the Amendments to Regulations E and DD

These revisions have already been noted above at Part XVIII.D. They became effective July 1, 2010 for the opening of new accounts and August 15, 2010 for deposit accounts in existence prior to July 1, 2010. As noted above, the rules require new customer account disclosures for fees charged when ATM or one-time debit card transactions will result in the customer’s account being overdrawn. The rules also require the customer to affirmatively opt-in to the overdraft protection (and payment of fees), including a written election by the customer and a disclosure of the customer’s continuing right to opt-out. The bank cannot otherwise discriminate between customers who opt-in and those who opt-out.

The new rules apply to “overdraft services,” defined essentially as a fee for paying certain ATM or debit card transactions drawn on insufficient funds (i.e., creating an overdraft). Thus, the rules do not apply to items that are dishonored (e.g., for ATM/Debit transactions that are rejected) for insufficient funds. A bank may choose not to offer the overdraft protection services covered by the rule, or to provide such services without additional charge; this would be outside the scope of the rule. However, if a fee is imposed for overdraft services covered by the rule, the rule applies whether or not the bank advertises or otherwise promotes the service.

The term “overdraft services” does not include line-of-credit programs subject to FRB Regulation Z (such as credit card transfers or a home equity line-of-credit (HELOC)). It also does not include services that transfer funds from one deposit account to another to cover overdrafts; it does not cover other regulatory programs relating to securities or commodities accounts. The rule is limited to ATM and one-time debit card transactions, and does not apply to checks, automated clearing house (ACH), or recurring debit card transactions.

C. The 2010 Clarification

The June 4, 2010 clarification112 reversed a prior FRB determination (in the 2009 rule113) that would have allowed a bank to charge for an ATM or one-time debit card overdraft if the transaction was authorized when made but is followed by an event that would have caused rejection of the transaction. In other words, under prior rule, if the overdraft results from circumstances that could not be foreseen by the bank when the transaction was approved (e.g., a subsequent depletion of the account after approval of the ATM or debit card transaction), the bank could charge an overdraft fee without complying with the new rules. The June 4, 2010 clarification withdraws this permission.

D. OTS and FDIC Supplemental Guidance

On April 29, 2010 the Office of Thrift Supervision (OTS) issued a Supplementary Guidance (the OTS Guidance) relating to fees for overdraft protection services.114 The OTS Guidance applies to overdrafts created by payments of checks (or other items) as well as ATM and debit card transactions. It addresses the fees and the order of payment when multiple items and/or electronic payments are presented on the same day. Essentially this extends the FRB 2010 amendments to Regulations E and DD, to cover overdrafts initiated by check. The OTS Guidance also takes the position that a failure of the bank to place a “reasonable limit” on the charging of overdraft fees (e.g., for multiple transactions) is an unfair practice under the Federal Trade Commission (FTC) Act.115 The OTS Guidance recommends real-time notification of the customer (e.g., on the ATM transaction) as well as of any thing to come to the customer’s attention. There is, however, recognition that this is subject to the limits of available technology.

The FDIC has issued related Consent Order against Woodforest Bank116 also seen to suggest that:

- an account cannot be marketed as “free” if high overdraft fees are charged;
- overdraft fees should be limited to the amount of the item paid;
- there should also be an opt-in regimen for checks (and other items), as for ATM and one-time debit card transactions under the 2009-2010 FRB rules;117
- punitive civil penalties equal to nearly 100 percent of the bank’s capital (as in the Woodforest Consent Order) are an appropriate sanction in such cases.

The conclusions go beyond the state of the current law as commonly understood, yet it has been reported that OTS and even OCC examiners may be following these standards in some instances.118 As suggested below at Part XX., it is possible that such standards may be embraced by the new Bureau of Consumer Financial Protection (CFPB) established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), and so may serve as a preview of things to come in this area of law.

On August 11, 2010 the FDIC issued a proposed guidance regarding risk management of automated overdraft payment programs, in essence extending the FRB 2010 Regulations E and DD amendments to cover checks as well as electronic payments.119

E. High-to-Low Posting Litigation

Much of the current overdraft-related litigation centers on the common practice by banks of paying insufficient funds checks (NSF checks) or electronic transfers initiated when multiple items are presented on the same day in the order of dollar amounts (with the largest amounts being paid first)-HTL posting. This creates a logical assumption that the largest checks are likely to be the most important to the customer (e.g., house and car payments, rent, etc.), but also results in disfavor (or overdraft charges) for a larger number of smaller-dollar items (thereby maximizing the bank’s overdraft charges).

The UCC clearly permits payment (or disfavor) in any order the bank chooses (subject to any contrary agreement), and traditionally most litigation has reflected this view.120 Particularly given the common deposit account contract provisions recognizing the bank’s authority to do so,121

Nonetheless, a spate of recent litigation on HTL posting has resulted in a California federal court decision adverse to the banking industry,122 and consolidation of a number of nationwide class action cases pursuant to an order of the Judicial Panel on Multidistrict Litigation.123 These cases focus on ATM and

...
debt card transactions (since these do not involve "items" subject to the UCC). Reportedly this litigation now involves more than twenty defendants and more than fifty lawsuits from multiple states. 129 The allegations are based primarily on three common law causes of action, including: the covenant of good faith and fair dealing; unjust enrichment; unconscionability; conversion; and state UDAAP (Unfair and Deceptive Acts and Practices) statutes. 130

The defenses being asserted include: federal preemption; lack of contractual authorization for the practices and charges; 131 lack of unconscionment; 132 and unconscionability is a shield, not a sword. 133 UDAAP statutes do not apply to or prohibit lawful practices; and 134

QUARTERLY REPORT

The Dodd-Frank Act is an important factor bringing on the consumer financial services field, this impact on the Dodd-Frank Act and CFPB. 135 At this writing, many organizational and staffing details remain unknown, so the following are some comments. The CFPB regulations. For now, it is powerful, with more extensive authority than previously experienced in our history of consumer financial services law (and your authors say this with full knowledge of the comprehensive authority previously conferred upon the federal financial regulatory agencies). Moreover, that power will be concentrated as never before, in contrast to the previous distribution of authority, e.g., among the many federal agencies, and with agencies (e.g., the Federal Trade Commission) not subject to the cost of the transactions. So, as noted above and again below, the impact of the Dodd-Frank Act and CFPB are yet to be known.

XX. The Dodd-Frank Act

A. The CFPB

An important factor in this field is the Dodd-Frank Act and CFPB. 135 At this writing, many organizational and staffing details remain unknown, so the following are some comments. The CFPB regulations. For now, it is powerful, with more extensive authority than previously experienced in our history of consumer financial services law (and your authors say this with full knowledge of the comprehensive authority previously conferred upon the federal financial regulatory agencies). Moreover, that power will be concentrated as never before, in contrast to the previous distribution of authority, e.g., among the many federal agencies, and with agencies (e.g., the Federal Trade Commission) not subject to the cost of the transactions. So, as noted above and again below, the impact of the Dodd-Frank Act and CFPB are yet to be known.

If this is the calm eye of that storm, it may be time to start bailing out now.

B. Interchange Fees

The Dodd-Frank Act includes an amendment to the Electronic Fund Transfer Act (EFTA) 136 limiting the interchange card transaction interchange fees to an amount "reasonable and proportionate" and providing that this regulation is subject to the rulemaking process. The FRB is directed to establish standards for the rulemaking process which, when effective on July 21, 2012. 137 This rule does not apply to issuers with assets of less than $10 billion or using transactions government payment programs or certain prepaid cards. 138

C. Network Exclusivity

The Dodd-Frank Act Amendment to the EFTA 139 also prohibits restricting the number of payment card networks on which debit card transactions are processed. The anti-discrimination provisions prohibit practices designed to inhibit merchants from accepting debit cards or routing the processing over a payment card network. 139

D. Interest on Checking Accounts

The Dodd-Frank Act repealed the prior prohibitions in federal law on the payment of interest on demand deposits, effective July 21, 2011. 140

E. EFAA and Regulation C

The Dodd-Frank Act increased the amount of available funds that must be made available for use by the customer in an every other than the business day after the deposit of a check under the Expedited Funds Availability Act (EFAA) 141 and FRB Regulation CC, 139 from $100 to $300 (and provides for an inflation-adjusted adjustment every five years). 140 This change is effective July 21, 2011. 140

G. Gift Cards

As noted elsewhere, 150 the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "Dodd-Frank Act") 151 amended the EFTA 152 to limit and regulate the use of dormancy and service charges with respect to stored-value cards. 153

125. See supra note 124.
126. See supra note 128.
127. Id. (citing Wilson v. United Westminster Bank PLC, 1993 CLC 604, [1993] 2 FLR 244 (Ch.)).
128. Id.
129. See supra note 124.
130. See supra note 124.
131. See supra note 128.
132. See supra note 128.
133. See supra note 128.
134. See supra note 128.
135. See supra note 124.
136. See supra note 124.
137. See supra note 124.
138. See supra note 124.
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140. See supra note 124.
141. See supra note 124.
142. See supra note 124.
143. See supra note 124.
144. See supra note 124.
145. See supra note 124.
146. See supra note 124.
147. See supra note 124.
date for some requirements was subsequently extended to January 31, 2011.152 The FRB issued a final rule to implement these changes, but then issued an interim final rule extending the effective date as noted above.153

The new rules apply to gift certificates, store-issued gift cards, and general stored-value cards, and prohibit dormancy or service charges within one year of the previous card transaction.154 The expiration date must be at least five years after issuance, and certain disclosures are required (including a toll-free telephone number).155

### IV. Payment Disclosures

#### A. Disclosures for Amortizing Mortgages

If all periodic payments will be applied to accrued interest and principal, for each interest rate that is disclosed for both fixed-rate and adjustable- or step-rate mortgages, the creditor must also disclose:

- the corresponding periodic principal and interest payment, labeled as "principal and interest." The Commentary states that for adjustable-rate mortgage transactions, for each interest rate required to be disclosed under Regulation Z section 226.18(3)(2)(i)156 (the interest rate at consummation, the maximum rate during the first five years, and the maximum possible rate), a corresponding payment amount must be disclosed. The Commentary notes that the format of the payment disclosure varies depending on whether all regular periodic payment amounts include principal and interest, and whether there will be an escrow account for taxes and insurance;

- if the periodic payment may increase without regard to an interest rate adjustment, the payment that corresponds to the first such increase and the earliest date on which the increase could occur;

- as amended by the December Interim Rule, if an escrow account will be established, an estimate of the amount of taxes and insurance, including mortgage insurance, payable with each periodic payment;157 and

- the sum of the amounts disclosed as noted above, as applicable, which must be labeled as the "total estimated monthly payment."

#### B. Disclosures for Interest-Only Mortgages

If the loan is an interest-only loan,158 for each interest rate disclosed, the creditor must also disclose the corresponding periodic payment as well as the following:

- if the payment will be applied to only accrued interest, the amount applied to interest, labeled as "interest payment," and a statement that none of the payment is being applied to principal;

- as amended by the December Interim Rule, if the payment will be applied to accrued interest and principal, an itemization of the amount of the first such payment applied to accrued interest and to principal. This itemization must be labeled as "interest payment" and "principal payment," respectively;159

- any escrow information, as applicable including an estimate of the amount of taxes and insurance, including any mortgage insurance; and

- the sum of all amounts required to be disclosed as noted above, as applicable, which must be labeled as the "total estimated monthly payment."

Note that the Commentary provides that the foregoing rules only apply if the loan is not also a negative amortization loan. If the loan is a negative amortization loan, even if it also has an interest-only feature, payments must be disclosed in accordance with the rules for negative amortization loans.

#### C. Disclosures for Negative Amortization Mortgages

With respect to negative amortization loans, the creditor must disclose:

- the minimum periodic payment required until the first payment increase or interest rate increase, which must correspond to the interest rate disclosure required as noted above at Part III.D. for negative (Continued on page 315)

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154. Id.

155. Id.


157. Previously, the requirement was to disclose that an escrow account is required, if applicable, and an estimate of the amount of taxes and insurance, including any mortgage insurance.

The Commentary states that these amounts should, among other things, reflect the consumer's mortgage insurance payments until the date on which the creditor most recently terminated coverage under applicable law, even though the consumer may have a right to request that the insurance be cancelled earlier. The payment amount must reflect the terms of the legal obligation, as determined by applicable state or other law.

158. The September Interim Rule states that the term "interest-only" means that, under the terms of the legal obligation, one or more of the periodic payments may be applied solely to accrued interest and not to loan principal; an "interest-only loan" is a loan that permits interest-only payments.

159. Previously, the requirement was to disclose if the payment will be applied to accrued interest and principal, the earliest date that such payments will be required as well as an itemization of the amount applied to accrued interest and the amount applied to principal. This itemization must be labeled as "interest payment" and the "principal payment," respectively.