

Payment Systems Update 2005

I. Introduction

There have been many significant recent developments in consumer payment systems and the law governing these systems. Although there is great variation in the developments, it is safe to say that the trend is toward increasing legal complexity. This complexity poses serious challenges for users of those systems, the lawyers who advise them, and for those teaching courses that include a consideration of payment systems. Users will be confused and have trouble understanding their rights and responsibilities. Their lawyers will have to stay abreast of many new statutes, regulations, and cases. Teachers will have to make difficult decisions on what additional material to include in courses so their students will be able to adequately represent future clients in matters where the new payments law applies.¹

This article describes new payment devices such as substitute checks, payroll cards and remotely created consumer items. It discusses new rules that apply to novel payment processing systems such as electronic check imaging and electronic check conversion. It identifies significant features of various devices and systems such as the following. Some systems appear the same to the consumer, but are not at all alike. For example, in both electronic check conversion and electronic check imaging exchange consumers who paid by



SUBSTITUTE CHECKS, REMOTELY-CREATED ITEMS, PAYROLL CARDS AND OTHER NEW-FANGLED PRODUCTS

By Mark E. Budnitz*

check and who never agreed to have their checks truncated nevertheless do not receive their original checks along with their monthly statements. Despite this common element, the two transactions are processed along different routes and very different law applies. The law that governs some payment devices depends upon how they are set up. For example, whether the federal Electronic Fund Transfers Act² (EFTA), together with the Federal Reserve Board's (FRB) Regulation E³ (Reg. E) or common law contract rules, apply to payroll cards may depend on what type of bank account the employer establishes to fund payments to unbanked workers. Some payment devices are subject to more than one set of laws. For example, checks are subject both to the state Uniform Commercial Code (UCC) and federal law, including the Expedited Funds Availability Act⁴ together with the FRB's Regulation CC⁵ (Reg. CC) and the Check 21 Act.⁶ In contrast, no federal law, and very few state statutes, govern stored value devices such as phone and gift cards.

Finally, there have been important amendments to two bodies of rules. After 50 years, the word "consumer" finally appears in Article 3 of the UCC as that statute takes two baby steps toward protecting consumers. And the private rulemaking organization that governs most automated clearing

house transfers, the National Automated Clearing House Association (NACHA), continued its efforts to keep up with developments in electronic fund transfers by adding new rules.

II. The Not So Identical Twins: Electronic Check Conversion & Check 21

Consumers who had always received their original checks along with their bank statements have become confused because they no longer receive some of their original checks along with their bank statements. Starting early in 2004, many believed this was the result of the Check 21 Act they've read about in the papers.⁷ In fact, Check 21 did not go into effect until October 28, 2004,⁸ and their checks instead were processed through a system known as electronic check conversion (ECC).⁹ The confusion felt by these consumers is understandable and probably shared by their lawyers.

This confusion is caused by the many different payment systems and rules that come into play when a consumer pays by check. In the good old days, circa 2000, checking accounts took basically two forms. Some consumers had the traditional checking account in which they received their original paper check along with their monthly bank statement. The UCC's Articles 3 and 4 govern these accounts. Many others, including almost all credit union customers, agreed to have their checks "truncated." Their original checks were not returned to them.¹⁰ The UCC as amended in 1990 permitted this as long as the customer's bank statement contained the check number, amount, and payment date.¹¹ Today, there are new systems and new rules.

A. ECC

A few years ago Wal-Mart and other retailers adopted ECC at the point of sale.¹² The consumer pays by handing the retailer a check. It is likely that most consumers believe it will be processed the same as any other check. If they have not agreed to truncation, these consumers expect that the originals will be returned with their statement. But it is not processed as a check. The check instead is treated as a "source document." The check is merely a source of information about consumers and their bank accounts. The retailer may have the consumer fill out the check or hand a blank check to the cashier. It may keep the check or return it to the consumer marked void. The retailer uses the information from the MICR line at the bottom of the check to process the check electronically. It is subject to the EFTA and Reg. E. The FRB requires the retailer to obtain the consumer's authorization. The FRB considers the authorization has been obtained if the business notifies the consumer that the check will be processed as an electronic transfer and the consumer completes the transaction.¹³ Most consumers probably do not see the small sign posted near the register that tells them the check will be processed electronically. It is unlikely those who do see it understand its legal significance. The great majority of ECCs are processed by automated clearing houses subject to a set of rules issued by NACHA. These rules impose requirements on merchants far beyond anything in Reg. E.¹⁴

Another type of ECC occurs when consumers pay certain businesses, such as credit card and insurance companies, by mailing a check. This is called "lockbox ECC."¹⁵ The business must notify the consumer that the check will be processed as an electronic transfer, but often the notice is buried within a dense paragraph in the monthly statement discussing many other matters. The consumer, therefore, may not see the notice. Businesses do not return the checks

in these transactions. These ECCs are subject to Reg. E as well as detailed NACHA rules that go well beyond Reg. E in providing consumer protection.¹⁶

B. ECC + Check 21 = Confusion

When the Check 21 Act took effect on October 28, 2004, matters became much more confusing.¹⁷ Both ECC and Check 21 transactions appear largely the same to consumers. In both types of transactions, consumers who have not agreed to check truncation nevertheless do not receive some of their original checks with their statements. An ECC appears to consumers to be a check transaction because consumers pay by tendering a check, but it is not processed as a check transaction. And it is subject to very different law: Reg. E and NACHA rules. Most consumers will realize it is not an ordinary check transaction only when they receive their monthly statement and fail to receive their original check.

A transaction subject to Check 21 also appears to be an ordinary check transaction because consumers pay by tendering a check. But as in ECC, consumers will not receive some of their original checks with their bank statements. They will not receive these checks because electronic images of the checks will be exchanged down the collection chain instead of the paper checks. They may instead receive a strange and entirely new type of payment instrument, the "substitute check." The substitute check has features very different from ordinary checks and consumers have a whole new set of substantially different rights and obligations under those transactions. To make matters even more complex, in addition to Check 21, the UCC also governs these transactions. But it does so only insofar as it does not conflict with Check 21.¹⁸

Many financial institutions will not process checks using electronic images, at least for the foreseeable future. They will continue to process them the traditional way, given the cost of imaging equipment and the organizational changes necessary to implement imaging. Therefore, some of the consumer's checks will never be converted to images and will be subject only to the UCC, while others will be subject both to the UCC and Check 21.

C. Check 21

Even without the confusion engendered by the apparent similarity between ECC and Check 21 transactions, the Act itself is complex and raises many questions. Consequently, the Act presents a formidable challenge to consumers, consumer educators, bankers, and law professors. Congress enacted Check 21 at the FRB's urging in order to foster the transition to a completely electronic payment system. Currently, tens of millions of drawers (the persons who write the checks) and many banks in the check collection chain refuse to accept electronic images of checks.¹⁹ Check 21 does not require drawers or banks to accept electronic images. Instead, if a bank does not agree to accept those images, it is entitled to a paper instrument called a "substitute check." Congress and the FRB hope that Check 21 will facilitate the transfer of electronic images, and thereby make check collection far speedier and more efficient than the current system that depends on planes and trucks transporting paper checks all across the country.²⁰ While increasing the check system's speed and efficiency, the adoption of widespread electronic check imaging will further reduce the consumer's float, restrict the opportunity to stop payment, and decrease interest earned on deposits. In addition, electronic imaging may result in new types of wrongful debits to consumer

accounts. Check 21 includes very limited consumer safeguards and imposes many new consumer responsibilities.

Check 21 applies to all checks including those written both by consumers who never consented to have their checks truncated and to those who did consent. Those consumers who did not agree to truncation are entitled to a notice explaining that a substitute check is the legal equivalent of the original check and describing the consumer's recredit rights.²¹ Consumers who do not receive the original because it was transferred via an electronic image are entitled to a substitute check with their monthly statement.²²

At least in the near future, when creditors claim consumers have not paid their bills and consumers attempt to prove payment by showing the creditor a substitute check, the creditor may be reluctant to accept this as proof of payment and demand a copy of the original. To facilitate the acceptability of the substitute check, all such checks must bear a legend: "This is a legal copy of your check. You can use it in the same way you would use the original check."²³ Hopefully, many creditors will read the legend and accept the substitute check as proof of payment.

The FRB and others have identified several types of errors that could occur when substitute checks are used.²⁴ These include multiple debits to the consumer's account arising out of the same single original check. Multiple debits can occur if the original check is processed along with the

to provide the substitute check can frustrate the consumer's effort to take advantage of the indemnity. In contrast, consumers have warranty rights regardless of whether they were provided a substitute check.

Even if the FRB's final rule on Check 21 had answered all the questions raised by the Act, and did so in a manner that protects consumers, consumers who do not receive their original checks with their bank statements will nevertheless continue to be confused. They still will have difficulty understanding when the cause of their not receiving their originals was Check 21 or ECC.

III. A New Payment Device: The Payroll Card

Paying employees by check is expensive for employers and runs the risk of lost, stolen, and forged checks, "padded payroll" (where a thief adds non-employees to the payroll), altered checks, etc. Employers, therefore, are increasingly transferring wages electronically into employees' bank accounts through direct deposit. Consumers participating in direct deposit are protected by Reg. E.³⁰ Direct deposit, however, is not possible for employees who do not have bank accounts. As a result, many employers are now paying wages to unbanked workers through "payroll cards." Some payroll cards are a type of debit card, while others are designed as a type of stored value card.³¹ Payroll

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electronic image, multiple electronic images are produced from the single original, or multiple substitute checks are produced from the electronic images and presented to the consumer's bank. In addition, the wrong account may be debited if the MICR numbers are altered in the transition from an original check, to a digital image, to a substitute check.

Consumers are entitled to a recredit up to \$2500 if they submit a claim that they suffered a loss due to an error in a transaction in which they are provided a substitute check and their bank cannot resolve the complaint within ten days.²⁵ The recredit right is a necessary safeguard for consumers who are subject to multiple debits, but Check 21 constructs a formidable barrier by imposing strict requirements for making a claim.²⁶

In addition, there are sections on warranties, indemnities, and damages. Unfortunately, there are many interpretive difficulties applying these sections. Some of these, however, have been resolved in the FRB's final rule. For example, it is not clear in the statute whether a bank must include substitute checks in the bank statement of those customers who have not agreed to truncation. From the Final Rule, however, it appears this is required.²⁷ If a consumer has agreed to truncation, but nevertheless demands a substitute check, it is not clear if the bank must provide one. If the bank, however, provides a substitute check, even if not required to do so, the consumer has the right to a recredit.²⁸ If the bank does not provide the substitute check, the consumer does not have a recredit right. Moreover, in order to benefit from the indemnity section, the consumer must have received a substitute check.²⁹ A bank that refuses

cards are plastic cards that are issued to employees. Employees can gain access to their wages by using the card at an ATM or at the point of sale. Payroll cards benefit both employers and unbanked employees. They are a less expensive way for employers to pay their unbanked workers. Employees avoid the expense of going to check cashers to obtain funds from their payroll checks.

Nevertheless, as described below, payroll cards also contain risks and costs for employees. One risk is that the law will not protect employees if they encounter problems.³² Currently, there is a bright line between stored value cards, including payroll cards, and debit cards. A pending FRB proposed rule would blur that line by subjecting payroll cards to the consumer protections of the EFTA and Reg. E.³³ If that proposal is not adopted, payroll cards would be subject to the private agreements between employers and employees and state law that does not contain consumer protection comparable to that in the EFTA.³⁴ If the proposal is adopted, it raises questions about what other types of stored value cards also may be subject to the EFTA.³⁵ In addition, the FDIC recently issued a proposal under which FDIC insurance would cover the funds accessed with certain types of payroll cards.³⁶

If the payroll card is treated as a stored value card, the employee may experience problems with no satisfactory legal remedy.³⁷ For example, if the card is stolen, the employee can recover the funds loaded onto the card only by recovering them from whoever stole it. Problems may arise if instead of having payroll cards issued by a bank, the employer uses a non-bank payroll card company. If that company becomes insolvent, employees may lose whatever funds remained on their cards.³⁸

Consumers face other problems regardless of whether the payroll card is treated as a stored value card or a card subject to Reg. E. The employee may be permitted to access funds only from a limited number of ATMs that may not be in locations convenient to the employee. Employees may have to pay a fee every time they use an ATM to withdraw a portion of their wages or after a limited number of withdrawals.³⁹ Employees may have to pay a monthly fee. If the fees are high, the costs may be as great as what employees pay to check cashers. There may be a POS fee every time employees use the card in connection with the purchase of goods. Inactivity fees may be imposed if an employee does not use the card for a certain period of time. There may be a fee every time new funds are loaded onto the card. If a card is lost, stolen, or defective, the employee may have to pay a fee to obtain a replacement card.

Payroll cards have come into wide use within a short time. Their success, together with the popularity of gift and phone cards, likely means new forms of stored value cards will be developed in the near future.⁴⁰ As payroll cards illustrate, stored value cards pose many risks for consumers. Moreover, there is no federal regulation and state regulation is spotty at best.⁴¹

IV. Payment Devices Subject to More Than One Set of Laws and a Payment System in the Legal Twilight Zone

Several types of payment devices are subject to more than one set of laws. For example, checks are subject to several separate federal laws.⁴² Checks also are subject to state law, raising questions of federal pre-emption.⁴³ Some so-called “telephone checks” are subject to a federal regulation and state law, while others are subject only to state law.⁴⁴ Whether payroll cards are subject to federal law may depend on how the employer sets up the accounts from which the money is transferred to the employees’ cards.⁴⁵

Millions of persons use the on-line payment system operated by PayPal.⁴⁶ It is unclear what set of laws it is subject to because its legal status is uncertain. PayPal asserts it is a money transmitter, not a bank. If regulators agree, it is subject to state money transmitter laws which are far less stringent than the rules imposed by bank regulation.⁴⁷ Several states have ruled that it does not qualify as a money transmitter. Other regulators have not rendered definitive rulings on PayPal’s status. PayPal’s status and the law applicable to it as a result of that status is of crucial importance to consumers and law enforcement agencies who have brought actions against PayPal. Several class actions have alleged, among other things, that PayPal freezes consumer accounts for long periods without justification.⁴⁸ The New York Attorney General found that consumers were misled into believing they had the same rights as those using credit cards when in fact they had fewer chargeback and billing dispute rights.⁴⁹

Perhaps PayPal is a unique case of a payment system that seems to fall between the regulatory cracks. Or perhaps it is a harbinger of things to come as the industry develops more novel systems and devices.



V. The UCC Finally Acknowledges that Consumers Are Entitled to a Little Protection

The UCC drafters have steadfastly refused to recognize that consumers should receive protection in the UCC for transactions involving negotiable instruments.⁵⁰ Instead, the position of the UCC’s sponsors has been that if a state wants to protect consumers, it should do so in other laws. Recently, however, the UCC has been amended to provide limited protection for consumers in two situations: (1) a new type of negotiable instrument; and (2) holder in due course status.

A. “Telephone Checks”

Consumers often deal with telemarketers, debt collectors, and others in ways that result in “telephone checks.” For example, when consumers order goods over the phone, sellers frequently request their checking account information. The seller may use that data to prepare a draft it presents to the consumer’s bank, resulting in the withdrawal of funds from the consumer’s account. That draft is referred to as a telephone check. Many consumers have alleged that phone transactions result in unauthorized withdrawals. Consumers complain that sellers and debt collectors obtain withdrawals when consumers have never authorized any, obtain multiple withdrawals when they authorized only one, or obtain only the one authorized withdrawal, but for an amount more than authorized.

To respond to this problem, in 2002 the UCC was amended to create a new type of negotiable instrument and to change the warranty rules to encourage the consumer’s bank (the payor bank) to recredit the consumer’s account when the consumer complains that an unauthorized withdrawal was made pursuant to a telephone check. The new negotiable instrument introduced in the 2002 amendments is called a “remotely-created consumer item.”⁵¹

As a general rule, if the consumer’s bank pays a check that the consumer did not authorize, the loss is on the bank unless it can recover from the wrongdoer. Amended Articles 3 and 4, however, include special warranty rules for telephone checks that enable the consumer’s bank to push liability back to the depository bank. The consumer’s bank is not required to take advantage of the new warranty rules. The expectation, however, is that the consumer’s bank will be more willing to recredit the consumer’s account if it can avoid liability by passing it on to another bank.

That expectation may not be met very often, however. The consumer’s bank may prefer not to get into a fight with the depository bank. Instead, the bank may refuse to recredit the consumer’s account, assuming consumers will not want the burden and expense of suing their bank. Instead, the consumer likely will terminate her account with that bank in anger and disgust. The prospect of losing a few low profit consumer accounts may not be enough to motivate banks to exercise their new warranty rights against depository banks.

As of April 2004, no state had yet adopted any of the 2002 amendments to Articles 3 and 4, except Minnesota. That state adopted the amendments, but refused to enact the provision on telephone checks. Instead it adopted

a non-uniform amendment that is similar to statutes that have been enacted in several other states. These jurisdictions have passed “demand draft” statutes that are like the UCC’s provisions on remotely-created consumer items except they apply both to consumer and non-consumer drafts that do not contain the drawer’s signature.⁵² These statutes also include a ‘reciprocity provision.’ The favorable warranty rules that permit the payor bank to pass liability to another bank apply only if the state where the other bank is located has reciprocated by also adopting the special warranty rules.

Banks favor the demand draft approach because under that system they do not have to distinguish between consumer and non-consumer checks, which they claim is difficult operationally. Amended Articles 3 and 4 apply only to consumer telephone checks so banks have to determine which checks fall into the consumer category. The American Bankers Association has opposed adoption of amended Articles 3 and 4 because of the alleged operational difficulties the telephone check provision requires.⁵³

B. Non-UCC Law Governing Telephone Transactions

Further complicating matters, some who do business with consumers over the phone are subject to a federal law in addition to the UCC. Those who engage in telemarketing are governed by the FTC’s Telemarketing Rule.⁵⁴ That rule requires telemarketers to follow strict requirements for obtaining the consumer’s “verifiable authorization.” The rule applies to consumers who pay with telephone checks. But some consumers pay with credit cards or debit cards; the authorization requirements do not apply to them. (Reg. Z and Reg. E apply instead.) If the consumer pays by means of an electronic fund transfer other than a debit card, however, the authorization requirements apply.

When a business in a phone transaction has the consumer pay by an electronic fund transfer instead of a check, the transfer usually is sent through the Automated Clearing House Network and is subject to the NACHA rules. Those rules contain several specific requirements for electronic transfers pursuant to telephone transactions.⁵⁵ In addition, because of the large numbers of consumers complaining about unauthorized ACH telephone transfers, in 2003 NACHA instituted a new procedure allowing the association to investigate businesses subject to many consumer complaints that they have engaged in unauthorized transfers.⁵⁶

This brief description of the patchwork of rules governing payment for transactions over the phone illustrates the trend toward increased legal complexity in the current development of payments law.⁵⁷

C. Effectuating the FTC Holder Rule

The FTC Holder Rule requires that negotiable instruments used in certain consumer transactions contain a legend that effectively destroys the ability of a transferee to claim holder in due course status.⁵⁸ The question arose as to the status of a person who obtained an instrument that failed to contain the required legend. In the 2002 amendments to the UCC, a new provision was added to section 3-305 which has the effect of treating the instrument as if it did contain the required legend, thereby negating the transferee’s ability to claim holder in due course status on these instruments as well.⁵⁹

VI. New Legal Regimes Imposed by the Feds and a Private Organization

Consumer payments law used to be solely the province of the UCC. Then, the federal government became involved in a limited way with passage of the EFTA and the Expedited Funds Availability Act (EFAA) together with Reg. CC.⁶⁰ Although the EFAA and Reg. CC intruded upon a legal regime that previously had been governed exclusively by the states through the UCC, they apply only to checks and the UCC was able to accommodate the federal rules without difficulty by making relatively minor adjustments to Article 4 to ensure there was no conflict. When enacted, the EFTA applied only to electronic payment devices and systems that were still quite new and little used.

The events of the recent past, however, will have a far more pronounced effect. Check 21 represents a dramatic imposition of federal power upon check transactions. It was enacted in order to further implement national policy to push the entire payments system toward elimination of checks and eventual universal adoption of electronic payments.⁶¹ In the aftermath of Check 21, lawmakers may want to reconsider the continued viability of the UCC process. Does the federal-state patchwork still make sense or should our national payments system be governed by federal law that reflects national policy? Does the application of both Check 21 and Reg. CC render the federal-state arrangement too cumbersome? Federal law and the UCC adopt fundamentally different approaches. Federal law establishes one set of uniform rules. It truly is a uniform code. The Uniform Commercial Code, despite its title, allows for non-uniform amendments, an approach that is directly counter to the federal one-size-fits-all approach.⁶² Does it make sense for check transactions to be subject to laws that take two very different approaches?

Electronic transfers are no longer new and relatively little used.⁶³ NACHA, a private organization with no government affiliation, has issued rules governing ACH transfers for several years and has been increasingly active adopting rules to govern new consumer payment systems and devices.⁶⁴ On the one hand, this is a positive development. NACHA can act faster than governmental bodies in responding to new market developments. Moreover, from the consumer’s perspective, the new rules NACHA has drafted have been largely protective of their interests. Nevertheless, from a jurisprudential perspective, it is troubling that state and federal governments have, in effect, delegated such important matters to a private law-making body, for the NACHA Rules embody significant policy decisions.

VII. Conclusion

The picture that emerges from this brief survey of recent developments in payments law raises profound policy issues. Given the plethora of new payment devices and systems for processing payments and the increasingly complex patchwork of laws and private rules applicable to them, legislators might consider simplifying the law to make it somewhat uniform and guarantee at least a few basic consumer protections. Questions lawmakers and regulators should consider include the following: Does it make sense to have different rules for consumer liability for unauthorized transactions depending upon whether payment is by check, credit card, debit card, or stored value card? Should the right to an error resolution procedure depend upon what type of

payment device is used? Should payment law instead be entirely federal with model disclosures, notices, and forms?⁶⁵ What is the proper role for private rulemaking bodies such as NACHA?

While it is uncertain whether lawmakers will undertake major payment system law reform, some developments can be predicted with confidence. In the future, many new payment devices will be invented and electronic systems will become more pervasive. There will continue to be changes in consumer behavior. For example, in the past few years payment by check has decreased markedly, and the use of debit and stored value cards has increased substantially.⁶⁶ A few states will enact laws to plug the holes left in federal statutes, such as the failure to regulate stored value cards, while most states do nothing.⁶⁷

The situation will become increasingly confusing to bank customers, both commercial and consumer, bringing new challenges to those educating them. To the extent that the task of customer education falls to the lawyers, even those who have taken courses in payment systems may find themselves ill-equipped. Because of the sheer volume of new laws and their complexity, teaching payments law has become far more challenging. Teachers have to make difficult decisions about what to include and what to eliminate, or at least spend much less time discussing. For example, some law professors still devote most of the course to basic negotiable instruments law under the UCC. Others believe there is far less need to teach negotiable instruments law⁶⁸ and the holder in due course doctrine is not very important.⁶⁹ Whichever approach a teacher takes, there will be major gaps in their students' knowledge unless their school offers an advanced course as well.

* Professor of Law, Georgia State University College of Law. Copyright 2004. This article was originally presented at the University of Houston Center for Consumer Law's "Teaching Consumer Law Conference," held in May of 2004.

1. Up-to-date sources on payments law include FRED H. MILLER & ALVIN C. HARRELL, *THE LAW OF MODERN PAYMENT SYSTEMS* (2003); BARKLEY CLARK & BARBARA CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS* (2004).
2. 15 U.S.C. § 902 et seq.
3. 12 C.F.R. Part 205. The Federal Reserve Board has proposed amending Reg. E to define the term "account" to include a payroll card account that is directly or indirectly established by an employer to transfer wages electronically on a recurring basis. 69 Fed. Reg. 55996, 55998 (2004). The term would not include one-time transfers such as a bonus, or non-salary types of payments such as travel reimbursements. *Id.* at 55999.
4. 12 U.S.C. § 4001 et seq.
5. 12 C.F.R. Part 210.
6. Check Clearing for the 21st Century Act, P.L. 108-100, 17 Stat. 1177 (2003)(hereafter Check 21).
7. "Floaters" of checks are sunk. Banks' new digital facsimiles will zap lag time between writing and processing checks. Akron Beacon J., July 18, 2004, available at 2004 WL 56280286 ("Surveys show lots of confusion already exists about Check 21. The law doesn't apply to transactions done through the Automated Clearing House Network.")
8. 12 U.S.C. §5001 et seq.
9. The financial services industry also calls this system ARC and POP, acronyms used by NACHA. POP stands for Point of Purchase ACH entries; ARC stands for Accounts

Receivable ACH entries. See 2004 ACH Rules: A Complete Guide to Rules and Regulations governing the ACH Network (2004)(hereafter NACHA Rules).

10. An estimated 41% of banking customers receive their cancelled checks with their bank statements. Banks Prepared For Check 21, But What About Their Customers? Item Processing Rpt., July 1, 2004, available in 2004 WL 61716541 (reporting on a 2003 Global Concepts study).

11. UCC § 4-406(a). Comment 1 acknowledges that consumers also would normally want to know the name of the payee and the date of the check, but the UCC does not require this information on the statement because it cannot be obtained from the MICR line. The entity retaining the checks must either keep the original or "maintain the capacity to furnish legible copies" for seven years. §4-406(b).

12. See Mark Budnitz, *CONSUMER BANKING AND PAYMENTS LAW 41-48* (National Consumer Law Center, 2004 Supplement)(hereafter Consumer Payments Law (2004 Supp.)).

13. Reg. E Official Staff Interpretation § 205.3(b)-3.

14. For example, under the NACHA rules the merchant must provide the consumer with a receipt that contains the merchant's name and telephone number, the date, the amount, the check serial number, and a number that identifies the merchant or the location of the transaction. Rule 3.7.3, NACHA Rules, *supra* note 9. There are specific rules for obtaining the consumer's authorization. *Id.* Rule 2.1.2. In addition, the merchant must void the check used as a source document. *Id.* Rule 3.7.1.

15. A third variation is called "drop box" ECC, in which the consumer goes to a designated location and pays the bill in person. It is subject to the same rules as lock box ECC.

16. For example, the consumer has a right to stop payment as long as this is done in time for the bank to have a reasonable opportunity to act on the consumer's stop payment order. Rule 7.4, NACHA Rules, *supra* note 9. Rules of conduct are imposed on the merchant. For example, the merchant must destroy the check within fourteen days of the settlement date. *Id.* Rules 2.9.3.3 & 2.9.3.4.

17. The text contains a brief discussion of only a few of the features of and issues raised by Check 21. For a more detailed analysis, See National Consumer Law Center, *New Check 21 Act Effective Oct. 28, 2004: Banks Will No Longer Return Original Cancelled Checks*, <http://www.consumerlaw.org>. See Consumer Payments Law (2004 Supp.), *supra* note 12, at 14-25.

18. Check 21 § 13.

19. See Consumer Payments Law (2004 Supp.), *supra* note 12, at 41-48.

20. Check collection was severely disrupted in the days after Sept. 11, 2001 when all non-military air transport was prohibited.

21. Check 21 § 12(a)(1).

22. Check 21, Final Rule, 69 Fed. Reg. 47290, 47322 (2004)(hereafter Final Rule).

23. Check 21 § 4(b)(2).

24. See *e.g.*, Final Rule, 69 Fed. Reg. at 47323-24; Check 21, Proposed Rule, 69 Fed. Reg. 1470, 1496-97, 1499 (2004).

25. If the amount of the substitute check is more than \$2500 and the bank has not resolved the complaint within 45 days, the remainder of the amount of the substitute check must be recredited. Check 21 § 7(c)(B)(ii).

26. *Id.* at § 7(b).
27. Final Rule, 69 Fed. Reg. at 47322.
28. *Id.* at 47325.
29. Check 21 § 6(a).
30. Reg. E, 12 C.F.R. § 205.3(b)(3).
31. Stored value cards, including payroll cards also are referred to as “prepaid cards.” See generally Mark Furletti, Conference Summary, Prepaid Cards: How Do They Function? How Are They Regulated? 10-11 (Fed’l Reserve Bank of Philadelphia June 2-3 2004)(hereafter How Do They Function?)(describing features of payroll cards).
32. Problems include torn cards, cards with defective magnetic stripes, erroneous amounts stored on cards, and amounts stored on cards later than when due.
33. The Federal Reserve Board has proposed amending Reg. E to include payroll card accounts “whether the funds are held in individual employee accounts or in a pooled account, with ‘subaccounts’ maintained by a depository institution (or by a third party) that enable a determination of the amounts of money owed to particular employees.” 69 Fed. Reg. 55996, 55999 (2004). If the employer opens a separate account for employees the USA Patriot Act also might apply, although this is unclear. One of the Act’s requirements is that the financial institution verify the identity of customers for whom it has opened an account. See Mark Furletti, Prepaid Card Markets & Regulation, 12 (Fed’l Reserve Bank of Philadelphia Feb. 2004), available at <http://www.phil.frb.org/pcc/index.html>.
34. See generally Judith Rinearson, *Regulation of Electronic Stored Value Payment Products Issued By Non-Banks Under State ‘Money Transmitter’ Licensing Laws*, 58 BUS. LAW. 317 (2002) (describing various states’ laws on stored value cards in the absence of federal regulation).
35. In justifying its proposal to extend Reg. E to payroll cards, the FRB noted that Congress intended the term “account” to be defined broadly. 69 Fed. Reg., 55996, 55998 (2004). The FRB also pointed out that the salaries paid through payroll cards often represent the “bulk of the consumer’s income” and the cards use the same types of access devices, electronic terminals, and other EFT services as traditional electronic transfers. *Id.* at 55999. Cards that deliver child support payments often share these characteristics. Cards that deliver insurance payments to disaster victims may serve a function just as crucial to a person’s financial well-being as a payroll card. In the future, these and other types of stored value cards also may be subject to Reg. E.
36. Definition of “Deposit”; “Stored Value Cards,” 69 Fed. Reg. 20558 (2004). The proposed rule applies to stored value cards generally, and payroll cards are subject to the general rules. The FDIC does not propose to issue special rules designed specifically for payroll cards.
37. The problems described assume nothing in the agreement between the employer and the card issuer protects the employee when the problems described in the text arise. See Consumers Union, Payroll Cards: Issues for Employers, http://www.consumersunion.org/pub/core_financial_services/000920.html.
38. Sixteen or more states have amended their money transmitter laws to include prepaid card issuers. Regulators in some other states believe their laws apply to prepaid card issuers even without an explicit reference to prepaid card issuers. These laws contain provisions to ensure the safety and soundness of money transmitters. See Furletti, *supra* note 33, at 15. Consumers in states that do not have laws ensuring the financial soundness of prepaid card issuers such as payroll card vendors are at risk if the vendor goes out of business.
39. How Do They Function, *supra* note 31, at 11.
40. Recent IRS rulings have facilitated the use of flexible spending and health reimbursement cards. Furletti, *supra* note 33, at 9. The federal government is implementing a payroll card for contractors and government employees, including the military. *Id.*
41. See Mark Budnitz & Margot Saunders, CONSUMER BANKING AND PAYMENTS LAW (2nd ed., 2002) at 170 (hereafter Consumer Payments Law). See Model Stored Value Card Protection Act, *id.* at 397-99. See Consumer Payments Law (2004 Supp.), *supra* note 12, at 81-82.
42. Checks are subject to Check 21 as well as the Expedited Funds Availability Act and Reg. CC. Checking accounts also are subject to the USA Patriot Act and the Bank Secrecy Act.
43. The principal state statute governing checks is the UCC.
44. See Part V, *infra*, for an explanation of the law of telephone checks.
45. See *supra* text accompanying note 33.
46. The company has been acquired by e-Bay. There are approximately 2 ½ million PayPal account holders in New York state alone. In the Matter of PayPal, Assurance of Discontinuance, Attorney General of the State of N.Y. Internet Bureau (Feb. 2004). Available at http://www.oag.state.ny.us/press/2004/mar/mar8a_04_attach.pdf.
47. See generally Consumer Payments Law, *supra* note 41, at 46.
48. Lisa Napoli, PayPal sued over frozen funds, <http://msnbc.com/news/712822.asp?cp1=1>. A settlement was announced in August, 2004. PayPal settles for \$9.25 million, St. Petersburg Times, August 2, 2004 available at 2004 WL 56643275.
49. The Attorney General and PayPal entered into an Assurance of Discontinuance. Assurance of Discontinuance, *supra* note 46.
50. See Fred H. Miller, *U.C.C. Articles 3, 4 and 4A: A Study In Process and Scope*, 42 ALA. L. REV. 405, 412-16 (1991)(explaining why the UCC drafters decided not to include consumer protection in Articles 3 and 4); See UCC § 4-101, Official Comment 3; § 4-406, Official Comment 3. See generally Norman I. Silber, *Consumer Protection and the Uniform Commercial Code: Substance Abuse at UCC Drafting Sessions*, 75 WASH. U. L. Q. 225 (1997).
51. UCC § 3-103(a)(16). It is an item “not created by a payor bank and does not bear a handwritten signature purporting to be the signature of the drawer [the consumer].” An “item” is an instrument handled by a bank for collection or payment. § 4-104(a)(9).
52. States with demand draft statutes include California, Colorado, Hawaii, Idaho, Nebraska, New Hampshire, North Dakota, Oregon, Tennessee, Texas, Utah, and West Virginia. Consumer Payments Law (2004 Supp.), *supra* note 12, at 11.
53. It is unclear how much of a burden the telephone check amendment would impose. Under Check 21, banks will have to differentiate between consumer and non-consumer accounts because consumers are accorded special protections under that Act. See Part II, *supra*. The FRB requested comment on whether to incorporate the UCC amendments

into Reg. CC. Commenters overwhelmingly supported the proposal, but some want the provision to apply to all drafts, not solely to consumer drafts. The FRB announced it would issue a proposal later in 2004. Final Rule, 69 Fed. Reg. at 47306 (2004).

54. Telemarketing Sales Rule, 68 Fed. Reg. 4580 (2003); 16 C.F.R. § 310.3(a)(3). Consumer Payments Law (2004 Supp.), supra note 12, at 11-12. See also state laws governing the authorization of payment instruments in telemarketing transactions. E.g., 9 Vt. Stat. Ann. 2464, noted in UCC § 3-416, Official Comment 8, as amended in 2002. See generally Payment Processor Barred From Helping Telemarketers, Banking Rep., April 19, 2004, at 703 (FTC filed proposed consent judgment against company that processed electronic debit to consumer accounts on behalf of fraudulent telemarketers, in violation of the Telemarketing Sales Rule).

55. Rules 2.1.5 and 13.1.58, NACHA Rules, supra note 9. See Consumer Payments Law (2004 Supp.), supra note 12, at 53-56.

56. Unauthorized Telephone-Initiated Entry Reporting Requirements, NACHA Rules, at R 12, supra note 9 (explaining 2003 rule amendment authorizing investigation of businesses with numerous consumer complaints of unauthorized transfers via telephone communication with consumers).

57. See Part IV, supra, for further illustrations of payments subject to more than one body of law.

58. 16 C.F.R. Part 433.

59. UCC § 3-305(e) and Official Comment 6.

60. 12 C.F.R. Part 229.

61. Andrea S. Klein, *Putting All Payment Data in One Place*, AM. BANKER, April 23, 2004, at 11 (“The Check 21 Act, enacted by Congress and the Federal Reserve, begins the process of moving to a paperless environment.”). See generally Remarks by Chairman Alan Greenspan, Fed’l Reserve Payments System Development Committee 2003 Conference (Oct. 19, 2003)(“[T]he U.S. Government is actively working on new technologies and services to increase the use of electronics in both its payments and collections.”).

62. There have been many non-uniform amendments affecting consumer check payment transactions. See, e.g., Consumer Payments Law, supra note 41, at 11 (non uniform amendments to § 4-406).

63. W.A. Lee, *Visa Debit Card Volume Tops Credit Worldwide*, AM. BANKER, April 20, 2004, at 11 (reporting that Visa International announced that, for the first time, in 2003 debit card volume worldwide exceeded credit card volume, \$1.48 trillion versus \$1.45 trillion).

64. E.g., ARC Opt Out Requirement, Notice of Amendment to the 2004 ACH Rules (April 6, 2004)(describing 2004 amendment requiring businesses engaging in electronic check conversion to permit consumers to opt out of electronic check conversion); Unauthorized Telephone-Initiated Entry Reporting Requirements, NACHA Rules, supra note 9, at R 12 (explaining 2003 rule amendment authorizing investigation of businesses with numerous consumer complaints of unauthorized transfers via telephone communication with consumers).

65. The issue of federal pre-emption of state law for national banks by the OCC is beyond the scope of this paper.

66. MasterCard predicts the use of stored value cards will soon expand tremendously. Furletti, supra note 33, at 9 (MasterCard estimates stored value cards may account for \$0.5 trillion in consumer payments).

67. See Consumer Banking Law (2004 Supp.), supra note 12, at 82 (describing state laws regulating stored value cards).

68. Professor Mann’s recent casebook relegates negotiable instruments and holders in due course to the end of his book, starting on page 397. RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS 397-447 (2003). See id. at 398 (stating that negotiable instruments are “considerably less common than they were even a generation ago.”).

69. *Id.* at 443 (stating that holder in due course does not “play a significant role in the checking system.”). Check cashers, however, may disagree. They often rely on the holder in due course doctrine in cases where they are sued by consumer drawers. See Consumer Banking Law, supra note 41, at 22.