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FOR THE UNIFORM COMMERCIAL CODE

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

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

Re: Amendments to Regulation CC, 12 C.F.R. Part 229
Docket No. R-~~1179~~ 1176

Dear Ms. Johnson:

The Permanent Editorial Board for the Uniform Commercial Code welcomes this opportunity to comment on the proposed amendments to Regulation CC that, among other things, will implement the Check Clearing for the 21st Century Act. As you may know, the Permanent Editorial Board ("PEB") is a body of representatives of law practice and the academy and is sponsored jointly by the American Law Institute and the National Conference of Commissioners on Uniform State Laws.[1] Its functions are to advise both sponsoring groups on developments in the law that require study or action and to provide guidance on the provisions of the Uniform Commercial Code in the form of PEB Commentaries.

Pursuant to our responsibilities to advise our sponsors on developments that require study or action, we have reviewed the Check Clearing for the 21st Century Act ("Cheek 21") and the proposed amendments to Regulation CC. Our focus has been to identify how the Act and proposed regulation will interact with provisions of Articles 3 and 4 of the Uniform Commercial Code and, particularly, those parts of the proposal that may require clarification for the smooth functioning and transparency of the check collection system. We have identified a small number of issues that the PEB believes require further attention in the final version of the amendments. We also urge the Federal Reserve Board ("Board") to extend Regulation CC to provide a warranty from the depositary bank or first collecting bank in the United States in favor of subsequent collecting banks and the payor bank for remotely-created items, which are covered under the current definition of the word "check" in Regulation CC.

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

These comments are organized in five parts. In the first part, we discuss our support for extending the rules for remotely-created items in Regulation CC. Next, we discuss issues in the proposed supplemental definitions of the Article 3 terms "transfer" and "consideration." In the third part, we support both the proposed exclusion from the concept of "alteration" of repairs to MICR lines that the banking industry customarily makes and the Board's proposal to limit the scope of "legal equivalence" of a substitute check to checks that do not contain "MICR-read errors" and to grant warranty, indemnity, and recredit rights to persons who suffer losses occasioned by "MICR-read errors." In the fourth part, we support the idea that a second charge resulting from an ACH debit transaction that was created using information from an original check or a substitute check ought to be eligible for coverage under the duplicative payment warranty in Check 21 and Regulation CC. Finally, we discuss some technical issues that arise under the proposed amendments. These observations focus on the relationship between Regulation CC and Articles 3 and 4 of the Uniform Commercial Code ("U.C.C.").[2]

1. Support for inclusion of liability rules for "remotely-created items" under Regulation CC

In response to the Board's specific request for comments on whether it would be appropriate to incorporate into Regulation CC the 2002 revisions to the U.C.C. regarding remotely-created consumer items, the PEB recommends their incorporation.

Remotely-created checks are ones that payees create on the verbal instructions of drawers, using account information supplied by drawers. The payee who creates these checks frequently inserts a phrase such as "on behalf of the drawer" in the location usually used for drawers' signatures on checks that drawers themselves issue. Remotely-created checks are in widespread use by legitimate debt collectors and other payees to speed up receipt of payment from persons who owe debts or who expect to receive goods or services from the payees. Unhappily, some less scrupulous payees create these checks in amounts different from the amounts the drawer authorized, or create duplicate or multiple checks when the drawer intended to authorize only one check. These are abuses of what is otherwise a valuable innovation in payments.

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[2] As indicated in Part 5 of these comments, Regulation CC appears to incorporate rights available under other law, specifically and appropriately including the U.C.C. The PEB is concerned about the possible impact of the recent Rule of the Office of the Comptroller of the Currency preempting state law as to the deposit taking and lending activities of national banks. 12 CFR Parts 7 and 34, 69 Fed. Reg. 1904 (Jan. 13, 2004). Paragraphs 7.4007(b)(2) and 7.4008(d)(2), respectively, appear to preempt "state law limitations" concerning "checking accounts" and the making of "non-real estate loans," thereby raising questions as to whether "limitations" in Articles 3, 4, 4A, and 9 are applicable to national banks. For example (and directly relevant to an analysis and application of Regulation CC), the OCC Rule may preempt the limitations in U.C.C. § 4-406 on the ability of a payor bank to shift or allocate loss for an unauthorized signature or alteration to a customer who fails to exercise reasonable promptness and care in examining its bank statement and discovering and reporting an unauthorized signature or alteration. (There are numerous other examples.) The PEB urges that a process begin immediately among the Board, the OCC, and the PEB to clarify and resolve questions concerning the consequences of the OCC Rule.

Because, in our view, remotely-created items are already included in the definition of "check" under Regulation CC,[3] we infer that your request pertains to whether the Board ought to adopt rules of liability for remotely-created items. Even though this will involve some preemption of state law, the PEB's answer is yes,[4] for the following reasons.

As you know, the 2002 revisions to Articles 3 and 4 of the U.C.C. include both a definition of "remotely-created consumer items,"[5] and additions to the transfer and presentment warranties made by a person who transfers or presents a remotely-created consumer item. The transferor or presenter warrants that the person on whose account the draft is drawn has in fact authorized issuance of the draft in the amount for which the item is drawn.[6] If an item is paid that the drawer-customer did not authorize, or is paid in an amount not authorized by the drawer-customer, then the payor bank may enforce the warranty and, eventually, the loss associated with the item returns to the depositary bank. The goal is to protect the payor bank and the drawer-customer from this type of check fraud (or error) and to create incentives for depositary banks to supervise their relationships with the depositors of these items more carefully.[7] No state has yet enacted these uniform revisions. California, Texas, and Nebraska have enacted warranties that reach remotely-created items but only if all of the transferors make the new warranty. Under these "reciprocal" warranties, if a depositary bank is in a state that has not enacted a warranty for remotely-created items, then none of the other banks in the collection chain make the warranty. The loss associated with paying these checks will continue to fall on the payor bank, which is not in a position to prevent these losses except by discovering and then dishonoring every remotely-created check and exposing itself to liability for wrongful dishonor. At least one more state, Minnesota, which previously amended Articles 3 and 4 to cover all remotely-created items, is considering enacting a "reciprocal" warranty for remotely-created items. Maine is considering a bill on the California and Texas model. Massachusetts has before it a bill based on the 2002 uniform revisions. Thus, instead of the uniform, universal treatment of remotely-created items that NCCUSL and ALI envisioned when they approved the 2002 revisions, we have a developing situation in which less uniformity is likely.

The "reciprocity" scheme enacted or proposed in California, Texas, Nebraska, and Minnesota creates a problem that a remotely-created-items warranty in Regulation CC would resolve. Under the existing non-uniform state of play, a company creating large numbers of these items could avoid the new uniform transfer and presentment warranties and continue to insulate itself and its depositary banks by selecting depositary banks in states that have not adopted these warranties. New York, for example, does not have and is not considering the warranty as part of its proposed revisions to Articles 3 and 4. Accordingly, if a depositary bank in New York took a remotely-created item for collection, it could do so with immunity under unrevised Articles 3 and 4 and the versions enacted in California, Texas, and Nebraska, and payor banks in any setting in which the

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[3] 12 C.F.R. §229.2(k) (2003).

[4] In supporting the incorporation of the 2002 UCC revisions with respect to remotely-created consumer items into Regulation CC, we confine our response to the question posed by the Board. This should not be construed as a statement of the PEB's position on a broader question not posed by the Board – whether the scope of those revisions should also be extended in Regulation CC to cover non-consumer items. The PEB has taken no position either for or against such a broadening.

[5] U.C.C. § 3-103(a)(16)(2002).

[6] U.C.C. §§ 3-416(a)(6), 3-417(a)(6), 4-207(a)(6), and 4-208(a)(6) (2002).

[7] 69 FED. REG. 1470, 1482.

depositary bank did not give the new warranty would continue to bear the fraud risks associated with these items.

We note that if a remotely-created item is deposited outside the United States, rules that place responsibility on the depositary bank would be ineffective. Accordingly, the PEB also recommends that, in such case, the warranties commence with the first bank in the United States that takes the item for collection or for value and run forward to the payor bank. The first U.S. bank must necessarily protect itself through appropriate agreements with its non-bank customers or through agreements with its bank transferors, but this approach would afford to payor banks and drawers in the United States uniform protection even if the telemarketer that contacts the drawer and later creates the remote item, or its depositary bank, is not located in the United States.

2. Support for the proposed expansion of the definitions of "transfer" and "consideration"

Check 21 provides that a bank that transfers, presents, or returns a substitute cheek, and receives consideration for the check, warrants, as a matter of law, to the transferee, any subsequent collecting or returning bank, the depositary bank, the drawee, the drawer, the payee, the depositor, and any indorser that the substitute cheek meets all of the requirements for legal equivalence under Section 4(b) of the Act and that no one shall be required to make a payment based on a check that the beneficiary has already paid. (Check 21, Section 5.) This means that, for example, if a payor bank creates and returns a substitute cheek in lieu of the original, it gives two warranties in the return process – first, a warranty that the substitute check meets the requirements for legal equivalence provided in Section 4 of the Act and, second, a warranty against a double debit, that is, a warranty that recipients will not be asked to pay if they have already paid or been charged for the original check.

The Board obviously believes that the warranty, indemnity, and recredit rights due under Check 21 should extend to the situation in which a payor bank creates and delivers a substitute check to its customer as part of the bank statement provided under U.C.C. §4-406. Traditionally, the delivery of paid items as part of a bank statement would not be considered a "transfer" for "consideration," the trigger event for the warranty under Check 21. For this reason, the Board has proposed to supplement the definitions of the terms "transfer" and "consideration" in order to provide the Check 21 warranties and other indemnity and recredit rights to those drawers who receive substitute checks created by their payor banks solely for inclusion in the bank statements. We support the Board's inclination to provide the warranty, indemnity, and consumer recredit rights to drawers under these circumstances.

To reach this outcome, the PEB recommends that the Board adopt the proposed expanded definitions of "transfer" and "consideration" with one minor revision. The placement of the qualifying clause "for the purposes of Subpart D" should be moved so that the final definition would read: "The terms *transfer* and *consideration* have the meanings set forth in the 2003 Official Text of the Uniform Commercial Code[8] and, in addition, for purposes of Subpart D ...."

[8] We suggest that this reference be to the "2003 Official Text of the Uniform Commercial Code," rather than simply to the Uniform Commercial Code (which is defined in § 229.2 of Regulation CC as the U.C.C. as

3. Support for the proposed exclusion, from the definition of "alteration," of certain corrections of information in the MICR line, and for separate treatment for "MICR-read" errors

The Board has made two proposals concerning banks' handling of MICR lines in conjunction with creating substitute checks. The PEB supports both proposals.

The first proposal deals with the custom in banking of correcting observed errors in MICR encoding so that the item can be processed in the manner intended. The proposed official staff comments on the definition of "substitute check" in §229.2(zz) and on 5229.51'srules for legal equivalence of the substitute check to the original describe ways in which the MICR line of a substitute check may vary from the MICR line of the original check. The first of these comments specifically discusses customary practice in the banking industry for banks to repair the MICR line that, for example, contains an encoding error in the amount field; and the comment states that such a repair would not constitute an alteration of the item in question.

In addition, the second of these comments deals with cases in which, although the MICR line of the original check was correct, the imaging equipment used to create the substitute check fails and introduces an error. These errors, known as "MICR-read errors," include failing to read a portion of the MICR line but noting the presence of MICR information on the original check by the inclusion of an asterisk where the original information would have been. (That is, the imaging equipment would misread the original check and insert an asterisk where there had been a "2", or might, as the equipment is programmed, read a space holder in the MICR line to be a "0.") Because of these errors, the resulting substitute check would not qualify as the "legal equivalent" of the original.

The Board proposes to apply to these "purported substitute checks" the warranty, indemnity, and applicable recredit provisions of Check 21. The recipient of a purported substitute check, as a result, would have the warranty, indemnity, and recredit rights granted in Check 21 to protect it against loss that arose because the recipient received neither the original check nor its legal equivalent. The Board notes that applying the warranty, indemnity, and applicable recredit rules to substitute checks facilitates compliance with Check 21 and also prevents evasion of its requirements. We support these goals.

4. Support for inclusion, in the Section 4 substitute-check warranty, of a second charge resulting from an ACH debit that was created using information from an original check or a substitute check

The Board asked for comments on whether using information from an original check or a substitute check to create an ACH debit entry ought to be a payment request covered by the warranty against duplicative payment under Check 21 and Regulation CC. The Board explains that such an ACH debit entry could be considered "an electronic version" of a substitute check or original check and so might qualify as a payment to which the duplicative payment warranty should ap-

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adopted in a state), because the former text of the U.C.C. still in effect in two states – New York and South Carolina – does not explicitly provide meanings for both of these terms.

ply. Although the Board covers the type of "check conversion" that uses information from an original check to create an ACH debit under Board Regulation E and rules of the National Automated Clearing House Association, the PEB nevertheless believes that a second charge from an ACH debit that used information from an original check or a substitute check should be covered by Check 21's Section 4 duplicative warranty provisions.

5. Some technical issues that bear on the relationship between U.C.C. Articles 3 and 4 and Check 21 and Regulation CC

It is extremely important that the relationship between Check 21 and Regulation CC and the U.C.C. be stated as clearly as possible. We have three concerns that bear on this relationship.

Our first concern focuses on the use of terminology in the proposed amendments, explanatory materials, and proposed official staff commentary that varies from longstanding use of the same words in U.C.C. Articles 3 and 4. For example, the verb "accept" and the noun "acceptance" have particular meanings in payments law; both describe a particular contract established under Article 3. At various points, the *Federal Register* materials use the word "accept" when it would appear what is meant is "take" (as in "take for collection" or "take for value"). In addition, the term "party" is not synonymous with the word "person" in Articles 3 and 4; rather, a "party" is a "person" who signed the instrument and against whom enforcement may be sought. To avoid creating confusion with terminology, the PEB uraes that the final regulation use the word "take" (rather than "accept") when the Board means "take for collection" or "take for value," and that it use '"party" only if referring, as the U.C.C. does, to a "person" who signed the instrument. Use of these traditional terms in their traditional ways will reduce the likelihood that someone will infer that a different meaning is intended in Regulation CC.

A second concern arises because proposed Regulation CC calls for the "reconverting bank" to identify itself and, if a different bank served as the "truncating bank," to identify that bank on the front of the substitute check. Longstanding payments law and practice recognize signatures made on the faces of drafts as "acceptances" – that is, as the drawee's signed engagement to pay the check. (See U.C.C., e.g., $3-409.) Thus, because we believe that the Board does not intend those identifiers to be read as Article 3 "acceptances," the PEB urges either moving those identifiers to the back of the instrument or stating clearly that any identifications of the reconverting and, as appropriate, truncating banks on the face of the instrument do not constitute "acceptances" of the draft. A similar question arises regarding the treatment of the "reconverting bank" and ''truncating bank" identifiers as "indorsements." To the extent that the Board does not intend these identifiers on the face of the substitute check to be "indorsetnents" (and, therefore, contracts for Article 3 purposes), the PEB suggests that the Board say so.

Our third concern – perhaps of greater significance in terms of the relationship between the U.C.C. and Check 21 – arises from the proposed sections of Regulation CC that state that those sections preserve rights available under the U.C.C and other law. It is important that references to rights arising outside Check 21 be as consistent as possible so that courts will interpret them as uniformly as possible. For example, references to preservation of rights arising outside of Check 21 appear in two subsections of §229.53, the indemnity provision. In the explanatory materials for proposed §229.53(b)(2) (effect of comparative negligence on the indemnity amount), the draft states

that the amount of indemnity will be reduced by the Comparative negligence or lack of good faith of the claimant, and in addition states that "nothing in that comparative negligence section reduces any person's rights under the U.C.C. or other applicable law."[9] The following text discussing §229.53(b)(3) (effect of producing an original check or sufficient copy on the indemnity amount) notes that production of an original check "does not absolve the indemnifying bank from liability for breaching a substitute check warranty or a warranty established under any other law."" The primary warranty "established under any other law" would include the transfer, presentment and encoding warranties available under the U.C.C. Failure to mention the U.C.C. as a source of other law in the second example, when it is mentioned in the first, suggests that the Board did not intend to include the U.C.C. in the potential of "other law" in the second instance. We think this result was unintended (because the U.C.C. warranty of "all signatures authentic and authorized" was clearly within the Board's contemplation in proposed official staff comment 2.a to §229.53(b), although it is not mentioned specifically). The PEB urges clarification that the scope of rights under "other law" includes rights arising under the U.C.C.

If you have questions about these comments, please contact Professor James J. White by telephone at (760) 777-8061 until late April or (734) 764-9325 thereafter or by email at jjwhite@umich.edu, or Professor Sarah Jane Hughes at (812) 855-6318 or by email at sjhughes@indiana.edu. Thank you for this opportunity to comment.

Sincerely,

Lance Liebman
Chair
Permanent Editorial Board for the Uniform Commercial Code

[9] 69 FED. REG. 1470, 1477.
[10] Id.