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Regulation CC Amendments Reallocate Risks of Remote Deposit

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More than three years after proposing amendments to Regulation CC to add new indemnities for remotely deposited checks, new warranties for electronic checks and electronic returned checks, and new indemnities for electronically-created items, the Federal Reserve has at last issued final rules. These new rules also modify the expeditious return rules, including by making electronic returned checks subject to those requirements. The final rules were issued on May 31, 2017, and will take effect on July 1, 2018.

Remote Deposit Indemnities

Perhaps the rules of most importance to the banking and emerging payments industries are those providing for indemnities for remotely deposited checks. An inherent problem with remote deposits is that the person depositing the check retains the original paper check and can negligently or intentionally deposit or cash it again. The bank on which the check is drawn will usually refuse to pay it twice, as it should. This leaves the writer of the check, the bank that accepted the remote deposit, and the bank or check cashing store that accepted the original paper check arguing over who should take the loss. Under current rules, unless the parties have entered into side agreements to allocate losses, the bank or check store paying the original check can normally bring a UCC holder-in-due-course claim against the check writer and that person has no remedy unless recovery is possible from the negligent or crooked payee that cashed the item twice.

Under the new rules, a bank that accepts the remote deposit indemnifies the bank that receives a deposit of the original paper check if it is returned unpaid because it was previously paid by the drawee bank. The Federal Reserve's basic rationale for this loss allocation is that the remote deposit bank is in the best position to prevent multiple deposits of the same item. One could argue that the second bank could have avoided the loss by waiting to pay the check until after the drawee bank had a chance to return the item unpaid, but that is an impractical solution for check cashing stores and other non-banks whose customers are often paying a fee to cash the check and expect to walk out of the store with cash in hand. The rule therefore shifts the risk of loss to the remote deposit bank. When the check cashing store deposits the check at its bank and that bank does not get paid on the check by the drawee bank because the check has already been paid, the check cashing store's bank will be able to recover from the remote deposit bank under the new rules.

The final rule improves on the 2014 proposal, however, by adding a measure of protection for the remote deposit bank. Under the final rule, a bank accepting the original check for deposit cannot make an indemnity claim if the check has a restrictive indorsement that is "inconsistent with the means of deposit." The Federal Reserve suggests in Supplementary Information for the final rule that an indorsement such as "for mobile deposit only" could be an appropriate restrictive indorsement for this purpose.

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While this limit on indemnification offers some protection for remote deposit banks, improvements in technology might be needed before a restrictive indorsement is fully workable in the consumer context. A bank can require its commercial remote deposit customer to use check scanning equipment that automatically prints the restrictive indorsement on the check, and the bank can implement corresponding systems to scan for this indorsement and to reject remotely deposited checks that do not include it. In the consumer context, however, most or all depositors will be hand writing this indorsement on the check, which could present a challenge for the automated systems that would need to read the scribbled indorsement. As is often the case with new financial services regulation, these rules will create new opportunities for vendors. Aside from technological changes, banks should consider amendments to their remote deposit agreements to require each remote depositor to include the restrictive indorsement on the check so that the bank then has a clear contractual right of recovery against the customer that fails to do so.

Finally, while Regulation CC has traditionally relied on a series of warranties by the parties presenting checks and electronic images, the remote deposit bank will be indemnifying the bank that incurs losses for accepting the original paper check for deposit. The amount of the indemnity will be limited to the total of (1) the amount of the loss of the indemnified bank, up to the amount of the settlement or other consideration received by the indemnifying bank, and (2) interest and expenses of the indemnified bank, including costs and reasonable attorney's fees and other expenses of representation. However, if it turns out that the indemnified bank has acted negligently or in bad faith, the indemnity amount will be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified bank. The rule thus incorporates a comparative negligence standard that might sometimes limit the losses of the remote deposit bank, as well as the losses of the remote depositor in those cases where the bank has the right to pass its losses to its customer.

Additional Regulation CC Amendments

The Regulation CC amendments also include new warranties for "electronic checks" and "electronic returned checks," add indemnities for "electronically-created items," and adjust the expeditious return rules for all checks, both paper and electronic.

Under current Regulation CC, the various check collection rules of subpart C apply only to paper checks. The new rules add warranties for "electronic checks" and "electronic returned checks," terms that are defined to mean an electronic image of, and electronic information derived from, a paper check or paper returned check that is sent to a receiving bank under an agreement between the sender and the receiving bank and that conforms with ANS specifications for Electronic Exchange of Check Image Data. Any bank that presents an electronic check or electronic returned check and receives a settlement or other consideration for it will warrant that the electronic image accurately represents all of the information on the front and back of the original check and includes an accurate record of all MICR line information. The bank will also warrant that no person will receive a transfer, presentment, or return of, or otherwise be charged for an electronic check or electronic returned check, the original check, a substitute check, or a paper or electronic representation of a substitute check such that the person will be asked to make payment based on a check it has already paid. All of these warranties would be made to the transferee bank, any subsequent collecting bank, the paying bank and the writer of the check (the drawer), in the case of transfers for collection or presentment. In the case of transfers for return, the

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warranties will run to the transferee returning bank, any subsequent returning bank, the depository bank, and the owner.

Regulation CC also is amended to add indemnities for “electronically-created items,” which are electronic images that have all the attributes of an electronic check or electronic returned check but that are created electronically and are not derived from an actual paper check. Each bank that transfers or presents an electronically-created item and receives settlement or other consideration for it will indemnify each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against losses resulting from the fact that (1) the electronic image or electronic information is not derived from a paper check; (2) the person on whose account the item is drawn did not authorize the issuance of the item in the stated amount or to the identified payee; and (3) the person receives a transfer, presentment, or return of, or otherwise is charged for an electronically-created item such that the person is asked to make payment based on an item or check it has already paid. The indemnity amounts are limited in the same way as under the remote deposit indemnity rules.

Lastly, the amendments modify the expeditious return requirements for checks, including by making electronic returned checks subject to those rules. The new rules generally will require returns in an expeditious manner such that the check would normally be received by the depository bank no later than 2 p.m. (local time of the depository bank) on the second business day following the banking day on which the check was presented to the paying bank. The final rule also requires a paying bank that determines not to pay a check of \$5,000 or more to provide notice of nonpayment such that the notice would normally be received by the depository bank by 2 p.m. on the second business day following the banking day on which the check was presented to the paying bank. This is a change from the current rule that requires the notice for checks of more than \$2,500 with a 4 p.m. deadline. To increase incentives for all banks to receive electronic returns, a paying bank and returning bank would be liable to a depository bank for failing to return a check in an expeditious manner only if the depository bank has arrangements in place to allow the electronic return of checks by commercially reasonable means. When the paying bank or returning bank is liable to the depository bank, it would be liable for the amount of the loss incurred, up to the amount of the check, but reduced by the amount of the loss that the depository bank would have incurred even if the paying or returning bank had exercised ordinary care (this is not a change from current Regulation CC).

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