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AN ENDANGERED SPECIES: THE INCREASING IRRELEVANCE OF ARTICLE 4 OF THE UCC IN AN ELECTRONICS-BASED PAYMENTS SYSTEM

Stephanie Heller*

As the 2002 revision project fades into the past and the enactment process creeps slowly forward, it seems an appropriate time to consider whether Articles 3 and 4 of the Uniform Commercial Code ("UCC"), particularly Article 4, continue to have relevance. The rules on bank collection set forth in UCC Article 4 (supplemented by federal statutes and regulations issued by the Board of Governors of the Federal Reserve System) are increasingly losing their relevance as the bank collection process shifts away from paper check processing and moves toward electronic processing. Thus, while other articles in this symposium have explored the degree to which parties are free to alter specific provisions of the UCC Articles by agreement, including the payment Articles, this article explores the emerging practice of effectively "contracting out" of Article 4 in its entirety.

* Counsel and Vice President, Federal Reserve Bank of New York. The views expressed herein are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or of any other component of the Federal Reserve System. The author would like to thank Greg Cavanagh, attorney, Federal Reserve Bank of New York, for his valuable assistance.

1. All references to the UCC are to the Official Text of Articles 3 and 4 effective at the beginning of 2002 unless otherwise indicated.


Generally, contracting out of the UCC entails carefully crafted contract provisions, revealing the underlying belief of at least one of the parties that the UCC default rule does not adequately protect its interests. In contrast, the practice of opting out of Article 4 reflects a simple desire on the part of one party to get paid faster. This is not a conscious decision about the rules, but rather a comment on the speed of various collection methods. Traditional paper check collection is giving way to automated clearing house ("ACH") check conversion products (in which the drawer of a check authorizes the payee to treat the check as a source of information for the origination of an electronic fund transfer) and to the use of electronic check image exchange (in which banks agree to collect a check by acting on electronic information, as opposed to the original piece of paper). In these instances, variation of the UCC rules is not the driver of the contracting out practice but rather an unexpected casualty of it. As discussed below, when these collection methods are used, Article 4 expressly does not apply or is largely displaced by detailed system rules.

I. SCOPE OF ARTICLE 4

Article 4 governs the deposit and collection of "items." Briefly stated, an item is a paper note or draft. An item is defined in section 4-104(a)(9) as "an instrument or a promise or order to pay money handled by a bank for collection or payment. The term does not include a payment order governed by Article 4A or a credit or debit card slip."

Section 4-104 goes on to provide that the definitions of instrument, promise and order used in Article 4 are the same as the definitions of those terms in Article 3. Thus, a promise is a written undertaking to pay money; an order is a written instruction to pay money; and an instrument is a negotiable promise or order.

8. U.C.C. § 3-103(a)(9).
9. Id. § 3-103(a)(6).
Because the definition of item in Article 4 turns on the Article 3 definitions of instrument, promise and order, an item must be a writing to be within the scope of Article 4. Unlike Article 3, however, Article 4 applies to both negotiable and nonnegotiable instruments.

In practice, Article 4 is largely about the way in which banks collect checks and the rights and obligations of banks and their customers with respect to the collection or payment of such items. This results from the limitation in Article 4's definition of "item" to a writing that is "handled by a bank for collection or payment." The overwhelming majority of items handled for collection and payment are checks. As implied in the Official Comments to Article 4 section 4-101, the importance of Article 4 depends on "[t]he great number of checks handled by banks" through the check collection channel. Unfortunately for Article 4, this number is shrinking significantly.

Surveys conducted by the Federal Reserve Banks show that the annual number of checks paid in the United States declined by almost thirteen billion from 1995 to 2003. Between 2003 and 2005, the volume of non-Treasury checks cleared by the Federal Reserve Banks declined at a twelve percent annualized rate. This decrease results not only from the decreasing number of checks being written.

11. The term "writing" is defined in Article 1 as "printing, typewriting or any other intentional reduction to tangible form." Id. § 1-201(b)(43) (2003). The only exception to this writing requirement is found in section 4-110 on electronic presentment notices. See id. § 4-110(a) (1995); discussion infra Part II.

12. A check is defined as "a draft, other than a documentary draft, payable on demand and drawn on a bank or . . . a cashier's check or teller's check. An instrument may be a check even though it is described on its face by another term, such as 'money order.'" U.C.C. § 3-104(f).


17. It is important to distinguish the number of checks actually being written by payors to make a payment from the number of checks once written that are actually collected and paid. Research conducted by the Federal Reserve Banks suggest that increased debit card usage is likely attributing to the decline in the number of checks that are being written. In fact, the increase "in the number of debit card transactions account for over half of all growth in [retail] electronic payments" between 2000 and 2003. FED. RES. SYS., THE 2004 FEDERAL RESERVE PAYMENTS STUDY, ANALYSIS OF NONCASH PAYMENTS TRENDS IN THE UNITED STATES: 2000–2003 8 (2004), available at http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf. "In 2003, there were 15.6 billion debit card transactions compared to 8.3 billion in
but, more importantly for purposes of this article, from the decreasing number of checks “handled for collection.” The remainder of this article explores the two main reasons for the decrease in the collection of checks and the resulting impact on Article 4 noted above: ACH check conversions and electronic check image exchange.

II. CHECK CONVERSION TO ACH

Perhaps the most significant factor contributing to the decline in the number of written checks that are sent through the check collection system to date is the National Automated Clearing House Association’s (“NACHA”) introduction in 2000 of rules authorizing the initiation of one-time automated clearing house (“ACH”) debits to consumer checking accounts. For purposes of this article, four of these one-time ACH debit products are

2000. The number of debit card transactions grew at an annual rate of 23.5 percent.” Id. The increased use of debit cards is contributing to the decline in the number of checks being written (as opposed to paid). Payroll cards also seem to be having an impact on the number of checks that are written. See SHERRIE L.W. RHINE & SABRINA SU, FED. RESERVE BANK OF N.Y., STORED VALUE CARDS AS A METHOD OF ELECTRONIC PAYMENT FOR UNBANKED CONSUMERS (2005), available at http://www.newyorkfed.org/publications/frame2.cfm?url=%2FRegional%2FStored%5FValue%5FCard%5FPaper%5FAugust%5F2005%2Epdf; SAMUEL FRUMKIN ET AL., PAYROLL CARDS: AN INNOVATIVE PRODUCT FOR REACHING THE UNBANKED AND UNDERBANKED, CMTY. DEV. INSIGHTS (COMPTROLLER OF THE CURRENCY & ADM'Y OF NAT'l BANKS/CMTY. AFFAIRS DEP'T, WASHINGTON, D.C.), JUNE 2005, AT 3, AVAILABLE AT HTTP://WWW.OCC.TREAS.GOV/CDD/PAYROLLCARDS.PDF.

18. NACHA is a not-for-profit association that represents more than 11,000 financial institutions through direct memberships and a network of regional payments associations, and 650 organizations through its industry councils. NACHA develops operating rules and business practices for the Automated Clearing House (ACH) Network and for electronic payments in the areas of Internet commerce, electronic bill and invoice presentment and payment (EBPP, EIPP), e-checks, financial electronic data interchange (EDI), international payments, and electronic benefits services (EBS). Nat'l Automated Clearing House Ass'n, About NACHA, http://www.nacha.org/About/default.htm (last visited Oct. 22, 2006).

19. The ACH system and the rules that support it were developed primarily to facilitate recurring payments. So, for example, a consumer that needs to make monthly mortgage payments could provide a single authorization to his or her mortgage company to initiate a monthly ACH debit transfer. While these ACH transactions have always been seen as a substitute for traditional check payments, recurring ACH payments have not posed the same threat to check collection as the one-time ACH debits. This may be because recurring ACH payments are more difficult to initiate (at least initially) and may be perceived by a payor as creating an unacceptable level of risk (the payee initiates the debit monthly without further authorization from the payor). See generally Nat'l Automated Clearing House Ass'n, 2006 ACH Rules: A Complete Guide to Rules & Regulations Governing the ACH Network, ACH Primer 1 (2006) (explaining the ACH Network).
particularly relevant: the point of purchase product (the “POP entry”), the accounts receivable product (the “ARC entry”), the telephone initiated product (the “TEL entry”) and the Internet initiated product (the “WEB entry”).

These one-time ACH debits are referred to by NACHA as “E-checks” and more commonly in the banking industry as check conversion products because these transactions are the means by which traditional check payments are collected through the ACH Network. The point of purchase and accounts receivable Echeck products replace the use of checks at the checkout counter (e.g., supermarkets) and the method for paying bills respectively. The Internet and telephone initiated Echeck products can be used in place of “remotely created check” or telemarketer drafts (paper checks created by the payee based on information supplied by the payor and “authorized” by phone or other means).

To create any of these Echecks entries, a payee needs the information contained on the MICR line of the payor’s paper check—the payor bank’s routing or transit number, the payor’s

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21. A remotely created check means

a check that is not created by the paying bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn. For purposes of this definition, “account” means an account as defined in paragraph (a) of this section as well as a credit or other arrangement that allows a person to draw checks that are payable by, through, or at a bank.


22. These last two products, particularly the WEB entry, also compete with credit and debit cards as a means of making payment.
checking account number and the check serial number. Therefore, these products are premised on the assumption that the payor will use a traditional paper check as a source of information (a source document) for the creation of the ACH entry.

A. The ACH Conversion Products

As the name suggests, the point-of-purchase entries are originated at the checkout counter—the brick and mortar point of purchase. Where a merchant previously accepted checks at the cash register as payment for goods or services, the merchant may now opt to accept that payment, not as a check payment, but as an ACH debit authorization instead. The check (whether completed, partially completed or blank) is used by the merchant as a source of information for the creation of the POP entry. The information necessary to format the POP entry is captured by the merchant at checkout when the merchant runs the check through special equipment that, at a minimum, can read and store the MICR line of the check. The paper check is marked void by the merchant at the point of sale and returned at the time of purchase to the customer. The information obtained from the MICR line is later used by the merchant/payee to create the ACH debit message that is sent for processing over the ACH Network.

The accounts receivable entry, a second ACH check conversion product, is the fastest growing ACH transaction type in the history of the ACH system, and works as follows. A biller sends an invoice

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23. See 12 C.F.R. § 229.2(vv). “MICR” stands for Magnetic Ink Character Recognition. The MICR line on a check must comport with industry standards as to location and content. Id.

24. For a discussion of POP entries, see NACHA OPERATING GUIDELINES § IV, ch. XII and § 1.B.2.a.

25. In addition to returning the check, as of September 2006, a merchant that initiates a POP entry is required to provide a receipt to the buyer containing the following information: “(a) Originator name (merchant); (b) company (merchant)/third-party service provider telephone number; (c) date of transaction; (d) transaction amount; (e) source document check serial number; (f) merchant number (or other unique number that identifies the location of the transaction); (g) Terminal City; and (h) Terminal State.” NACHA OPERATING RULE 2.11.4 (2006).

The NACHA rules strongly recommend, but do not require, that the merchant also provide the following information on the receipt: (a) merchant address; (b) merchant identification number; (c) buyer’s financial institution routing number; (d) buyer’s truncated account number; (e) buyer’s truncated identification number; and (f) transaction reference number. Id. “The [buyer’s] complete account number and complete identification number are not permitted to be placed on the receipt.” Id.

26. For a discussion of ARC entries, see NACHA OPERATING GUIDELINES § IV, ch. XIII and § 1.B.2.a.
to its customer.27 Somewhere on the back of the invoice, there is a statement indicating that, by submitting a check as payment, the payor/customer authorizes the biller to use the information on the check to initiate an electronic fund transfer (the ARC entry). When the invoice is returned to the biller's lockbox with the signed check, the lockbox operator captures the relevant information from the MICR line of the check and creates the ARC entry. The original check is held by the lockbox operator and, under the NACHA rules, must be securely stored prior to destruction. A copy of the check must be retained for two years.

The last two check conversion products, the TEL28 and WEB29 entries, are used when a person is trying to make a one-time purchase30 of goods or services over the telephone or on the Internet. A seller is permitted under the NACHA rules to originate a one-time ACH debit to a buyer's checking account based on MICR line information provided by the buyer over the telephone, if the buyer and seller have an existing relationship31 or if the buyer initiates the call.32 With respect to a WEB entry, no prior relationship is required.

27. Bank credit card providers were the first billers to take advantage of the ARC rules. See Kevin Roper, The Growing Success of Electronic Check in Lockbox Operations, J. WORK PROCESS IMPROVEMENT, Apr. 2003, at 32, 32. Today just about any bill payment is a likely target of the ARC check conversion product.

28. For a discussion of TEL entries, see NACHA OPERATING GUIDELINES § IV, ch. XV and § 1.B.2.a.

29. For a discussion of WEB entries, see id. § IV, ch. XIV and § 1.B.2.a.

30. WEB entries can also be used for recurring debits. Id. § IV, ch. XIV.

31. Under the NACHA rules, an existing relationship occurs where there is an agreement between the buyer and seller or where the buyer has purchased goods or services from the seller in the past two years. NACHA OPERATING RULE 14.1.28 (2006).

32. The seller is required to obtain authorization from the buyer prior to initiating the ACH entry. This requirement is aimed at meeting the concerns underlying The Telemarketing and Consumer Fraud and Abuse Prevention Act of 1994, 15 U.S.C. §§ 6101–6108 (2000), namely abusive and deceptive telemarketing practices. The Federal Trade Commission ("FTC") regulations implementing the act prohibit a telemarketer from collecting or attempting to collect payment for goods or services (or charitable contributions) directly or indirectly without the consumer's express verifiable authorization. 16 C.F.R. § 310.3(a)(3) (2006). Consistent with the FTC regulations, NACHA requires that the buyer's authorization must be readily identifiable as an authorization and must clearly state its terms. Under NACHA rule 2.1.6, the following minimum information must be included as part of the authorization: (1) the date on or after which the ACH debit to the buyer's account will occur; (2) the amount of the transaction; (3) the buyer's name; (4) a telephone number for buyer inquiries that is answered during normal business hours; (5) the date of the buyer's oral authorization; and (6) a statement by the seller that the authorization obtained from the buyer is for a one-time ACH debit.

NACHA OPERATING RULE 2.1.6. "The [seller] must either (1) tape record the oral authorization, or (2) provide the [buyer] with written notice confirming the oral authorization" prior to the date
The buyer’s authorization and MICR line information are obtained on the Internet.  

B. The Growth of Check Conversion and Its Impact on Article 4

The growth of these “Echeck” products over the past few years is impressive. According to statistics furnished by NACHA, the annual volume for the ARC check conversion product grew by more than 900 million payments in 2005 to more than 2.15 billion, an increase of 60 percent.  

In the first quarter of 2006, there were 491,156,390 ARC transactions, a growth of 6.98 percent over the fourth quarter 2005.

These same statistics reveal that Internet-initiated ACH payments (WEB) grew by 38.9 percent in 2005 to 1.34 billion. This growth continues in 2006 with the number of WEB transactions in the first quarter totaling 322,937,337, a 13.96 percent growth over fourth quarter 2005 and a 43.59 percent growth over first quarter 2005. There were 42,440,861 POP transactions in the first quarter of 2006 representing a 9.99 percent growth over first quarter 2005, and 71,367,384 TEL transactions representing a 30.97 percent growth over first quarter 2005.

In the view of the author, the success of the ACH check conversion products has a direct impact on the continued importance of Article 4. This is because each time a check is converted, its “collection” is outside the scope of Article 4.

As noted previously, to be subject to Article 4 these ACH entries would have to be:

the ACH entry will settle. *Id.*

33. The NACHA rules are less prescriptive as to what the authorization must look like, instead relying on warranties from a seller’s bank that the seller: (1) “has employed a commercially reasonable fraudulent transaction detection system to screen each entry;” (2) “has employed commercially reasonable methods of authentication to verify the identity” of the buyer; and (3) “has used commercially reasonable procedures to verify that routing numbers are valid.” *Id.* 2.10.2-2.10.2.2, 2.10.2.4.


36. Nat’l Automated Clearing House Ass’n, *supra* note 34. “NACHA estimates that 80 percent of these payments are to pay bills via companies’ or billing services’ web sites [and] 18 percent are to transfer funds.” *Id.*

37. *NAT’L AUTOMATED CLEARING HOUSE ASS’N, supra* note 35.

38. *Id.*
(1) an instrument, promise or order (i.e., a writing),
(2) handled by banks for collection or payment.\textsuperscript{39}

The WEB and TEL transactions are clearly outside the scope of Article 4. Although the information used to initiate a WEB or TEL entry is the same information that would be found on the MICR line of a check, a check is never issued,\textsuperscript{40} let alone sent to a bank for collection or presented for payment. There is no written document involved in these transactions.\textsuperscript{41} A WEB or TEL transaction is simply an electronic fund transfer. Attempts to apply Article 4 to electronic fund transfers such as these have been consistently rejected by the courts.\textsuperscript{42}

The legal analysis is somewhat less clear with respect to POP and ARC transaction where the payor may in fact “issue” a check. In a POP or ARC transaction a payor provides a check to the payee arguably to give rights to the payee on the instrument.\textsuperscript{43} As such, the check is issued and the first prong of Article 4’s definition of item is satisfied.\textsuperscript{44}

According to section 1693 of the Electronic Fund Transfer Act (“EFTA”), an “electronic fund transfer” or “EFT” “means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or


\textsuperscript{40} “Issued” is defined in Article 3 as “the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.” U.C.C. § 3-105(a) (1995).


\textsuperscript{43} The degree to which this statement is true may well turn on whether the payor gets notice that the check is going to be used as a source document and not collected as a check and whether the notice indicates that the payee can choose to collect the check as a check or as an electronic fund transfer. See discussion infra note 52.

\textsuperscript{44} The fact that a payor may deliver an incomplete check in a POP transaction may not alter the analysis. See U.C.C. § 3-115(b) (an incomplete instrument can be an instrument under Article 3).
At first blush, therefore, it would appear that POP and ARC entries are check transactions subject to Article 4 and not EFT transactions.

Of course, to be within the scope of Article 4 the check must be "handled by a bank for collection or payment." As described above, when a check is converted to a POP or ARC entry, the check is never sent for collection or payment to a bank. Instead, the information on the check is used by the payee or its agent to formulate an electronic instruction that is then sent to the relevant banks over the ACH Network. Although there are no cases that address this specific fact pattern, the plain language of Article 4 would appear to exclude such transactions from its coverage. This is because the phrase "handled for collection or payment" is understood to mean that the check (or the electronic information related to the check) is collected and paid using processes developed exclusively for handling checks and not funds transfer networks.

Reacting perhaps in part to the fact that these transactions were arguably outside the scope of both Article 4 and the EFTA, the Board of Governors of the Federal Reserve System amended Regulation E, which implements the EFTA, so that POP and ARC transactions would be treated as EFTs. Specifically the Board of Governors revised the definition of EFT in section 205.3(b)(2) to include: "Electronic fund transfer using information from a check. (i) This part applies where a check, draft, or similar paper instrument is used as a source of information to initiate a one-time electronic fund transfer from a consumer's account. The consumer must authorize

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45. 15 U.S.C. § 1693a(6) (2000) (emphasis added). Thus, a consumer transaction can be either a check transaction or an EFT, but it cannot be both.
47. See supra pp. 13–15.
48. See infra Part II for a discussion of section 4-110 and electronic check collection.
49. There is a current effort by the Check ACH Coalition to use the ACH Network to settle check payments with check images available on demand. The Coalition, which is comprised of Wells Fargo, JPMorgan Chase, Bank of America Corporation and Zions Bancorp, is interested in finding a way for check law (as opposed to electronic fund transfer law) to govern the transactions that would flow over the converged check image-ACH Network. While this effort is in its infancy, it could change the analysis in the text by further blurring what is currently viewed as two discrete payment channels—ACH and check. See Steve Bills, ACH-Image Convergence: Which Rules?, AM. BANKER, June 8, 2006, at 1; Patrick J. Moore, Payor Bank Requirements Will Drive Acceptance of ACH/Image Convergence Plan, BAI BANKING STRATEGIES, Sept.–Oct. 2006, at 36; Mott, supra note 20; Will Wade, New Project Could Link ACH, Image Networks, AM. BANKER, May 17, 2006, at 1.
the transfer."  

Regulation E treats the check as a source of information used by the consumer to initiate a one-time EFT from his or her account. This conclusion is bolstered by the requirement under the NACHA rules that prior to the initiation of a one-time ACH debit transfer, the consumer must authorize the payee to initiate the EFT. In effect, at the point of authorization, the consumer is agreeing with the payee to opt out of Article 4.

However, just because a payor authorizes the payee to initiate an EFT does not guarantee that the payment will in fact be processed as an EFT. Only certain types of checks are eligible for conversion under the NACHA rules. Even when a check is eligible for


51. Electronic Fund Transfers, 71 Fed. Reg. at 1659 (to be codified at 12 C.F.R. § 205.3(b)(2)(i)).

52. NACHA OPERATING RULE 2.1.2 (2006). According to Regulation E, a “consumer authorizes a one-time electronic fund transfer... when the consumer receives notice” that the check will be used to initiate an electronic fund transfer “and goes forward with the transaction. For point-of-sale transfers, the notice must be posted in a prominent and conspicuous location, and a copy of the notice must be provided to the consumer at the time of the transaction.” Electronic Fund Transfers, 71 Fed. Reg. at 1659 (to be codified at 12 C.F.R. § 205.3(b)(2)(ii)).

Regulation E provides model notices that payees can use at the point of purchase or on an invoice:

(a)—Notice About Electronic Check Conversion

When you provide a check as payment, you authorize us either to use information from your check to make a one-time electronic fund transfer from your account or to process the payment as a check transaction.

... 

(b)—Alternative Notice About Electronic Check Conversion (Optional)

When you provide a check as payment, you authorize us to use information from your check to make a one-time electronic fund transfer from your account. In certain circumstances, such as for technical or processing reasons, we may process your payment as a check transaction. [Specify other circumstances (at payee’s option).]

Id. at 1661 (to be codified at 12 C.F.R. pt. 205 app. A-6).

As is implied by the model notice language, however, it is often the case that a consumer does not know until after the fact whether his or her check was processed as a check or whether the check was used as a source document to initiate an ACH entry.

53. As of September 2006, to be eligible for conversion, a “check or sharedraft must (1) contain a pre-printed serial number, (2) not contain an Auxiliary On-Us Field in the MICR line, (3) be in an amount of $25,000 or less, and (4) be completed and signed by the [drawer].” NACHA OPERATING RULE 2.9.1. There is also a fairly lengthy list of things that can never serve as a source document including third-party checks, government checks and obligations of a financial institution (e.g., travelers checks, cashier’s checks, official checks, money orders, etc.). Id. 2.9.1, 2.11.2.
conversion, the associated ACH entry may not be successfully processed.\textsuperscript{44} When there is a problem with the ACH entry, the payee (or its bank) may attempt to collect the check that was originally submitted, a copy of the original check or a remotely created check based on the original check.\textsuperscript{45} While it is true that at any given time a payment is either a check payment or an EFT, a single payment may be attempted through the ACH Network and later through the check collection channel.\textsuperscript{46}

Arguably, therefore, each check submitted for conversion to an ARC entry (and even sometimes a POP entry) is issued—delivered for the purpose of giving rights on the instrument. As a result, whether such a transaction will be governed by Article 4 will turn on whether the check is processed through the banking industry’s check collection channel or whether it is successfully used to initiate an ACH entry. However, if an item that was ineligible for conversion is nevertheless converted or where a court (or jury) determines that authorization to convert a check to an ACH debit entry was never obtained, a significant exception to this rule may result. In such instances, Article 4 may well apply, at least with respect to the rights of the drawer, despite the fact that the check was “collected” through the ACH Network.\textsuperscript{47}

\textsuperscript{44} This could happen, for example, because the payor’s financial institution (the drawn on bank) might not participate in the ACH Network. In such instances, the ACH entry will be rejected and the payee is left trying to obtain payment by collecting the check.

\textsuperscript{45} Often the original check will be destroyed or otherwise unavailable. The NACHA rules require a merchant in a POP transaction to return the original check to the payor at the point of purchase and permit the payee in an ARC transaction to destroy the original paper check. \textit{Id.} 2.9.3.5, 2.11.5.1. This is intended to reduce the likelihood that both the ACH entry and the paper check are collected.

\textsuperscript{46} For this and other reasons, a payee may not be able to inform a payor in advance as to how a payment will be processed and will instead seek authorization to process a payment in multiple ways. \textit{See supra} note 52 (model notice language in Regulation E providing for such alternative collection methods).

\textsuperscript{47} While the decision to process a “check” as an ACH item instead of as a check is driven primarily by the desire of the payee to get paid using the fastest possible method, the decision has a real legal consequence. The legal rights of a payor against its bank, for example, are significantly different when a payment is governed by Article 4 then when the same payment is governed by Regulation E and the NACHA rules. These differences include differences in the timeframe within which a payor must notify its bank about an unauthorized payment, and differences in the allocation of loss for unauthorized transfers between the payor and its bank. \textit{Compare} U.C.C. §§ 3-406, 4-401, 4-406 (1995), \textit{with} 12 C.F.R. § 205.6 (2006), \textit{and} NACHA OPERATING RULE 8.1–8.8. In addition, the degree to which a recredit right is available to the payor will depend on whether Article 4 or Regulation E applies to the payment. \textit{Compare} U.C.C. § 4-406 (no recredit right), \textit{with} 12 C.F.R. § 229.54 (limited recredit right for substitute check). The rights of the banks involved in the payment chain vis-à-vis each other also differs depending
Despite the complexities, the overwhelming majority of checks submitted at the point of purchase or mailed to a lockbox for conversion are eligible for conversion, are authorized in a manner that would satisfy Regulation E and are successfully converted and processed over the ACH Network. Thus, as the ACH check conversion products grow in popularity, the number of items expressly governed by Article 4 declines and so does its relevance.

58. According to NACHA, “many checks written by businesses are being inadvertently converted because [the payees] cannot distinguish many business checks from consumer checks.” News Release, Nat’l Automated Clearing House Ass’n, NACHA Approves Rules for Identification of Business Checks Ineligible for Conversion (Nov. 2, 2005), available at http://www.nacha.org/News/news/pressreleases/2005/Pr110205/Pr110205.htm. To address this problem, NACHA amended the NACHA rules so that as of September 2006, certain types of business checks are now eligible for conversion at the point of sale and through a lockbox. Nat’l Automated Clearing House Ass’n, 2006 Revisions & NACHA (ACH) Operating Rules and Guidelines 16–21 (2006), available at http://www.gbt.com/ebranch/2006-ACH-Rules-Revisions-for-OriginatorsPDF.pdf. It is worth noting that unlike the consumer check conversions, the legal status of the business check conversion is not dependent on the definition of an EFT under the EFTA and Regulation E. Instead, the legal status of these transactions will turn on their characterization by courts. To date, courts have not considered this exact fact pattern—where a check is arguably issued and then used to initiate an ACH debit transaction—although courts have held that commercial EFTs are not within the scope of Article 4. See cases cited supra note 42. As long as the commercial drawer agrees that its check can be used as a source document for the creation of an EFT, these transactions will likely be treated by courts as EFTs outside the scope of Article 4.

59. See supra note 52.

60. In addition to the introduction of business check conversion (see supra note 58), next year NACHA will introduce a new ACH conversion product, referred to as “back office conversion” or the “BOC entry,” that is likely to increase the number of ACH check conversions. See Nat’l Automated Clearing House Ass’n, Recent Amendments to the NACHA Operating Rules, http://www.nacha.org/ACH_Rules/Rule_Making_Process/Recent_Ammendments_to_Rules/recent_amendments_to_rules.htm (last visited Oct. 22, 2006). Beginning in March 2007, businesses will be permitted to accept checks at the point of sale for conversion to an ACH entry at some later point. What distinguishes this conversion product from the POP conversion product is that unlike the POP entry, where the MICR line information is captured at the cash register and the paper check is returned to the purchaser, the BOC entry will require the merchant to retain the check and handle the conversion in its back office at some later date. Compare id., with NACHA Operating Guidelines § 1.B.2.a.

61. Because the NACHA rules incorporate the Article 4 rules by reference one might think the NACHA rules preserve the relevance of Article 4. Specifically, NACHA rule 14.1.26 provides that:

For all entries except RCK entries, each debit entry shall be deemed an “item” within the meaning of Revised Article 4 of the Uniform Commercial Code (1990 Official Text) and that Article shall apply to such entries except where the application is inconsistent with these rules, in which case these rules shall control. An RCK entry is
III. ELECTRONIC CHECK EXCHANGE

A second innovation in the banking industry that is arguably leading to the diminished importance of Article 4 of the UCC is the slow but steady growth of the collection and presentment of electronic check images through the check collection system.\(^6\) Electronic check image exchange is fundamentally different from the check conversions products described in section II.A above.

First, the use of electronic check image exchange does not depend on, and does not involve, the payor/drawer's authorization to create an electronic instruction. In fact, the drawer of the check will not be told in advance that the check may be converted to electronic form. Instead, the decision to use electronics will be made by the banks involved in collecting and paying the check.

Second, the banks handling these electronic images agree to handle them "for collection or payment." The electronic files are not transmitted over the ACH Network nor are they compatible with the ACH file format.\(^6\) In fact, the development of electronic check image exchange may be seen as an attempt by bankers to keep the

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\(^6\) NACHA is trying to determine whether it is possible to combine image exchange and the ACH Network. This concept is in the very early stages, and there is already debate as to what legal rules would govern if it were to be successfully deployed. See, e.g., sources cited supra note 49.
check collection system alive by creating a new electronic debit transfer system that will compete with the ACH Network. At present, a check may be converted to an electronic image at different stages of the collection process. This part of the article considers the impact that a wholly electronic check collection system would have on Article 4.

A. The Check Image Exchange Process

Currently there are three basic models used by banks to collect electronic check images in which no bank uses the paper check at any point in the collection process. Each of these models begins with a paper check that is issued to a payee. In the first model, Model One, the payee deposits the paper check with its bank for collection as a check.\(^{64}\) The payee’s bank (the bank of first deposit), at some point prior to sending the check forward for collection or payment, images the check (i.e., captures an electronic picture of the front and back of the check). The electronic images, along with electronic images of other checks deposited with the same bank of first deposit and drawn on the same payor bank, are included in an electronic file. The electronic file is referred to as an image cash letter.\(^{65}\)

Also included in this file (although in a different file field) is the MICR line information associated with each of the imaged checks contained in the file. The bank of first deposit then sends the electronic file for presentment directly to the payor bank. This transmission does not occur over the ACH Network but rather over communication channels established specifically for check collection.\(^{66}\) The payor bank will process the checks primarily

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64. It is possible that the check will be negotiated to a third party prior to deposit. For ease of discussion, however, this article assumes that the payee deposits the check directly with its bank.


66. The transmission of the file might flow over electronic connections established directly between the two banks or, more likely, would be sent to a check clearing house or other nonbank processor that serves as a central distribution point for electronic files. Similar to an ACH Operator, the central clearing house or processor may be capable of sorting the electronic file and redistributing the content based on the end destination. If such capabilities exist, the bank of first deposit could send an electronic file containing electronic check images (and related information)
relying on the MICR line information contained in the electronic file and reviewing the electronic images only to the extent that its internal procedures so require.\(^6^7\) If the payor bank decides to return one or more of the checks contained in the image cash letter, it will do so by creating a return image cash letter and sending it back to the bank of first deposit.\(^6^8\)

The second check image exchange model, Model Two, is similar to Model One but involves the use of a collecting bank in addition to the bank of first deposit. The only difference between Models One and Two is that in the second model, the bank of first deposit sends the image cash letter forward for collection to an intermediary collecting bank,\(^6^9\) such as a Federal Reserve Bank, which in turn presents the file to the payor bank.\(^7^0\)

In the third model, Model Three, the electronic check images are created by the payee, and the electronic images, as opposed to the paper checks, are deposited by the payee in its bank and transmitted directly or through another collecting bank to the payor bank.

Under each of the three image exchange models described above, the payor bank agrees to accept the transmission of an electronic image of an item as presentment. The form of the agreement may be a bilateral contract between the payor bank and the presenting bank or, if the presentment occurs through a clearing house, a multilateral agreement in the form of clearing house or system rules binding all of the banks in the particular check to be presented to any of the payor banks involved in that clearing house or processor arrangement.

\(^6^7\) Typically, a payor bank will set a dollar threshold which triggers a manual review of presented checks. The check images can also be used by the payor bank to create image statements for its customers or even to create a substitute check. See infra note 74 for a definition of substitute check.

\(^6^8\) The use of return image cash letters is not common today. Instead, in a Model One arrangement, the payor bank and the bank of first deposit will typically agree that the payor bank can satisfy its return obligation by simply providing timely notice of return. After all, the bank of first deposit has the original item which it can “pull” to return to its depositor. In a Model Two or Model Three scenario, a payor bank wishing to return an “item” contained in an image cash letter will typically require the presenting bank to “pull” the original item and return the original item to the bank of first deposit on its behalf. Alternatively, the payor bank (or one of the prior collecting banks) could create and return a substitute check.

\(^6^9\) Because the intermediary collecting bank is a bank in the collection chain, Model Two differs from Model One even where the Model One involves the use of a check clearing house.

\(^7^0\) While Model Two is possible, it is currently much more likely that the intermediary collecting bank would use the electronic image file to create substitute checks to present to the payor bank.
exchange. In Model One, all that is required is the agreement of the payor bank, commonly referred to as an electronic presentment agreement or an ECP agreement. However, both Models Two and Three involve something more. In Model Two, in addition to an ECP agreement, there must be an electronic collection agreement between the bank of first deposit and the intermediary collecting bank. In Model Three there also needs to be an account agreement that authorizes the payee to deposit electronic images of checks.

**B. The Growth of Check Image Exchange and Its Impact on Article 4**

The recent growth of electronic image exchange was sparked by the enactment of the Check Clearing in the 21st Century Act ("Check 21 Act").71 Although it is commonly believed that the Check 21 Act authorizes the creation and use of electronic checks,72 it actually does not. A close reading of the law and its implementing regulation will not yield a single provision addressing the creation, storage or exchange of images.73 Nevertheless, the Check 21 Act facilitates the use of electronics in the check collection system by establishing conditions under which a properly prepared paper copy of a check, referred to as a substitute check,74 will be considered the “legal

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72. See, e.g., Richard Burnett, Banks Have Check 21—What About Consumers?, ORLANDO SENTINEL (Fla.), Jan. 16, 2005, at H1 (claiming Check 21 permits “banks to clear checks electronically by transferring mere digital copies of the checks”); P.J. Huffstutter, Signed, Sealed, Delivered: "Freight Dogs" Fly Bundles of Checks Worth Billions in a Nightly Race to Keep Banks Balanced, But Electronic Transfers Could Ground Them, L.A. TIMES, Jan. 11, 2005, at A1 (claiming Check 21 permits financial institutions to send digital copies of checks to one another over the Internet); Teresa Dixon Murray, As Banks Go Paperless, Checks Rarely in the Mail, PLAIN DEALER (Cleveland), Nov. 1, 2005, at C6 (claiming Check 21 grants “digital copies” of checks the same standing as originals).


74. A substitute check is

a paper reproduction of an original check that—

(1) Contains an image of the front and back of the original check;

(2) Bears a MICR line that, except as provided under ANS X9.100-140 (unless the Board by rule or order determines that a different standard applies), contains all the information appearing on the MICR line of the original check at the time that the original check was issued and any additional information that was encoded on the original check’s MICR line before an image of the original check was captured;

(3) Conforms in paper stock, dimension, and otherwise with ANS X9.100-140 (unless the Board by rule or order determines that a different standard applies); and
equivalent" of the original paper check. The ability to create a legal equivalent to the original paper check changes a fundamental principle of negotiable instrument law—that a negotiable instrument is a transferable obligation (separate from the underlying obligation for which it was issued) to pay that is reified in the particular piece of paper on which it is written. If a legal equivalent to the original check can be created, then there is no need to transport the original check through the check collection system. At any given point in the collection process or thereafter if it becomes necessary to produce "the check," the Check 21 Act permits the creation of a legal equivalent. It is this innovation that has truly opened the door to using electronics to collect checks through check collection channels.

There are few public statistics on the use of electronic check images by banks in the check collection process. Those that do exist are not particularly helpful as they focus on the use of both substitute checks (paper) and electronic check images and do not attempt to contrast these numbers with the overall check volume numbers. However, if we assume that the number of checks that will be collected and paid in 2006 is the same as it was in 2003 (approximately 36.7 billion checks), then roughly 9.95 percent (or

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(4) Is suitable for automated processing in the same manner as the original check.
12 C.F.R. § 229.2(aaa).

75. 12 U.S.C. § 5003(b); 12 C.F.R. § 229.2(aaa). To be a legal equivalent, the substitute check must accurately represent all of the information on the front and back of the original check at the time the original check was truncated and bear the legend "This is a legal copy of your check. You can use it the same way you would use the original check." 12 U.S.C. § 5003(b).


77. Prior to the Check 21 Act, banks were able to use electronics to collect a check, but it required that each party with an interest in the check agree to the use of electronics. In addition, prior to the Check 21 Act, there was no clear emerging standard for image cash letters, making it difficult, if not impossible, to have any real impact on check collection. As a result, those banks that were willing to accept electronic presentment prior to the Check 21 Act tended to accept MICR information files (as opposed to receiving images) and to require the original paper checks to follow the electronic presentment. See, e.g., FEDERAL RESERVE BANK, OPERATING CIRCULAR NO. 3: COLLECTION OF CASH ITEMS AND RETURNED CHECKS 66–74 (2006), available at www.frbservices.org/OperatingCirculars/pdf/Oc3.pdf; SVPCO, Electronic Check Presentment, http://www.svpc.com/paye ment_services/electronic_check_presentment/000094.php ("This service transmits electronic non-image check information with 'paper to follow'. More than 450 exchanges take place each day at over 100 sites, with daily volume averaging close to three million transactions per day.") (last visited Nov. 3, 2006).


79. FED. RES. SYS., supra note 17, at 5.
3.65 billion items) of all checks that will be collected and paid in 2006 will be collected through electronic check channels. This number underestimates the percentage of checks that will be collected through the use of electronic check channels in 2006 given that the overall number of checks collected and paid in 2006 will certainly be less than the number collected in 2003. The difference, however, is not likely to be more than a few percent.

Despite the fact that currently only a small percentage of check collection is wholly electronic, the use of electronic check image exchange is clearly on the rise. It is timely, therefore, to consider the impact that this change in check processing will have on Article 4 of the UCC. The inevitable move toward an all electronic check collection system will simply add to the waning importance of Article 4. It will do so not because check images are necessarily excluded from the coverage of Article 4, but because the significant legal issues arising from the collection of electronic check images are simply not addressed in Article 4.

As previously noted, to be an item under Article 4, there must be a writing that is handled for collection or payment. In each of the electronic check image exchange models described above, a check (as defined in Article 3) is issued. The check is an item under Article 4. However, instead of sending the item forward for collection or payment, an electronic image of the item is sent forward for collection or payment. An electronic check image is not a writing as defined under the UCC. So the question arises as to whether Article 4 applies once the check is converted to an electronic image.

The answer appears to be yes. According to section 4-110, a bank may agree to accept the transmission of an image of an item or information describing an item as a presentment (a "presentment

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80. According to statistics posted by the CheckImage Collaborative, based on December 2006 data, the annualized number of items that will be collected and involve check images (either image only or image plus substitute checks) is 5.98 billion. Based on these statistics, by December 2006 approximately 61 percent of these items were being collected using images. CheckImage, supra note 78. Although it is not entirely clear from the way in which the figures are presented, it appears that the 61 percent figure represents items that were both collected and presented as electronic images.

81. See Federal Reserve Board, supra note 16, showing the decrease in check volume handled by the Reserve Banks since 2003. The number also does not include image exchange transactions that take place outside of SVCPCo, the NCHA or the Reserve Banks.

If presentment is made by presentment notice, Article 4 tells us that any reference to "item" or "check" in Article 4 "means the presentment notice unless the context otherwise indicates."\(^8\)

Under section 4-110, therefore, as long as there is an "item" initially,\(^8\) the payor bank may agree to accept presentment of an electronic image, and Article 4 will continue to apply to the electronic image as though it were an item, except when the "context otherwise indicates."\(^8\)

The first electronic check image exchange model, Model One, in which the only time an electronic image is used is to make electronic presentment under an ECP agreement, falls squarely within section 4-110. The analysis is somewhat more difficult in Models Two and Three where electronic images are being exchanged not only for presentment but also for collection. Section 4-110 does not, on its face, address agreements between a bank of first deposit and another collecting bank to exchange electronic information.\(^8\) It is possible, therefore, to argue that Article 4 does not support such use of electronics in the check collection process. If this view were adopted, only Model One would be governed by Article 4.

However, the better view is to read section 4-110 to say that, as long as there is an electronic presentment agreement in place,\(^8\) it does not matter where in the collection chain the electronic image is produced; the electronic image, whenever it was created, is a "presentment notice," and any reference to item in Article 4 is a

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83. U.C.C. § 4-110(a) (1995). This provision in Article 4 first appeared in the 1990 Official Version of Article 4 which has not yet been adopted in New York or South Carolina. Uniform State Laws Scorecard, COM. L. NEWSLETTER (ABA Bus. Law Section/Commercial & Fin. Servs. and Unif. Commercial Code Comms., Chicago, Ill.), July 2006, at 11 n.3. A similar provision was included in Regulation CC but has subsequently been removed in favor of viewing ECP agreements as no different from other agreements entered into by banks to vary the provisions of Regulation CC. Compare 12 C.F.R. § 229.36(c) (1999), with 12 C.F.R. § 229 (2006).

84. U.C.C. § 4-110(c).

85. A growing desire exists on the part of payees that produce remotely created checks to eliminate the initial step of creating the paper check. If there is never a paper check, then Article 4-110 would not apply as an item needs to have existed at some point. See supra note 21 for a definition of remotely created check.

86. U.C.C. § 4-110(c).

87. See id.

88. In today's check collection environment, it is quite common for collection to begin with the transmission of electronic images but end with the presentment of a substitute check. Because section 4-110 requires an electronic presentment agreement and because such an agreement does not exist where a substitute check is presented, Article 4 arguably does not apply to this method of collection. See 12 C.F.R. §§ 229.51--60 (2006); U.C.C. § 4-110. But see infra note 90.
reference to the check image. Although there is no case law confirming this interpretation, the official comment to section 4-110 suggests that this is what the Drafter's had in mind. The comment states that "[t]he electronic presentment agreement may provide that the item may be retained by a depositary bank, other collecting bank, or even a customer of the depositary bank . . . ." The ECP warranty in section 4-209(b) also supports this conclusion in that it provides that the warranty is given to "any subsequent collecting bank and to the payor bank."

But even if Article 4 continues to apply, its application in an electronic check collection system is increasingly strained, and its importance is diminished. When Article 4 was revised to accommodate ECP, only the most modest of changes were made. Instead, the drafters assumed that anything needed to implement an ECP arrangement would be addressed in the ECP agreements. As a result, the issues that are most troublesome when collecting electronic check images are being addressed outside of Article 4. An entire article could be written on each of these issues. What follows, therefore, is just a brief description of some of the more significant issues that arise in an electronic collection system, but fall outside of Article 4 and need to be addressed by agreement.

1. Issues concerning the essence of electronic presentment.

The first set of issues concern the essence of electronic presentment. What information is required to make presentment

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89. U.C.C. § 4-110 cmt. 1.

90. Id. § 4-209(b). The language of section 4-209 actually suggests that the drafters viewed any agreement under which the original check is retained and only an electronic image (or information) is sent for collection as an ECP agreement, even an agreement addressing electronic collection and not presentment.

91. In addition to the ECP provision and the ECP warranty, Article 4 was revised so that a payor bank did not have to make paid items available to its customers, but could instead provide "sufficient information" about a paid item or a copy of the paid item. See id. § 4-406(a). The definition of ordinary care in section 3-103(a)(9) was also revised so that the failure to examine an item was not per se the absence of ordinary care. See id. § 3-103(a)(9) (1995) (amended 2002).

92. As the Official Comment to section 4-110 notes, the drafters did not make extensive changes "[b]ecause agreements will exist, [and] only minimal amendments are needed to make clear that the UCC does not prohibit electronic presentment." Id. § 4-110 cmt. 3 (1995).

93. Each of the issues discussed in this section must also be considered with respect to the acceptance of electronic returns.
electronically? Article 4 does not answer this question, but rather, provides that electronic presentment can be made by using an electronic image or other electronic information. Because a bank that receives electronic information may need to provide its customer or another party with a legal equivalent of the original check, the agreement should require that the electronic file contain all of the information that would be needed to create a substitute check or otherwise produce a sufficient copy. Because these are electronic files and not substitute checks, the law will not provide any protection to the recipient of the file that the information contained in the file is complete or accurate absent a provision in the agreement.

Once the parties agree on the information that will be required for presentment, the parties will also have to agree on the format for presentment. While there is an emerging industry standard for image cash letters, there is no law that requires the use of that standard. Even if the parties agree to use the industry standard, what guarantee does the recipient of an image cash letter have that the image quality of each of the electronic images in the cash letter will be acceptable? There is currently no standard when it comes to determining image quality, and so, the parties will need to specify whether the electronic images must be captured in black and white or gray scale, and at what resolution (number of dots per inch).

94. Section 4-406 does indicate the minimum information that a payor bank must be able to provide to its customer in order to trigger the reporting requirements set forth in the Article. U.C.C. § 4-406(a). In this regard, therefore, section 4-406 provides some guidance as to what information a payor bank would likely require.

95. See id. § 4-110(a).

96. The models discussed in this article assume a wholly electronic check collection system that does not involve the use of substitute checks. It should be noted, however, that if a bank handles an electronic image of a substitute check, certain provisions of the Check 21 Act, including the warranty provisions, would apply to the electronic information. See 12 U.S.C. § 5004 (Supp. 2006).

97. See FED. RES. FIN. SERVS., supra note 65.

98. While a legal standard currently does not exist for all electronic check images, there may be laws that address image quality standards that could apply to check images in certain instances. For example, the Florida Administrative Code sets out an image standard that must be met by the Florida government in order to store a record in electronic form. See FLA. ADMIN. CODE ANN. r. 1B-26.003(10) (2003). The Florida standard requires a higher image resolution than many in the banking industry use for check images. Compare id., with discussion infra note 99.

image files are transmitted between banks, each bank will conduct its own image quality assurance tests. What is the legal result if a file or an electronic image within a file complies with all of the technical standards in the agreement but still fails to pass the receiving bank’s image quality test? Has the electronic file been successfully sent and/or presented in such instances?

As noted above, under the ANSI standard an image cash letter contains not only the electronic images of the presented checks but also the MICR information. What is the legal consequence when an image cash letter that is received contains blank or black electronic images but completely usable MICR information? Is the answer different depending on whether the electronic file passed all of the receiving bank’s image quality screens?

What requirements must be met concerning the transmission of the electronic file regarding encryption and other security protocols, transmission capacity, and so on? What, if any, testing must the collecting or presenting bank conduct prior to sending an electronic file? Which party is responsible if a transmission results in the introduction of viruses or other operational problems at the receiving bank?

2. Other issues concerning electronic presentment.

When does presentment occur, at the time that the sender pushes the button to send or only after the collecting bank or payor bank receives the file? Will there be a real time acknowledgement or


100. See supra note 65.

101. A payor bank would be able to process the payments based solely on the MICR line information contained in the file. See supra note 23.

102. A number of the issues raised thus far relate to the question of when, or in some instances whether, presentment occurs. Presentment is a critical concept in check collection. Once an item is presented, the payor bank is obligated to settle for the item or return the item within tightly prescribed timeframes. See 12 C.F.R. § 229.30 (2006); U.C.C. § 4-301(a)-(b) (1995) (amended 2002). If the payor bank fails to meet these deadlines, it becomes accountable for the amount of the item. See U.C.C. § 4-301 cmt. 3. Equally important, however, is the interplay between the time that it takes to present an item (and trigger the pay/no pay decision) and the exposure that the bank of first deposit has with respect to making funds available to its depositor. Often, when a check is deposited, the bank of first deposit will be required to make the proceeds of the deposit available to its customer before knowing whether the check will be honored upon presentment and paid. See Expedited Funds Availability Act, 12 U.S.C. §§ 4001–4010 (2000). This results from the mandatory funds availability rules found in the Expedited Funds Availability Act. Id. To the extent that the contractual provisions prolong the period of time that it takes to make good presentment (perhaps because of image quality issues) or
other notice that the file was successfully transmitted? If the parties are using acknowledgements, what should the sending bank do if it does not get an acknowledgement or gets a negative acknowledgement? In light of the significant problems that could arise if a file were presented more than once, should there be some conversation prior to resubmitting a file? Are there any restrictions on the sending bank in connection with resubmitting an electronic file? For example, may the sending bank split up a very large file in order to get it to transmit successfully? What is the legal status of an image cash letter that is only partially received by the collecting or paying bank?

Because each of the models discussed in this article assume a wholly electronic collection system, the double debit warranty in the Check 21 Act will not apply.\(^\text{103}\) What requirements, if any, will be placed on the parties to detect and prevent multiple presentments? How will the risk of multiple presentments be allocated among the parties? Absent agreement to the contrary, duplicate electronic images may well be treated as fraudulent items even where the duplicate was created as a result of operational errors.

Similarly, how should the risk of loss due to forgeries and alterations be allocated in an electronic check collection system? In the absence of a contractual provision addressing this issue, the traditional Article 4 allocation rules will apply and not the rules contained in the Check 21 Act. Thus, despite the fact that the payor bank will not have the original check to examine for security features or other evidence of fraud, the payor bank will typically be responsible for forged checks.\(^\text{104}\) In contrast, if a substitute check had been presented to the payor bank, then the Check 21 Act would permit the payor bank to assert an indemnity claim against prior

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\(^{103}\) See 12 U.S.C. § 5004 (Supp. 2006) for the double debit warranty of the Check 21 Act. See also supra note 96.

banks for losses due to the receipt of the substitute check instead of the original check.105

One of the conditions for Article 4 to apply in the first instance is that the electronic information used for presentment must be information about an "item." Article 4 does not provide any rules about the treatment of the original item when electronic presentment is used. The expectations of the parties with respect to the retention, destruction and availability of the original check must be addressed in the agreement.106

As noted previously, these are just some of the key issues that currently fall outside of Article 4 or which are not adequately addressed by the Article 4 default rules.107 For electronic check collection to be successful, however, there must be a significant degree of technical interoperability among banks, and arguably, a single rule set answering the questions posed above. In the absence of legislation addressing electronic check collection, the void will likely be filled by an industry group. In fact, the Electronic Check Clearing House Organization ("ECCHO")108 is already touting itself in the payments press as the next NACHA.109 The role that Article 4 plays in those rules is unclear, but given the inadequacies of Article 4 identified above, Article 4 will likely become a "gap filler" under the ECCHO rules with few if any identifiable gaps to fill.


106. The interplay between Article 3 and electronic check collection is particularly strained in this area. What is the legal consequence to the payee/depositor if the original check is destroyed by one of the banks and the payor bank decides to return the check? Is intentional destruction of the original a discharge of the underlying obligation under Article 3? Has the payee lost all of its rights to enforce the instrument? If the original check is not destroyed and the item is returned, can the depositor demand the original (or a substitute check) in order to enforce its rights on the instrument?

107. Others include expectations concerning endorsements, contingency plans when an electronic delivery channel is unavailable, and record keeping relating to the electronic files.

108. ECCHO is "a not-for-profit, mutual benefit, national clearinghouse that is 100 percent owned by its member institutions. Any depository financial institution, regardless of size, is eligible for membership in ECCHO. ECCHO was created in 1990 by banks as a cooperative venture to encourage the implementation of electronic check presentment (ECP)." ECCHO, About ECCHO: Overview, http://www.eccho.org/about_overview.php (last visited Oct. 22, 2006); see Mott, supra note 20.

IV. CONCLUSION

Absent some change in the law, Article 4 of the UCC (as well as the Federal laws and regulations governing check collection) will become increasingly irrelevant as ACH check conversion continues to grow and check collection continues to shift toward electronic processing. The diminished importance of Article 4 is not occurring in a vacuum, but is occurring at the same time that: (1) the check and ACH product lines are blurring; (2) distinctions between consumer payments and business payments are eroding; (3) transparency is missing (it is often not until after a payment has been processed that the payor knows what payment channel was used and, as a result, its legal rights); (4) reliance on “private” rules instead of “public” rules is growing (resulting, some would argue, in the absence of representation of the interests of many of the users of the payment system and in unbalanced allocation of risk); 110 and (5) the technology and methods used by banks to process check and ACH payments are rapidly converging. Ultimately the diminution of Article 4, and the need for any efforts to revive it, must be judged in the context of these broader changes in the payments system.