

## Practitioner's Perspective

by Holly K. Towle, J.D.



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**Practitioner's Perspective** appears periodically in the monthly Report Letter of the CCH Guide to Computer Law. Various practitioners provide in-depth analyses of significant issues and trends.

## ECK or Eeeeeeeek?

**Question:** your company is a retailer that accepts checks. Some processor is telling your payments group that it can do "ECK" or "electronic check conversions," *i.e.*, convert checks to "e-checks" and clear them faster. Everyone sees a win—win and hounds you for approval. Should you say yes?

Every lawyer's natural inclination is to say no to anything that sounds too good to be true, so you get bonus points if you can articulate your answer:

- A. I'm too tired to figure it out.
- B. The federal Check 21 Act passed a few years ago, why am I hearing about this now?
- C. There are several ways to electronically process checks—which ones are you talking about and if you don't know, have the processor give me a description so I can figure it out.

The answer is "C" (well, it might be "A" too, but you're likely stuck). "B" is probably not what is intended when the phrase "electronic check conversion" is used because the Check 21 Act ultimately involves a substitute check that is on paper, so it's not a "pure" electronic path. That leaves "C," and the reason to figure it out yourself instead of believing the processor, is that it changes the governing legal regime and requires your company to take compliance steps before converting checks. Why that is the case is the subject of this column.

### What are the choices for checks?

There are at least five general ways a paper check may be "processed."<sup>1</sup> *The catch is that some methods do not actually process the item as a check but instead treat it as something else.* The alternatives look much the same in the sense that each time, a signed check results in receipt of money that is pulled from a checking account. But that's a little like saying that a lease, license, and sales contract are the same because each results in payment of money. There are material legal distinctions. In an over-simplified nutshell, here are the basic choices:

1. **Full collection as a paper check:** under this alternative, the retailer deposits the check with a bank; the bank sends the paper check through the ordinary check collection system. The primary legal regime is the Uniform Commercial Code and federal Regulation CC.
2. **Truncation of check:** under this alternative, the retailer deposits the check with a bank; the bank forwards it, but in a digitized form by using the MICR\* line or image exchange data; it does this through interbank

agreements. Under this path, the primary laws are also the UCC and federal Regulation CC.

\*“Magnetic Ink Character Recognition”—this is line on the bottom of the check with the dark characters—it’s in a special font and magnetic ink which allows the check information to be automatically read by machines.

3. **Truncation of original check with transformation as Check 21 “Substitute Check:”** under this alternative, the check proceeds under The Check Clearing for the 21st Century Act (“C21”). C21 requires, ultimately, processing with a paper substitute check bearing special legends, so this path does not fit pure electronic processing. The primary laws are the UCC, C21, Subpart D of Regulation CC and image exchange agreements.

4. **Remotely created checks:** this path does not actually involve a check completed by the customer. It is stereotypically used in telemarketing transactions where a customer wants to pay other than by credit card but is dealing via telephone or Internet (remote means). The retailer obtains (*e.g.*, orally or via the Internet) check MICR data and then the retailer, not the customer, creates a *paper* item that is sent through the collection system as an “item.” Under this path, the primary laws are the UCC, as amended by several states which have special amendments to deal with “demand drafts.” Federal Regulation CC was amended in 2005 to create uniformity. When the draft is created in a telemarketing transaction, the FTC’s Telemarketing Sales Rule applies and includes special provisions.

5. **Conversion of Check to ACH Debit Entry—Electronic Check Conversion or “ECK”:** under this alternative, the retailer does not use the customer’s check as a “check.” Instead, it uses it as a “source document” to obtain MICR and other data necessary to initiate a debit entry under National Automated Clearing House Association (“NACHA” or “ACH”) rules. This causes the customer to lose the legal protections afforded by “check” laws, although they gain the protections afforded by the replacement laws. Depending on the ACH transaction type, the ACH rules *and* federal Regulation E rules apply regarding electronic debits of consumer accounts—it is those two sets of rules that will make you glad you said “no” until you work through them (in which event you’ll be back to answer “A”).

Customers who think they wrote a check and want to be treated under check rules can be confused, and that is why the ACH rules and Regulation E require that certain notices be given to customers (*e.g.*, that their checks will be converted to debit entries and there won’t be any of the “float” afforded by the “check” clearing system). It also provides certain “opt—out” opportunities. The

ACH rules distinguish among business and consumer checks (not all business checks are eligible); types of checks (not all types are eligible); checks that are mailed to lockboxes; checks that are taken at the “cash” register and handed back to the customer; checks that are taken at the register and not handed back; how the data is pulled from the check, and so on and on.

Alternative #5 is likely what your folks were talking about and it is complex and laden with front—end legal work.

### What’s the deal with ECK?

The deal is that you won’t really be dealing with a check. In essence, it will be treated like a piece of paper containing certain information that you need in order to do what you’re really on a path to do, which is to engage in a debit transaction under the federal Electronic Funds Transfer Act and its implementing regulation, Regulation E. But you say— “How can Regulation E apply to my company— we looked a long time ago to make sure it wasn’t a ‘financial institution’ under Reg E and it wasn’t—so how can you say Reg E applies?

The answer is that your company has been beamed into Regulation E, courtesy of the Federal Reserve Board. Its invitation became effective January 1, 2007 and as of that date, merchants engaging in ECK transactions are deemed to be “financial institutions” for limited purposes listed in the final regulation. Actually, the FRB made a mistake in that list, so you really need to look at the amendment to the final regulation. The regulations are too detailed to go into here, but the bottom line is that your company cannot just take the check and convert it: it must give prescribed notices and obtain authorizations under both Regulation E and the ACH rules (which are not the same). And if your company wants to be able to debit fees electronically, additional new rules apply.

### What else is going on in payment systems?

Tons. There has been a sea change in retailer obligations under payment systems in the last five years. The most obvious is in the credit and debit card world with respect to new rules and standards (*e.g.*, PCI or Payment Card Industry standard) focusing on the security of personally identifying information—new rules and fines abound, as does the need for taking a very close look at your company’s next processing contract before signing. Similarly, payroll cards are now regulated under Regulation E and gift cards and smart cards are in a transition of existing and increasing regulation.

Although most lawyers dislike dealing with payment system issues, it is likely time to embrace them.

### Endnotes

<sup>1</sup> See generally, Barkley Clark and Barbara Clark, *The Law of Bank Deposits, Collections & Credit Cards* (A.S. Pratt & Sons, 2006).