

IS YOUR BANK PREPARED TO COMPLY BY JULY?

In 1987, Congress enacted the Expedited Funds Availability Act of 1987 (“EFA”) to provide depositors of checks with prompt fund availability and to foster improvements in the check collection and return processes. The EFA gives the Board of Governors of the Federal Reserve System (“Board”) authority to regulate any aspect of the payment system, and any related function of the payment system with respect to checks, in order to carry out the provisions of the EFA. In exercising its authority, the Board implemented Regulation CC (“Reg CC”) a few years later.

When Reg CC was first implemented, all checks were in paper form. Now, with mobile banking and remote deposit capture being utilized by even the smallest financial institutions, the Board has been playing catch-up by implementing a round of amendments to Reg CC in order to provide guidance on electronic checks and electronically-created items. The interbank clearing process is almost entirely electronic; in 2017, Federal Reserve Banks received 99.99% of their checks electronically, and received 99.96% returned checks electronically. With the overwhelming majority of checks being cleared and returned in an electronic form, it came as no surprise when the Board published a notice of proposed rulemaking, requesting comments on amendments to Reg CC to create or amend existing provisions to include electronic checks.

After receiving and reviewing the comments, the following amendments have been made, and will be effective as of July 1, 2018 (“Effective Date”).

Return Requirements

Reg CC requires that a paying bank return a check to the depository bank “expeditiously”, upon the determination that it will not make payment. When the EFA was enacted in 1987, expeditiously meant by snail-mail. Under Reg CC as it reads today, the paying bank must return the check using either the “two-day test” or the “forward-collection test.”

Under the two-day test, the paying bank must send the check to the depository bank, and it must be received by 4 p.m. on the second business day following the day on which the check was presented. Under the forward-collection test, the check must be returned in a manner that a similarly situated bank would return a check for a forward collection drawn on the depository bank. In addition, a paying bank is required to provide notice of nonpayment to the depository bank for any check over \$2,500 that the paying bank determines it will not pay. Such notice must be sent and received following the two-day test.

Moving forward after the Effective Date, all checks, whether electronic or paper, will have to satisfy an amended two-day test. It is the same two-day test as laid out above; however, the cut-off is 2 p.m. instead of the previous 4 p.m. The Board also added an incentive for depository banks to accept returned checks electronically. Typically, the paying bank will be liable to the depository bank if they do not return the check in a timely manner as set forth by the two-day test. However, the liability falls upon the depository bank if the depository bank does not have a commercially reasonable means of accepting electronic checks. It is this threat of liability that will provide an incentive for depository banks to accept returned checks electronically. The

final rule also provides a higher threshold for notice of non-payment, increasing the value of the check from \$2,500 to \$5,000, and following the new two-day timeline (2 p.m. rather than 4 p.m.).

Same-Day Settlement

Reg CC requires a paying bank to provide same-day settlement for checks presented in accordance with reasonable delivery requirements established by the paying bank and presented at a location designated by the paying bank by 8 a.m. on a business day. This rule was enacted in 1994, and only encompasses paper checks. Since there is no regulatory guidance on electronic presentment and settlement, financial institutions have been privately negotiating such terms by and between themselves. The Board, upon recommendation from the commenters, is going to continue to allow financial institutions to privately negotiate the terms of electronic presentment and settlement, and is not going to amend the current rule to include electronic same-day settlement.

Warranties

Similar to the same-day settlement rules, financial institutions have privately negotiated warranties of electronic checks by and among themselves, since Reg CC was lacking any guidance in this area. The current Reg CC provides for warranties of only paper checks. The Board has amended the rule to now include electronic checks under the already existing warranties, and have further created specific new warranties for electronic checks. Electronic check warranties include: (i) returned-check warranties; (ii) notice of nonpayment warranties; (iii) settlement amount, encoding, and offset warranties; (iv) transfer and presentment warranties related to a

remotely-created check; (v) warranties that a bank will not be asked to pay an item twice; and (vi) warranties that the electronic image and information are sufficient to create a substitute check.

This new Reg CC amendment will help financial institutions have uniformity in their warranties and potential liability with both paper and electronic checks, and across all agreements and bank-to-bank relationships.

Indemnities

The current Reg CC provides indemnities for paper checks, which has grown to include electronic images derived from such paper checks. The Board proposed, and subsequently adopted, additional indemnities for electronic information that is *not* derived from a paper check.

The new amendment provides for the bank transferring such electronic information to indemnify each transferee bank, any subsequent collecting bank, the paying bank, and any subsequent returning bank against any loss, claim or damages that are a result of the fact that the image or information is not derived from a paper check. This indemnity is limited to the amount of settlement or other consideration received by the indemnifying bank, including interest and expenses of the indemnifying bank. There will also be an indemnification for losses caused by the fact that the electronically created item was not authorized by the account holder, and for a subsequent bank that pays an item that has already been paid.

A final indemnity was created for financial institutions that use mobile deposit. It indemnifies the depository bank that received a deposit of an original paper check that was returned unpaid because the check

was previously deposited and paid using a remote deposit service. To address concerns that this would make financial institutions shy away from mobile deposit, the mobile depository bank does not have to indemnify the paper depository bank if the mobile depository bank uses restrictive depository language on the check, such as “for mobile deposit only.” This allows financial institutions to continue with a mobile deposit capture without added liability.

For compliance questions, contact us [here](#).



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