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Developments in Payment Systems Law 2005-2006

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2005



2006

Developments in Payment Systems Law¹

By Mark E. Budnitz*

Introduction

This article discusses major developments in payments law that occurred in 2005 and 2006. In addition to a brief description of specific statutes, regulations, and cases, the article will discuss and identify current trends, common themes, and underlying concerns. New payment products and systems to transfer payments are constantly being developed. The rapid changes make it difficult to determine what to call new products and the legal categories in which they fit. The law is always at least one step behind these developments. Furthermore, major systems are subject to private rules, in addition to public law. When the law changes its regulation of a payment product, it often becomes necessary to switch the legal category in which that product belongs and to find a more appropriate name to identify the product. This results in a confusing environment for consumers and a challenging one for lawyers trying to educate and advise their clients.

I. Payroll Cards: Will the Walls Come Tumbling Down on Other Cards as Well?

A. Freedom from federal regulation will soon be over

Before 2005, one could state with confidence that there were three types of payment cards separated by solid legal walls: credit cards subject to the Truth in Lending Act and Regulation Z,² debit cards subject to the Electronic Fund Transfers Act (EFTA) and Regulation E (Reg. E),³ and stored value cards, subject to no federal law. Most employers use direct deposit to transfer wages to employees with bank accounts. Employers wanted an alternative to payroll check for workers who do not have a bank account. Payroll cards meet that need. The employer can issue employees a card that can be used to withdraw their salary from ATMs. In some plans, employees also can withdraw their pay at stores when they buy goods.⁴ Payroll cards were classified as stored value cards or prepaid cards along with bank issued "cash" cards, gift cards,⁵ mall cards, telephone cards, etc.

In 2005, however, the Federal Reserve Board (FRB) smashed a big hole in the wall separating debit and stored value cards when it issued an Interim Final Rule amending Reg. E and the Official Staff commentary to the regulation to include payroll cards, and followed this up with a Final Rule in 2006 that became effective July 1, 2007.⁶ The FRB's action will have a substantial impact on consumers because the use of payroll cards is greatly increasing each year. It is currently a \$2.7 billion business and is estimated to grow ten-fold by 2009.⁷ This development illustrates that the legal wall separating debit and stored value cards is not impenetrable and Reg. E may govern other types of stored value cards in the future. Finally, in issuing the rule the FRB pointed out that it has broad authority under the EFTA to regulate electronic payments.⁸ The payroll card rules illustrate this authority by subjecting payroll cards to Reg. E. Although this is a significant departure for the FRB, it is clearly authorized by the EFTA.⁹ Still pending is an FDIC proposal that certain types of stored value cards be covered by FDIC insurance.¹⁰ Under that proposal, funds transferred via the typical payroll card would be included as an insured deposit.

The FRB Final Rule defines an "account" broadly to include a "payroll card account" that is established by an employer to which the consumer's "wages, salary, or other employee compensation (such as commissions) are made [by electronic transfer] on a recurring basis...."¹¹ Payments for seasonal workers or employees that are paid on a commission basis are included, as are workers employed for a short period of time, even if it is only for one pay cycle. The determining factor is whether the "employer intended to make recurring payments to the payroll card account." Although payroll cards are generally subject to Reg. E's requirements, Reg. E grants an exception in regard to periodic statements.¹²

Consumer advocates urged the FRB to amend Reg. E to cover all types of stored value cards that are marketed as substitutes for consumer bank accounts as well as cards used to receive payments of significant funds. That would have included under Reg. E payments such as workers' compensation, unemployment benefits, social security payments, and tax refunds. The FRB declined to adopt their position. Nevertheless, the FRB promised to "monitor the development of other card products" and acknowledged it "may reconsider Regulation E coverage as these products continue to develop."¹³

B. States also regulate payroll cards

Several states have recently enacted laws regulating payroll cards. Minnesota has perhaps the most comprehensive.¹⁴ Payroll card issuers must file a notice with the Commission of Labor and Industry. The employer must provide a written disclosure of the employee's wage payment options, including a complete itemized list of all fees that may be deducted by the employer or the card issuer. If the employer offers the payroll card option in a language other than English, the disclosure must be in that other language. The employer must obtain the employee's voluntary consent in writing.¹⁵ Certain fees are prohibited such as initiation, participation, loading, dormancy, and inactivity fees. Employees must have one free withdrawal per pay period that allows withdrawal of the full amount of wages for that period. They also can obtain one free transaction history per month. There can be no link to any form of credit extension. The statute also includes a privacy provision. Finally, employees can request to change their payment method and the employer must honor it within 14 days.

When the federal rule becomes effective, businesses with employees in more than one state will face the challenge of complying with that rule as well as possibly different state requirements in each of the states in which they have workers. Each employee will face the challenge of trying to determine what

protections he or she may have, and those protections will change if the company transfers the employee to another state.

II. Regulation CC: It's No Longer Just Funds Availability

The FRB's Regulation CC (Reg. CC)¹⁶ contains the rules spelling out the requirements of the Expedited Funds Availability Act;¹⁷ rules that ensure depositors have prompt access to the funds they deposit into their accounts. In 2005, the FRB amended Reg. CC to include two more sets of rules.

A. Check 21

Reg. CC now contains the rules for the Check 21 Act.¹⁸ The Act encourages electronic image exchange by permitting banks to stop returning original checks to the drawer (the person who writes the checks) even where the agreement between the drawer and the bank requires the return of originals.¹⁹ Electronic image exchange enables new opportunities for fraud and errors, resulting in wrongful withdrawals from consumers' checking accounts.²⁰ The Act and regulations provide limited remedies for consumers whose checking account agreements require their bank to provide their original checks with the monthly statement, and almost no remedies for those whose agreements do not include that requirement and allow the checks to be "truncated."²¹

B. Preauthorized drafts

Telemarketers, debt collectors and others often obtain the consumer's bank account information over the phone and use it to produce preauthorized drafts, called demand drafts and telephone checks. The drafts and checks are presented to the consumer's bank and result in the transfer of funds to the business without the consumer ever having written a check payable to the business or signing a written authorization. The official version of the UCC recently was amended to include rules that are intended to encourage banks to recredit their customers' accounts when consumers claim they never authorized the draft.²² The UCC rules apply only in consumer transactions, and states have been slow in enacting this change.

The FRB has now included its own version of these rules in Reg. CC, extending coverage to all customers, not only consumers.²³ This addition may have significance beyond the amendments on preauthorized drafts. In the past, the FRB has not encroached on UCC turf. When it has issued rules, such as those on funds availability and Check 21, generally it was only after Congress enacted legislation that required the FRB to promulgate regulations. The rule on drafts takes a UCC amendment, revises it, expands it, and imposes it nationally. Arguably, this represents a new direction for the FRB. It will be interesting to see if in the future the FRB goes one step further by issuing rules that have a direct effect on UCC payment rules and are entirely independent of any UCC or Congressional initiative. When considered in conjunction with the FRB's initiative in subjecting payroll cards to Reg. E, there is support for speculating that this indicates a trend with the FRB becoming more aggressive in widening the scope of consumer protection. Other FRB actions, however, suggest a far more timid FRB.²⁴

III. NACHA Rules: The Partial Privatization of Payments law

The National Automated Clearinghouse Association (NACHA) has issued a comprehensive body of rules and operating guidelines to govern the commercial parties that participate in the Automated Clearinghouse (ACH) system for transferring funds electronically.²⁵ NACHA rules cover consumer electronic payments such as transfers authorized over the phone and the

Internet, preauthorized transfers, electronic check conversion at the point of purchase and at the lockbox, other types of transfers at the point of purchase, and bounced checks that are presented electronically. The rules are amended continuously as marketplace conditions change and new rules are added as new types of payment procedures are developed.²⁶ NACHA also tests new payment systems to determine if they are technically feasible and to gauge banks' interest.²⁷ Two issues are discussed below. One type of electronic funds transfer, electronic check conversion, is discussed in detail in Part IV.

A. Do consumers have a private right of action when the rules are violated?

The NACHA rules are issued by a private organization. The merchants and financial institutions that use the ACH system to process electronic transfers enter into contracts requiring them to comply with the rules. Consumers are not a party to the agreements. The agreement between consumers and their banks, however, may require the consumer to comply with NACHA rules. In *Security First Network Bank v. C.A.P.S. Inc.*, the court found that the agreement between the customer and the bank incorporated the NACHA rules.²⁸ The court found that because of that incorporation, the customer was "a party to the rules, bound by its obligations as well as entitled to its benefits."²⁹ The court

The court held that the customer could sue for breach of the NACHA warranty rules.

held that the customer could sue for breach of the NACHA warranty rules. The court suggested two other possible theories that would allow the customer to take advantage of those rules. One was a claim for breach of contract based on the customer's allegation that the bank had violated one of the NACHA rules. The second was an argument that the customer is a third

party beneficiary of the agreement between the customer's bank and NACHA.

It is far from clear, however, that consumers can sue for a company's violation of the NACHA rules. For example, in 2006 in a case involving different circumstances, the Eighth Circuit came to a contrary conclusion, adding further uncertainty.³⁰

B. Are private rules appropriate?

The split in the courts over whether consumers have a private right of action for breach of the NACHA rules illustrates the inappropriateness of leaving to private contract the rules governing a national payment system that affects funds crucial to consumer well-being. Transfers subject to the rules involve funds in consumers' bank accounts that are needed to pay for essentials such as food, transportation, jobs, and health care.³¹ Rules governing the transfers should be proposed and discussed in a public forum, enacted into the public law, and consumers should have clear authorization to sue in court for violation of the rules. In contrast, neither the government nor consumers are involved in drafting the NACHA rules. NACHA has done excellent work in providing consumers with protections that, in some situations, go beyond those established in the law. However, NACHA could decide to repeal those consumer-friendly rules tomorrow.³² The FRB should incorporate into Reg. E, those NACHA rules that provide consumers with needed protection. Such incorporation would accomplish two important objectives: (1) it would protect consumers if NACHA decides to restrict consumer protection in its rules;

and (2) it would ensure that consumers have a private right of action.

IV. Electronic Check Conversion

Electronic check conversion (ECC) is a transitional step toward an all-electronic payment environment.³³ Both federal law and private rules determine the rights and obligations of participants in the system. The federal rules received needed clarification in 2006 when the FRB issued rules governing ECC. To consumers, ECC is one of several illustrations of how confusing the payment system has become and how impossible it is for them to work through the maze of different laws and rules that govern each transaction. The following focuses on a few of the many rights and obligations that apply to ECC.

A. ECC at the point of purchase

ECC takes place in two situations. One situation is the point of sale, where the consumer buys goods at the store, hands the cashier a check, and the cashier inserts the check into a scanner that captures the MICR information.³⁴ What happens next depends on whether the NACHA rules apply. If the merchant uses the ACH system subject to those rules, the cashier is required to mark the check "void" and return the check to the consumer.³⁵ This wise rule prevents a double debit to the consumer's account, which could occur if the transfer were made both electronically and by presentment of the consumer's check. In addition, returning the check to the consumer may signal to the alert and sophisticated consumer that the check itself will not be processed and the transaction is subject to some law other than that which is applicable to checks. NACHA calls an ACH electronic transfer made in this fashion a point of purchase (POP) entry.³⁶ Major retailers including Wal-Mart have adopted POP ECC.

B. ECC at the lockbox

In the second situation, the consumer mails a check to the biller (e.g., a credit card issuer such as American Express or CitiCorp or a retailer such as Macy's). The check goes to what is referred to as a "lockbox." The biller scans the check for the MICR information and keeps the check. The consumer's funds are transferred from her account to the biller's account electronically. This is ECC at the "lockbox." NACHA refers to an ACH transfer made this way as an ARC (accounts receivable) entry. NACHA estimates there were 220 million lock box transfers in 2003. In 2004 that number had increased to an estimated 1.27 billion.³⁷ In 2005, the number was up to 2.15 billion.³⁸

In ECC at the lockbox, the customer pays by mailing a check to the biller, and probably believes the payment will be processed as a check, subject to the rules governing checks, including the Uniform Commercial Code (UCC). The customer's assumption is reasonable, but wrong; the transaction is subject to Reg. E and the NACHA rules.

C. What law applies?

The FRB has issued a final rule establishing the rights and obligations of the parties to ECC transactions.³⁹ The rule was effective Feb. 9, 2006, and became mandatory Jan. 1, 2007.

Before the final rule, Reg. E did not specifically say that Reg. E applied to ECC. ECC was referred to only in the FRB staff commentary. That commentary did not apply Reg. E specifically to merchants and other payees; rather, like the rest of Reg. E and the commentary, it imposed obligations only on financial institutions. In contrast, the new rule explicitly imposes obligations on merchants to obtain the consumer's authorization for each ECC.⁴⁰

In addition to Reg. E, the NACHA rules apply to those

commercial parties who participate in the ACH system. These include merchants at the point of sale, credit card billers, banks, and ACH operators.

The FRB requires the merchant to notify consumers that their checks may be processed electronically. The NACHA rules have their own requirements for obtaining the consumer's authorization. The consumer can order a stop payment if the consumer can do so "at such time and in such manner as to allow the RDFI [consumer's bank] to act upon the stop payment order prior to acting on the debit entry."⁴¹ The NACHA rules are more favorable than Reg. E, which provides no right to stop payment on this type of EFT.

D. Consumer confusion

Consumers will not understand how their payment is being processed when they send a check to a credit card biller and the biller processes it electronically. Reg. E requires the biller to include in the credit card statement a notice informing the consumer that the biller "will or may" process the transaction electronically.⁴² The biller has the option of processing the check either electronically or the traditional way by having its bank present the actual paper check to the consumer's bank. The consumer has no way to know which option the biller will choose. Furthermore, credit card companies bury these notices in places where consumers are unlikely even to see them, much less understand them.⁴³

The Check 21 Act has introduced still another level of complexity. Consider the consumer who has not agreed to check truncation and still receives the original paper checks with the monthly bank statement. The consumer mails a check to the credit card company. Three things may happen. It may be processed as an ECC, in which case the original check will not be returned to the consumer,⁴⁴ and the statement will include an arcane entry with the name of the biller, the amount, and numbers with the letters "ARC" buried within. Alternatively, the consumer will receive the original paper check, as usual. Third, the check may be processed via electronic check image exchange, with the consumer receiving a "substitute check" with the statement instead of the original. Reg. E and the NACHA rules apply to the first scenario, the UCC to the second, and the UCC and the Check 21 Act to the third.

If a problem arises with regard to a payment, in order to effectively argue their case with a recalcitrant business, consumers somehow will have to ascertain how the payment was processed, what might have gone wrong, and what law applies.

V. Check Issues

A. Overdrafts: Discretionary bounced-check "protection"

Financial institutions have developed a new type of overdraft protection. Consumer advocates call the service "bounced-check protection." The industry often refers to it as "courtesy overdraft protection." Consumers do not apply for this service. It is provided at the discretion of the institution. The deposit account agreement typically disclaims any legal obligation to pay overdrafts. Regulatory agencies have criticized the marketing of these services because it is designed to promote the generation of fee income and encourage consumers to overdraw their accounts and use bounced check protection to meet short-term borrowing needs.⁴⁵

The Federal Reserve Board's regulatory response was to amend Regulation DD, effective July 1, 2006.⁴⁶ Reg. DD implements the Truth in Savings Act. The amendment and new staff commentary address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their deposit accounts. Among other things, the final

rule requires institutions that promote the payment of overdrafts in an advertisement to disclose on periodic statements, total fees imposed for paying overdrafts and total fees imposed for returning items unpaid on periodic statements, both for the statement period and the calendar year to date. The regulation requires the inclusion of certain other disclosures in advertisements of overdraft services. There is no private right of action for violation of Reg. DD.

Consumer advocates believe far more protection is needed. They want an amendment to Regulation Z to make it clear that the Truth In Lending Act (TILA) applies to bounced check protection.⁴⁷ An amendment to Reg. Z also would provide consumers a private right of action.

A consumer challenged a bank's bounced check protection program in *Smith v. Wells Fargo Bank, N.A.*⁴⁸ In addition to illustrating one way to challenge bounced check protection, the Court of Appeals' decision represents a rare victory over the OCC's preemption regulation.⁴⁹ The bank changed its practice to extend the check protection program to Check Card POS transactions and sent customers a notice informing them of the change. The consumer claimed the notice was contrary to the bank's marketing materials and inadequate. The consumer alleged false and misleading advertising, unfair business practices under California's Unfair Competition law, and violation of the state's Consumer Legal Remedies Act. The trial court certified a class but held the action was preempted by the OCC's preemption regulation. On appeal, the court held that the action was not preempted by the regulation. The regulation only preempts state law limitations related to a bank's disclosure requirements and does not preempt state law that incidentally affects a bank's deposit-taking powers. The court found that the consumer's cause of action did not relate to such a limitation and only had an incidental effect on the bank's powers. Finally, the court held that the bank was not entitled to summary adjudication and the case was remanded for trial.



B. NSF Fees: Checks, EFTs, Reg. E, and NACHA rules

When consumers pay for goods and services but have insufficient funds in their accounts, the UCC, Reg. E and NACHA rules all come into play.

The West Virginia Attorney General sued TeleCheck alleging, inter alia, that its collection of NSF fees violated Reg. E and NACHA rules. When a merchant seeks payment of a bounced-check fee via an electronic transfer, Reg. E requires the merchant to obtain authorization from the consumer.⁵⁰ The merchant can obtain authorization merely by showing the consumer received notice of the fee, such as by posting a sign by the cash register. NACHA rules require a written consumer authorization before a fee may be recovered.⁵¹

The case was resolved when the West Virginia Attorney General reached a settlement with TeleCheck.⁵² The company agreed not to collect NSF fees in violation of the law. It will conduct periodic reviews of fees collected in West Virginia to monitor compliance and return any fees not permitted by law. TeleCheck will instruct its merchant customers, in writing, to

post signs in their stores in West Virginia indicating the NSF fee it charges in the correct amount permitted by the law. It will comply with the NACHA rules for debiting NSF fees when it uses the ACH network to debit NSF fees, including the rule that requires TeleCheck to obtain the consumer's authorization in writing. It will redeposit electronically converted checks in accordance with NACHA rules and will "attempt in good faith to refrain from redepositing a paper check when it knows, based upon the stamp provided by the payer's bank, that the account is closed or that a 'stop payment' has been issued or if the payer's bank punches out or removes the check routing number so as to prevent redeposit."

C. Counterfeit cashier's checks: so near to cash, and yet so far from good funds

When a customer has a bank issue a cashier's check, that check is drawn on the bank's funds, not the customer's. Consequently,

payment is regarded as far more certain than with an ordinary check that has the risks of insufficient funds, theft, forgery, alteration, etc. Because of this certainty, cashier's checks are often called "near cash" and "good funds." Recently, however, consumers have been subjected to widespread scams in which they accept cashier's checks that turn out to

Consumers have been subjected to widespread scams in which they accept cashier's checks that turn out to be counterfeit. Moreover, use of counterfeit cashier's checks has been increasing dramatically.

be counterfeit. Moreover, use of counterfeit cashier's checks has been increasing dramatically.⁵³ There are several variations to the scam. In one, consumers deposit the checks into their accounts and provide value to the person who paid with the cashier's check, assuming the check will be paid. When the check is presented to the bank whose name is on the check, that bank rejects it because it is counterfeit, and the consumer suffers the loss.

Banks are well aware of these scams; the FDIC posts reports of counterfeit cashier's checks on its web site almost daily. Counterfeit cashier's checks often contain obvious errors, such as misspelled city names.⁵⁴ Often, they are not even similar to authentic checks. These circumstances raise the issue of whether the consumer's bank fails to exercise ordinary care when it does not alert the consumer who deposits a cashier's check that is obviously counterfeit.

VI. Credit Cards

A. When a convenience check is not convenient and not even a check

The names industry gives to new payment products are often confusing and sometimes misleading. "Check cards" are not checks and check law, including the right to stop payment, does not apply. Check cards are considered debit cards, and Reg. E applies. "Convenience checks" are not checks and check law does not apply. Convenience checks trigger a line of credit, and Reg. Z applies.

However, Reg. Z does not specifically address the unique type of confusion engendered by convenience checks. California has filled this gap with a law that mandates protections for

consumers who are provided convenience checks by credit card issuers. Issuers must disclose that use of the check will constitute a charge against the consumer's credit account, the APR and calculation of finance charges, and whether the finance charges are triggered immediately upon use of the check or draft.⁵⁵

B. If you rent a car, don't speed; big brother is watching

Companies are constantly dreaming up new types of extra charges to impose on consumers. Statutes and regulations are always slow to catch up to the latest schemes. Fortunately, courts sometimes come to the rescue. The Connecticut Supreme Court has imposed strict requirements on rental car companies in Connecticut that install global positioning systems in rental vehicles to track speed and charge the consumer's credit card account for traveling at speeds in excess of a certain amount. The court required the companies to clearly and conspicuously disclose the amount of the fee in writing in the rental agreement, disclose the use of the GPS device, inform the consumer that the speeding fee would be charged to their credit card account, and obtain the consumer's consent to use of the GPS device and to the amount of the fee in writing immediately adjacent to the disclosures. The company must provide the consumer with an opportunity to refute the alleged violation of the company's policy on speeding. Furthermore, the company's \$150 fee charged each time the consumer exceeded the designated speed was a penalty, not a valid liquidated damages provision.⁵⁶

C. Credit card holds

Some companies place a hold on the consumer's account in excess of the purchase price when consumers charge gas purchases to their credit cards. Bills have been introduced in state legislatures to restrict this practice.⁵⁷

VII. Debit Cards

Debit cards have enjoyed phenomenal growth in the past few years. "By 2009 it's expected that debit cards will be the dominant feature of all payments for American consumers."⁵⁸ Whereas consumers have several credit cards issued by various banks and non-banks, most consumers have only one debit card accessing one checking account.⁵⁹ Therefore, the bank where consumers have their checking account will be in an influential position. Consumers will be increasingly dependant on the bank that issued their debit card as ever more payments are transferred via that card. While consumers using debit cards have the benefit of Reg. E's disclosures and protections, the following illustrates that consumers have encountered problems that Reg. E does not address.

A. Debit cards: Holds on consumer's account

Some companies place a hold on consumers' accounts in excess of the purchase price when they charge their gas purchases to their debit cards. In 2002 the California Attorney General issued an opinion banning holds as a violation of that state's UDAP law unless the consumer receives prior notification.⁶⁰ A consumer has alleged that the practice violates Florida's Unfair and Deceptive Acts or Practices law.⁶¹ Bills have been filed in state legislatures to restrict the practice.⁶²

B. State law protections for debit card holders

A California law prohibits businesses that accept debit cards from printing more than the last five digits of a debit card account on receipts.⁶³

A court has come down hard on rental car companies in Connecticut that install global positioning systems in rental

vehicles to track speed and charge the consumer's debit card account for traveling at speeds in excess of a certain amount.⁶⁴

VIII. Paypal and Wal-Mart: When is a Bank Not a Bank

The Internet has created opportunities for new types of institutions that hold consumers' money and transfer funds into and out of their accounts. These institutions have a business plan that differs from that of traditional financial institutions. As a result, the legal status of those institutions is uncertain. This uncertainty presents a challenge for consumers who seek to apply the law when suing institutions to recover for loss resulting from the conduct of those institutions.

Paypal is the dominant player on this new frontier, with about 96 million accounts.⁶⁵ Paypal provides financial services to many persons transacting business on eBay and other venues (and is owned by eBay). Paypal claims it is a money transmitter and is subject to the states' money transmitter laws. During 2005 and 2006, several state regulators followed their colleagues in other states by registering PayPal as a money transmitter.⁶⁶ Money transmitter laws provide little consumer protection as consumers have no private right of action if companies violate those laws, and enforcement of the laws is lax.⁶⁷ Even if PayPal does not come within current legal definitions of a bank, Paypal performs many of the same functions as a bank, and arguably should be regulated as a bank, not a money transmitter.⁶⁸

The need for strong laws that apply to PayPal and enforcement of those laws is illustrated by a lawsuit brought by consumers. The consumers allege that Paypal wrongfully removed funds from customer accounts, made erroneous charges to accounts, allowed fraudulent accounts to be established under customer names, and wrongfully restricted access to their funds.⁶⁹ Although Paypal claimed it was not subject to the EFTA, PayPal agreed to settle the class action. According to the terms of the settlement, a \$3.4 million fund was established for dispute resolution claims, as well as a \$1 million fund to pay consumers seeking damages under the EFTA.

Like Paypal, General Motors, Toyota Motor Corporation, Target Corporation and American Express Company conduct some of the same types of operations as traditional regulated banks. The aforementioned companies, like Paypal, avoid strong banking laws and effective enforcement by owning industrial loan companies (ILC).⁷⁰ Recently, Wal-Mart and Home Depot applied for ILC charters, which are state-chartered financial institutions whose deposits are protected by FDIC insurance. (Utah has issued the charters of most major national retailers and creditors seeking ILC status.) Laws governing ILCs provide protection for consumers that are far weaker than the laws governing banks. Retailers and creditors own ILCs for a variety of reasons. Target uses its ILC to offer credit cards to businesses; Home Depot hopes to use its ILC to offer home improvement loans through third party contractors. Wal-mart claimed it wanted an ILC in order to lower its costs for processing credit and debit cards. Critics feared Wal-Mart would use its ILC to engage in other types of financial services and pose a serious threat to traditional banks.⁷¹ In March, 2007, Wal-Mart withdrew its application. Congress is considering several bills that would restrict the ability of retailers and creditors to operate ILCs.⁷²

IX. Conclusion

The years 2005 and 2006 have witnessed many significant developments in payment systems law. There have been new statutes, regulations, and court decisions. Previously unregulated payment devices are now subject to federal regulations without

Congress ever having even considered the matter. States have taken the initiative on some fronts when Congress and federal agencies have not acted. Private law-making by NACHA continues to establish many rules affecting consumer transactions.

In the future, technology will lead to the development of new payment systems and payment devices. On-line banking will continue to grow; more consumers will engage in banking transactions from their home PCs, and financial institutions will offer more types of services on-line.⁷³ At the same time, mobile wireless

While some consumers are only now getting used to banking with their PCs, some experts predict the cell phone will replace the PC both in transferring money and making purchases.

communication devices will be used to make "mobile payments."⁷⁴ For example, companies are testing cell phones that consumers can use to initiate payments from their accounts. While some consumers are only now getting used to banking with their PCs, some experts predict the cell phone will replace the PC both in transferring money and making purchases.⁷⁵ It is reasonable to anticipate that consumers taking advantage of these new products and services will encounter problems. Those offering the new services may have an ambiguous legal status and past history of consumer complaints, such as PayPal, a company testing mobile payments.⁷⁶ Consumers seeking legal relief when they are injured by new services that transfer money erroneously may have difficulty finding a legal handle under current law that was not drafted with the new payment methods in mind.⁷⁷ Consumers can only hope lawmakers and regulators will respond promptly to these future developments with creative and effective legal solutions, even as they continue struggling to deal with unresolved current legal issues such as federal preemption and who can obtain bank charters as ILCs .

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1. This article is based largely on materials prepared for *Teaching Consumer Law, The Past, Present and Future of Consumer Law*, a conference held in 2006 and sponsored by the University of Houston Law Center's Center For Consumer Law. The author is a Professor of Law at Georgia State University College of Law. The author gratefully acknowledges the research assistance of Jodi L. Green, a student at the College of Law and thanks the College for its support of his research. A comprehensive technical analysis of most of the topics addressed in these materials is included in Mark Budnitz & Margot Saunders, *CONSUMER BANKING AND PAYMENTS LAW* (Third edition 2005) and the 2006 Supplement to that book.

2. 15 U.S.C. § 1601 et seq. and 12 C.F.R. Part 226.

3. 15 U.S.C. § 1693 et seq. and 12 C.F.R. Part 205.

4. Although those who developed payroll cards intended them for employees without bank accounts, a recent study found that 54% of those using payroll cards had bank accounts and used direct deposit as well as payroll cards. They used the funds stored on the payroll card for savings and discretionary spending. *Payroll*

[articles/2006-03-01-release.html](#) (last visited June 1, 2006).

5. In 2006, retailers sold over \$27 billion worth of gift cards to consumers. Michelle Koetter, Gift cards' cheer still being spent," Pantagraph, available at 2007 WLNR 2373024. Courts have reached different conclusions as to whether state consumer protection law is pre-empted by federal law when banks are involved in the issuance of gift cards sold by an affiliate of Simon Property Group, owner and operator of shopping malls across the country. Compare SPGGC, Inc. v. Blumenthal, 408 F. Supp.2d 87 (D. Conn. 2006)(holding that Connecticut Gift Card Law is not pre-empted and rejecting a Commerce Clause challenge), with SPGGC, LLC v. Ayotte, 2006 U.S. Dist. LEXIS 52823 (D. N.H. Aug. 1, 2006)(holding that New Hampshire's Consumer Protection Act is pre-empted by federal banking laws). In 2006, the OCC issued a guidance for national banks on gift card disclosures. OCC Bulletin 2006-34.

6. Electronic Fund Transfers, 71 Fed. Reg. 1473 (2006)(Interim Rule), 71 Fed. Reg. 51437(Final Rule). The Rule is effective as of July 1, 2007.

7. Margarita Bauza, *Use of payroll cards grows*, Detroit Free Press, July 13, 2006.

8. Electronic Fund Transfers, 71 Fed. Reg. at 51440.

9. 71 Fed. Reg. at 51440. The Electronic Fund Transfers Act provides: "If electronic fund transfer services are made available to consumers by a person other than a financial institution holding a consumer's account, the Board shall by regulation assure that the disclosures, protections, responsibilities, and remedies created by this subchapter are made applicable to such persons and services." 15 U.S.C. §904(d)(1).

10. "Definition of Deposit; Stored Value Cards," 69 Fed. Reg. 20558, 20563 (2004).

11. 12 C.F.R. §205.2(b)(2).

12. A financial institution is not required to furnish a periodic statement satisfying Reg. E if it instead makes the consumer's account balance available through a "readily available telephone line." 12 C.F.R. §205.18(b). The telephone line must be either a local or a toll-free line that is available at least during standard business hours. 71 Fed. Reg. at 51443. If the employer chooses that alternative, it also must make available an electronic history of the consumer's account transactions that covers transactions for at least the 60 days preceding the consumer electronically accessing the account. The electronic history can be made available through an Internet Web site. Finally, in recognition of the fact that some workers may have limited on-line access, an employer selecting this alternative must make a written history of the consumer's account transactions available "promptly" when the consumer makes either an oral or written request.

13. Electronic Fund Transfers, 71 Fed. Reg. 1473, 1475. See 71 Fed. Reg. at 51441.

14. MINN. STAT. ANN. § 177.255 (2005).

15. Michigan requires "the full, free, and written consent of the employee, obtained without intimidation, coercion, or fear of discharge or reprisal for refusal to accept the payroll debit card." MICH. COMP. LAWS ANN. § 408.476. In Virginia, if an employee does not consent to payment via a "prepaid debit card," the employer must pay in money or by check. ANN. CODE OF VA. CODE ANN. § 40.1-29(B).

16. 12 C.F.R. Part 229.

17. 12 U.S.C. §§ 4001-4010.

18. 12 C.F.R. Part 229. See generally Budnitz & Saunders, *supra* note 1, at 16-19, 31-39; Barkley Clark & Barbara Clark, CLARKS' GUIDE TO ELECTRONIC CHECK COLLECTION 8-1 to 8-86 (2006).

19. In transactions subject to such an agreement, the Check 21 Act requires banks engaging in electronic image exchange to convert those images to substitute checks. 12 U.S.C. § 5003.

20. The FRB identified the problems that may occur. 69 Fed. Reg. 1470, 1496-97 (2004). See Mark E. Budnitz, *The Check 21 Challenge: Will Banks Take Advantage of Consumers?* 58 CONSUMER FINANCE LAW QUARTERLY REP. 369, 370-71 (2004).

21. If the agreement with the customer requires return of original checks, the consumer is entitled to certain disclosures, a recredit under specified circumstances, warranty protection, and indemnification. 12 U.S.C. §§ 5004, 5005, 5006, & 5011. Only the warranty provision applies to customers who agree to truncation. See Budnitz, *supra* note 20, at 373.

22. UCC §§ 3-103(16), 3-416(a)(6), 3-417(a)(4), 4-207(a)(6), 4-208(a)(4). The rules encourage the drawer's bank to recredit its customer's account by permitting that bank to shift liability to the depositor's bank.

23. 70 Fed. Reg. 71218 (2005), (effective July 1, 2006).

24. See *supra* Part V.A., describing the FRB's unsatisfactory response to bank overdraft programs.

25. See Budnitz & Saunders, *supra* note 1, at 14. See generally Benjamin Geva, THE LAW OF ELECTRONIC FUNDS TRANSFERS (2004). The number of payments made over the ACH network increased 16.2% in 2005, to 13.95 billion. Will Wade, *Bill Payment, PayPal Spur ACH Growth*, AM. BANKER, May 8, 2006, available at 2006 WLNR 8192557.

26. See, e.g., Will Wade, *New Project Could Link ACH, Image Networks*, AM. BANKER, May 17, 2006 (reporting that banks are considering launching a test of an electronic check-clearing system that would use both check imaging technology and the ACH network) available at 2006 WLNR 8853326.

27. See e.g., Will Wade, *Nacha Eyes 2007 Test For Internet/ACH System*, AM. BANKER, May 12, 2006 (reporting that in 2007 NACHA will test a system in which consumers who do not have credit cards could pay using the ACH network) available at 2006 WLNR 8569652.

28. 47 UCC Rep. Serv. 2d 670, 2002 WL 485352 (N.D. Ill. 2002).

29. 2002 WL 485352, at *6.

30. *Volden v. Innovative Financial Systems, Inc.*, 440 F.3d 947 (8th Cir. 2006). A consumer sued a check guarantee company that hired EFT Networks to use the ACH system to process the consumer's returned checks. The company violated the NACHA rules by not obtaining the consumer's written authorization before collecting a fee from the consumer's account. The court stated that the company's violation of its agreement with EFT Networks to comply with the NACHA rules provided a breach of contract claim for EFT Networks rather than for the consumer.

31. Courts recognize that bank accounts are indispensable. *State of N.J. v. McAllister*, 875 A.2d 866, 874 (N.J. 2005).

32. An example of a NACHA rule that goes beyond what the law requires is the requirement in "lockbox" transactions that the business not return the check to the consumer and use commercially reasonable methods to secure consumer checks and all bank information about these transfers. NACHA Rule 2.9.3.5. See text accompanying notes 37-38 for a description of electronic check conversion at the lockbox. See Mark E. Budnitz, *Consumer Payment Products and Systems: The Need for Uniformity and the Risk of Political Defeat*, 24 ANNUAL REV. OF BANKING & FINANCIAL L. 247, 263-64 (2005)(describing further examples of NACHA rules providing more consumer protection than the law requires).

33. ECC is sometimes referred to as ECK. As with many new technological products and services, it takes a while for the terminology to become standardized.

34. Under a new NACHA rule, effective March 16, 2007, a merchant could avoid the sometimes cumbersome process of running the check through the scanner. Instead, the check would

be processed elsewhere, in a “back office” operation. NACHA Rule 2.1.5.

35. The NACHA rules require return of the voided check, but no law requires this. Alternatively, as of March 16, 2007, merchants are permitted to retain the check and process it as a “back office conversion” but must provide consumers with notice and the opportunity to opt out. NACHA Rule 2.1.5. A merchant could participate in a system that operates outside that governed by the NACHA rules.

36. Not to be confused with a POS entry which applies to other ACH electronic transfers that occur at the point of sale and are subject to different NACHA rules.

37. Will Wade, *Spectacular 3-Year Growth Arc for ARC Payment*, AM. BANKER, April 11, 2005, available at 2005 WLNR 5923525.

38. Will Wade, *Bill Payment, PayPal Spur ACH Growth*, AM. BANKER, May 8, 2006, available at 2006 WLNR 8192557.

39. 71 Fed. Reg. 1638 (2006).

40. 12 C.F.R. §205.3(b)(2)(ii). Rather than being phrased narrowly in terms of the merchant, the rule applies to any “person that initiates an electronic fund transfer using the consumer’s check as a source of information.” *Id.* See 71 Fed. Reg. at 1639, 1641.

41. NACHA Rule 8.4.

42. 71 Fed. Reg. at 1639-40.

43. This is contrary to the NACHA rules that require that the notice must be “clear and conspicuous.” NACHA Rule 3.6.2.

44. NACHA rules prohibit the biller from returning the check. The check and all banking information relating to the payment transfer must be securely stored using a commercially reasonable method. NACHA Rules 2.9.3.3 & 2.9.3.5.

45. 70 Fed. Reg. 29582, 29583 (2005). See *Guidance on Overdraft Protection Programs*, Office of Thrift Supervision, 70 Fed. Reg. 8428 (2005); Interpretive Letter #914, O.C.C., Sept. 2001. For the industry’s perspective on overdraft plans, see Sam Davis & Stanley Mabbitt, *Checking Account Bounce Protection Programs*, 57 CONSUMER FIN. QUARTERLY REP. 26 (2003). For a consumer advocate perspective, see National Consumer Law Center & Consumer Federation of America, *Bounce Protection: How Banks Turn Rubber into Gold by Enticing Consumers to Write Bad Checks, An Examination of Bounce Protection Plans*, available at www.consumerlaw.org. See Carolyn M. Gillikin, *Overdraft protection programs: consumers still in the dark under Regulation DD*, 10 N.C. BANKING INST. 231 (2006).

46. 70 Fed. Reg. 29582 (2005). See the comparable rule issued by the National Credit Union Administration, 70 Fed. Reg. 72895 (2005)(Interim Final Rule); 71 Fed. Reg. 24568(2006)(Final Rule).

47. See *In re: Washington Mutual Overdraft Protection Litigation*, 201 Fed. Appx 409 (9th Cir. 2006). Consumers filed a class action alleging WAMU extended credit in its overdraft protection program. The Ninth Circuit upheld the district court’s dismissal of the consumer’s claim that the bank violated TILA for failing to disclose the APR rate applicable to credit cards because the charges, not being incident to extensions of credit, were not finance charges. However, the Ninth Circuit reversed the district court’s dismissal of the consumer’s other TILA claims related to the unsolicited issuance of credit cards and off-setting without an agreement to do so. The court noted that the consumers may be able to prove that their ATM cards come within the definition of a credit card.

48. 135 Cal. App. 4th 1463, 38 Cal. Rptr.3d 653 (2005)(modified on denial of rehearing 2006).

49. The OCC preemption rule at issue in the case was 12 C.F.R. § 7.4007. Case law is split on the effect of the OCC preemption rules on state law protecting consumers, with many cases holding

that the specific state law at issue in the case is preempted. *E.g.*, *Nat’l City Bank v. Turnbaugh*, 367 F. Supp. 2d 805 (D. Md. 2005)(OCC regulation preempts Maryland law restricting mortgage lender’s prepayment fee). See also *infra* note 55 for further discussion of preemption.

50. Reg. E, 12 C.F.R. Pt. 205, Supp. I (Official Staff Interpretation to § 205.3-(3)(c)(1)) .

51. 2006 NACHA Operating Guidelines, at 189, D4.

52. State of West Virginia *ex rel* Darrell McGraw, Jr., Att’y Gen. v. Tele-Check Servs., Inc., Docket No. 30731 (W. Va.).

53. Li Cao, *IQ Surge in Check Fraud*, AM. BANKER, April 5, 2006 (reporting that the number of alerts to banks about counterfeit payment instruments the FDIC issued in the first quarter of 2006 was more than twice the number in the first quarter of 2005, and the majority involved cashier’s checks) available at 2006 WLNR 6114995.

54. *E.g.*, Counterfeit treasurer’s checks drawn on Somerset Trust Company, Somerset, Pennsylvania, FDIC Special Alert, SA-3-2006, Jan. 19, 2006, available at www.fdic.gov.

55. CAL. BUS. & PROF. CODE §1748.9. A court held national banks are not bound by this provision because of the OCC’s preemption regulation. *Rose v. Chase Manhattan Bank USA*, 396 F.Supp.2d 1116 (C.D. Cal. 2005). Federal preemption of state payment law is an issue of major importance, but beyond the scope of this article. See generally *OCC Preemption Rules: OCC Should Further Clarify the Applicability of State Consumer Protection Laws to National Banks*, Government Accountability Office, (GAO-06-387) available at <http://www.gao.gov/new.items/d06387.pdf>.

56. *American Car Rental v. Commissioner of Consumer Protection*, 273 Conn. 296, 869 A.2d 1198 (2005).

57. *E.g.*, Maine Bill LR 2627 (2005)(prohibiting merchants from placing a hold on a credit or debit card for more than the amount actually spent unless within one hour from the sale the merchant or card company reduces the temporary hold to no more than the amount of the actual sale rounded to the nearest dollar).

58. H. Michael Jalili, *Debit Use May Top Cash and Checks This Year*, AM. BANKER, May 25, 2006, available at 2006 WLNR 9340787. “Electronic payments – including debit and credit cards–eclipsed paper-based ones for the first time in 2003, according to the Federal Reserve Board.” *Id.* The credit card market is saturated, and the industry is promoting debit cards for small payments that consumers now make with cash and checks. The goal is to “replace cash and checks rather than credit card payments.” *Id.* Consumers will be induced to increase their use of debit cards through rewards programs. *Id.*

59. *Id.* “Payments provide a constant connection to the customer. Payments are made every day; branch visits are not. Debit cards can therefore give banks an edge over banks in knowledge of customer behavior. Issuers can analyze transactions to learn how and why people make debit payments. That knowledge can help them acquire and serve customers and encourage them to use debit cards more.” Richard G. Lyons Jr., *Analyzing Debit Patterns Can Spur Account Growth*, AM. BANKER, April 28, 2006, available at 2006 WLNR 7665995.

60. 85 Op. Atty Gen. Cal. 17 (2002), available at <http://caag.state.ca.us/opinions/published/00-1009.pdf>.

61. *Grillasca & Mayzik v. Amerada Hess Corp.*, 2006 WL 3313719 (M.D. Fla. 2006)(court denied defendant’s motion to dismiss, holding that the EFTA did not apply, and even if it applied it did not preempt state law. Court also denied the defendant’s motion to dismiss the consumer’s implied contract, fraud, negligent misrepresentation, and unfair and deceptive practice claims).

62. *E.g.*, Maine Bill LR 2627 (2005)(prohibiting merchants from

placing a hold on a credit or debit card for more than the amount actually spent unless within one hour from the sale the merchant or card company reduced the temporary hold to no more than the amount of the actual sale rounded to the nearest dollar).

63. CAL. CIV. CODE § 1747.09.

64. American Car Rental v. Comm' of Consumer Prot., 273 Conn. 296, 869 A.2d 1198 (2005). See *supra* text accompanying note 56 discussing this case as it pertains to credit card holds. The court's ruling on credit cards also applies to debit cards.

65. A "significant part" of the growth of the ACH network in 2005 was due to consumers using PayPal to make payments over the Internet. Will Wade, *Bill Payment, PayPal Spur ACH Growth*, AM. BANKER, May 8, 2006, available at 2006 WLNR 8192557. The total dollar value of PayPal's transfers in 2005 was \$27 billion. In the first quarter of 2006, it was 41% more than the first quarter of 2005. *Id.*

66. According to PayPal's web site, it is licensed as a money transmitter or the equivalent, in 32 states, the District of Columbia, and Puerto Rico. www.paypal.com (last visited March 23, 2007). Money transmitter laws vary as to their requirements. Complex issues arise as to which state's law applies when the financial institution transfers funds from a consumer in one state to a consumer in another state. Jeffrey P. Taft, *Internet-Based Payment Systems: An Overview of the Regulatory and Compliance Issues*, 56 CONSUMER FIN. L. Q. REP. 42, 43 (2002).

67. Mark E. Budnitz, *Consumer Payment Systems, New Products and Services, New Laws and New Problems*, 56 CONSUMER FIN. L. Q. REP. 52, 53 (2002).

68. In its 2002 registration with the SEC, PayPal acknowledged: "Our status under state, federal and international financial services regulation is unclear." Olufunmilayo B. Arewa, *Securities Regulation of Private Offerings in the Cyberspace Era's Legal Translation, Advertising and Business Context*, 37 U. TOLEDO L. REV. 331, 345 n. 71 (2006). "PayPal is not a bank. Because we don't accept deposits or give loans, we are not classified as a bank." Interview with Amanda Piers, PayPal representative, Marketplace Morning Report, Aug. 31, 2004, available at Lexis.

69. In re PayPal Inc. Litigation, No. C-021227 JF (PVT). See Joyce E. Cutler, *Court Approves \$9.25 Million PayPal To Settle*

Restricted Account Lawsuit, 83 BNA BANKING REP. 528, Oct. 4, 2004.

70. Marilyn Geewax, *Banking separation defended*, Atlanta J. Constitution, July 13, 2006, available at 2006 WLNR 12064975; Joe Adler, *Twin aims of ILC Bill: Prevention, Pressure if FDIC Oks Wal-Mart, lawmakers are ready with plan to overturn*, AM. BANKER, July 10, 2006, available at 2006 WLNR 12166665.

71. Wal-Mart's testing of ATMs in New York state may be an indication that it intended to do more than merely process credit and debit cards. *Wal-Mart ATM raises fears*, Int'l Herald Tribune, July 14, 2006, available at 2006 WLNR 12160333.

72. Adler, *supra* note 70.

73. Ieva M. Augustums, *Banks rushing in to meet needs of Generation Y customers*, Dallas Morning News, June 4, 2006, available at 2006 WLNR 11036682. See generally Mark E. Budnitz, Donald F. Clifford, Michael Ferry, & Margot Saunders, *Home Banking Agreements: Don't Bank on Them*, 61 BUS. LAW. 641 (2006) (describing provisions in on-line banking agreements that fail to protect consumers).

74. Daniel Wolfe, *Firms See a U.S. Market For Payments by Phone*, AM. BANKER, April 5, 2006, available at 2006 WLNR 6115013.

75. *Id.* For example, one company is testing a service whereby consumers can use their cell phones to check the balance in their bank account, then call a merchant to order a product, using the phone to authorize payment. *Id.*

76. See *supra* text accompanying note 69. The service PayPal is testing would enable consumers to use text messages to transfer money to other PayPal customers and make purchases and pay by transferring funds from their PayPal accounts. Wolfe, *supra* note 74.

77. For example, MasterCard International is testing use of cell phones to issue credit and debit cards. Consumers would be able to contact a bank and activate their cell phone's payment chip remotely. "Issuing credit and debit products used through cell phones 'is a very different world from a traditional world of bank card issuance.'" Daniel Wolfe, *Remote Activation Featured In a MasterCard Phone Test*, AM. BANKER, April 7, 2006, available at 2006 WLNR 6247075.