1-1-2013

Checking Out of the Exception to 3-104: Why Parties Should Be Able to Negotiate Whether Checks Should Be Payable on Demand, 3 Colum. J. Race & L. 73 (2013)

Linda R. Crane
John Marshall Law School

CHECKING OUT OF THE EXCEPTION TO 3-104: WHY PARTIES SHOULD BE ABLE TO NEGOTIATE WHETHER CHECKS SHOULD BE PAYABLE ON DEMAND

LINDA R. CRANE*

Many aspects of American society, including its legal system, operate to the disadvantage of minorities. Obvious examples include inequities in our criminal justice system and in school funding. Much has been written on those and other topics. This article focuses on another example, specifically on how a sweeping change to an obscure banking rule regulating the check collection process has negatively affected consumers in general, and minority groups in particular.

U.S. check collections require a complex system comprised of a variety of institutions including commercial banks, savings and loans, savings banks, and credit unions, as well as the customers who rely upon them to collect payments from far and near. Traditionally, the check collection process, including the timing rules under U.C.C. Article Four, was inherently cumbersome and slow to honor the payee's right to receive immediate payment of funds from the paying bank. Frustration among payees, which grew due to not having their funds available fast enough because of delays that were inherent within the system, led lawmakers and others to reform the check collection timing rules..

It has now been more than twenty years since Congress passed the Expedited Funds Availability Act (EFAA), which empowered the Federal Reserve Board of Governors to regulate the speed with which commercial banks are required to make funds available to depositors after their checks were deposited for collection. There is evidence, however, that these reforms have had an negative impact on checking account customers as a whole, but in particular, a disproportionate impact on minority communities.

Specifically, by reducing the maximum amount of waiting time between the date of deposit and the date when funds are available to deposit customers, the reforms also reduced the time that the funds were available to the check-issuing consumer. Thus, in every checking transaction, checking account customers lost the benefit of the float that was built into every transaction under the traditional U.C.C. rules.

It is my thesis, therefore, that recent reforms in the timing rules that regulate the speed of the check collection process have indeed reduced the wait time for funds to be available, but have also resulted in increases in the appetite for various risky cash management alternatives by consumers to obtain the money that under old timing rules would stay in their deposit accounts for a longer period. Put another

* Professor of Law, The John Marshall Law School, Chicago, Illinois. Northwestern University, J.D. /M.B.A.
To the following people and institutions: The John Marshall Law School faculty scholarship research grant; The Midwest People of Color Legal Scholarship Conference, Inc.; The Society of American Law Schools; my colleagues, Prof. Kevin L. Hopkins (John Marshall), Prof. Linda S. Greene (Wisconsin-Madison),; my research assistants, In Yung Yi, Christopher Ehresman, Jeffrey Gaster, Stephanie Day and the student editors of the Columbia Journal of Race and Law.

way, consumers who issued checks liked float, too! To address this problem, I will propose two recommendations that can provide a remedy for consumers, at their option. First, that the definition of "check" should be changed under both state and federal commercial law to remove the limitation that all checks are due on demand. Second, I propose that the federal check collection timing rules should be amended to require banks to honor checks that are payable on a definite due date just as they honor those that are payable on demand.

I. INTRODUCTION

This Article is organized as follows:

Part II provides an overview of the check collections systems under the Uniform Commercial Code (U.C.C.) as well as the pre-reform timing of payment issues that persisted under the midnight deadline rules. Part III provides an overview and description of the characteristics of the new federal regulations that have been added to augment the state regulations. Particularly with respect to the new timing rules, it also provides a comparison of the operation of new timing rules to that of the traditional timing rules.

Part IV describes the changes in consumer behavior since the federal reforms went into effect, and posits that data revealing a dramatic increase in risky behavior by consumers, specifically and disproportionately among minority groups, show a connection between these behaviors and the reform of the check collection timing rules.

Part V contains two recommendations that provide a solution to the problems that the regulatory reforms have caused consumers. The first recommendation is that both the U.C.C. and Regulation CC's statutory definition of "check" should be amended to allow bank drafts to be treated like all other negotiable instruments, which are able to be payable either at a definite time or on demand—at the option of the parties at the time of the transaction. The second recommendation is for bank regulators to require banks to honor presentations of checks that are not payable on demand on the definite date in the future when they become due and payable.

Part VI provides a brief rebuttal to some potential objections that may be raised in response to the recommendations made in Section V. Part VII is a brief summary and conclusion.

II. OVERVIEW OF PRE-REFORM SYSTEM OF CHECK COLLECTIONS, INCLUDING MIDNIGHT DEADLINE TIMING RULE

Article 3 of the U.C.C. governs the rights and obligations of parties to negotiable instruments. Its provisions require that the transfer of checks occur using a special form of transfer called "negotiation" through which the transferee becomes a "holder" and, therefore, is entitled to enforce it.[1] Under U.C.C. Article 3, negotiable instruments fall into two broad categories: notes,[2] which are always two-party instruments,[3] and drafts,[4] which are always three-party instruments.[5] The definition of "Negotiable Instrument, U.C.C. 3-104, allows parties to decide whether their instruments will be payable immediately (demand instruments) or at a definite date in the future (time instruments)[6]. Notes and drafts can be issued without involving a bank as one of the parties. If, however, a bank is a party to a three party draft, it becomes a "check"[7] as defined by 3-104(f).

---

[1] U.C.C. §§ 3-201, 3-301 (amended 2002).

[2] *See generally* U.C.C. §§ 3-104(a), 3-103(a)(8), 3-103(a)(12) (amended 2002).

[3] The parties to notes are referred as the "maker" and "payee."

[4] *See generally* U.C.C. §§ 3-104(a), 3-103(a)(8), 3-103(a)(12) (amended 2002).

[5] Drawer, Payee, Drawee/Paying Bank or Paying Bank under Regulation CC 12 C.F.R. § 229.2.

[6] *See* U.C.C. § 3-104(f) (amended 2002).

[7] The terms "checks," "negotiable bank drafts," and "items" are all used interchangeably through the relevant state and federal regulations and this article.

In addition to defining "check" as "a draft drawn on a bank," Article 3 also defines "check" as "payable on demand."[8] Thus, while the U.C.C. provides parties to notes and drafts broad flexibility to, choose the precise date when they will be payable, parties to checks are denied this ability.[9] Applicable reforms at the federal level, referred to colloquially as "Reg. CC," define "check" in a similar manner as "a negotiable demand draft drawn on or payable through . . . a bank . . . ."[10]

Somewhat perversely, it is because checks are 3-party instruments that it is so difficult—arguably logistically impossible—to pay them immediately upon demand. This is because all three parties to a check have interests that must be balanced—and that takes time—even after the check is presented to the drawer's bank for payment.

Pre-reform rules under Article 4 of the U.C.C. impose strict timing rules for check collection once an item is deposited for collection. Among other things, these pre-reform rules required payment to occur within a limited amount of time after the check was presented for payment.[11] During the collection process any bank in the chain of collection has up to two days before it must forward the check to the next bank in the collection chain. This timing of collection and of payment rule is called the "midnight deadline rule."

Specifically, a bank's "midnight deadline" is defined as "midnight of the banking day following the banking day of receipt."[12] Under Article 4, each bank that touches a check during the collections process has a separate midnight deadline.[13] That means that every person entitled to enforce the check must wait up to two days, multiplied by the total number of banks involved in the process. Of course, under Article 4 the actual demand for payment does not occur until the check reached the only bank that could make the payment decision—the paying bank.

Once the check finally reaches its ultimate destination, the paying bank is actually allowed to await the expiration of two different midnight deadlines prior to becoming legally accountable for the amount of the item. First, the paying bank has until midnight of the day of receipt to decide whether to give provisional and revocable credit for the check. Second, if the paying bank gives provisional credit for the check before midnight of the first banking day on which it receives the check for payment, then the U.C.C. extends the deadline by which the paying bank must make a final decision to either pay or to dishonor the check to midnight of the next banking day. Remarkably, it is not until the expiration of the paying bank's second midnight deadline that it must make a final decision to pay or to dishonor the item at which time it will either be finally paid or notice of dishonor will be sent to the depositary bank.[14]

---

[8] *Id.*

[9] *Id.* (distinguishing "checks" as a special subset of drafts payable on demand and drawn on a bank). U.C.C. § 1-104 (amended 2002) allows parties to vary this default rule by agreement, but there is no evidence that banks include such a waiver in their customer agreements, nor that they honor such items.

[10] *See* Regulation CC, 12 C.F.R. § 229.2(k) (2012). Recent events are of importance here. One of my proposals is to redefine the definition of check to allow consumers to choose the date when the check will become payable. *See infra* Section V(A) and accompanying footnotes. After the passage of Dodd-Frank, that task is not so simple as merely petitioning the Federal Reserve. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 STAT. 1376, Public Law 111-203, §§ 1011, 1022 (establishing Bureau of Consumer Financial Protection and giving it rulemaking power over federal consumer financial law).

[11] U.C.C. §§ 4-203, 4-301 (amended 2002).

[12] *Id.* § 4-103(a)(10).

[13] *Id.* §§ 4-203, 4-302.

[14] *Id.* § 4-202.

The "midnight deadline" rule, taken alone, provides no incentives for the collecting banks to take action before the expiration of their midnight deadline.[15] This is only slightly less true for the paying bank—which is not technically a collecting bank.[16] The paying bank faces the daunting risk of becoming accountable for the amount of the item if it has not completed its process for determining whether the item is properly payable from its customer's account prior to the expiration of its midnight deadlines.[17] Collecting banks (including the depositary bank, any intermediary banks, and the presenting bank), however, are only liable for their negligence, if any, for failing to meet their midnight deadlines.[18]

Under U.C.C. rules, for the depositor awaiting receipt of the collected funds, the midnight deadline clock does not begin to run until the check is actually presented to the paying bank when the demand for payment officially occurred. As an example, the following is an illustration of a short check collection involving two intermediary collecting banks on opposite coasts. The length of the wait for the payment decision depended on how many banks were involved in the collection, but could generally be reduced to the formula 2X = D, where X is the number of collecting banks and D is the number of days the payee must wait for payment. The paying bank will generally have two days instead of one because the rule that they must make a final payment decision by midnight of the banking day of receipt is extended until their real midnight deadline if they give provisional credit on that day. Thus, in a transaction involving a depositary bank, a paying bank, and two Federal Reserve bank branches on opposite coasts as well as an additional intermediary bank on either coast, the average length of time that elapsed between the date of deposit and the date of expiration of the drawee's midnight deadline under Article 4 was usually more than ten days.[19]

Historically, the U.C.C. required privity among the parties to a check, including all of the banks involved in the collection and payment process. This requirement, in conjunction with the liberal midnight deadline timing of payment rule, complicated the relationships among the collecting and paying banks, and added more time to the already cumbersome collections process. Consequently, despite the fact that checks are demand instruments, because of the logistics of the national bank check collections system, they were never capable of being paid immediately—neither as a practical matter nor under the applicable U.C.C. rules.

The problems caused by this slow process were not limited to their effects on consumers. The old check collection rules also produced problems associated with a financial concept called "float." In general, float results when a bank is credited with funds before they are disbursed from a payee's account. One specific consequence of bank float that concerned the Federal Reserve Bank Governing Board is that the funds associated with checks in the collections system were being accounted for in the accounts of multiple banks, simultaneously. This is due to the banking industry's practice of booking provisional (temporary revocable) credit for checks on the presumption that they will be honored when presented to the paying bank for payment. This approach, through which the banks account for the value of checks while they move through the collection process, while efficient from an accounting entry viewpoint, created a problematic inflationary impact insofar as it distorted the actual balances of money on deposit throughout the U.S. monetary system at any given moment. This type of float results from the fact that funds behind each check were concurrently reflected in the account balances of all of the banks (depositary, collecting, and paying) during the collection process. Consequently, this float

---

[15] *Id.*
[16] *Id.* § 4-105(3)–(5).
[17] U.C.C. §§ 4-301–4-302 (amended 2002).
[18] *Id.* §§ 4-105, 4-202, 4-203.
[19] 2 days x 5 banks = 10 days.

artificially inflates the size supply of money in the banking system[20] and necessarily affects the Federal Reserve Governing Board's determination of monetary policy.[21]

This was the confluence of problems that the U.C.C. could not, or would not, address that eventually led to federal intervention by Congress. Consumer protection activists and the Federal Reserve Governing Board, for their respective reasons, sought reform of the check collection process in part out of frustration with the inaction of state legislatures and the National Conference of Commissioners on Uniform State Law, which had recently revised U.C.C. Articles 3 and 4 extensively without changing the midnight deadline collection and payment timing rules. Moreover, Congress was becoming more engaged in consumer protection and was also aware of the Fed's increasing concern over the float in the monetary supply. However, it is important to keep in mind throughout the following sections that although Congressional reforms of timing rules in the check collection process were justified and overdue, they were not done in a way that proved advantageous for all consumers.

Specifically, the loss of float time created destructive consequences for poor consumers, the majority of whom are members of minority groups. As will be explored later on in this article, this new reform resulted in a disproportionate increase of risky behaviors such as borrowing money using payday loans, credit cards, and HELOCs. These increases were not merely coincidental. Historical data and social studies suggest that these industries purposefully targeted minority groups for exploitation. The financial devices in question frequently have significant financial costs. A typical payday loan, for instance, may end up costing the consumer hundreds if not thousands of dollars in excess of the loan principal. That is startling, given that a typical payday loan is for only a small amount of money. In the aggregate, these instruments drain millions of dollars from local communities, making economic and social advancement all the more difficult.

III. FEDERAL INTERVENTION AND REFORM INITIATIVES

Even though U.C.C. Articles 3 and 4 were amended extensively in 1990, the timing of collection rules in the "Revised Articles" was not significantly revised.[22] Several state legislatures took steps during the 1980s to limit the length of hold periods, but the prevailing U.C.C. timing rules remained largely unchanged.[23] Most notably, the Revised Articles governing check collections retained the midnight deadline rules despite an ever increasing chorus of customer complaints about the length of their wait times for their funds to be available following deposits of checks for collection.

In the absence of a meaningful state level response to the unacceptably long waits for funds availability, Congress enacted two new statutes designed to speed up the check collection process and to expedite the availability of the depositor's funds. First, in 1987 it passed the Expedited Funds Availability

---

[20] *See Float*, FED. RESERVE BANK OF NEW YORK (April 2007), http://www.newyorkfed.org/aboutthefed/fedpoint/fed08.html (noting that "float is created when a Reserve Bank credits a bank for depositing a check but has not yet collected funds from the bank upon which the check is drawn. Both banks now list the funds on their books, and they continue to do so until the check is presented and the Reserve Bank collects funds from the bank on which the check is drawn. As a result, both banks have use of the same funds for a short time.").

[21] *See id.* (noting that "although the amount of float is subject to random fluctuations, definite weekly and seasonal trends have been observed. The Federal Reserve Bank of New York uses these float trends to forecast float levels. The forecasts are given to the Open Market Desk, which implements the Federal Reserve's monetary policy. Using these forecasts and other information, the Open Market Desk buys and sells Government securities daily, usually in an attempt to smooth fluctuations in the aggregate level of bank reserves.").

[22] WILLIAM WARREN & STEVEN WALT, PAYMENTS AND CREDITS 3 (Foundation Press 7th ed. 2007).

[23] *Id.* at 167.

Act (EFAA).[24] An important part of the EFAA was its broad delegation of rulemaking authority to the Federal Reserve Governing Board. The Fed first exercised this authority when it promulgated Part 229 of the Chapter 12 of the Code of Federal Regulations (12 C.F.R. Part 229) under the title "Availability of Funds and Collection of Checks (Regulation CC)."[25] The second statute, The Check Collections For the Twenty First Century Act, commonly known as "Check 21", was passed in 2004 and has resulted in changes to the way banks can process checks and allows them to create substitute checks using image technology. These additional rules have been added to Regulation CC.

A. The Expedited Funds Availability Act and Regulation CC

Regulation CC was the first of two recent major reforms in the national bank check collection system in the United States. Regulation CC's primary focus was to impose shorter time limitations within which depositary banks were required to make funds available to their checking account customers "as a matter of right."[26] To accomplish this, Regulation CC shifted the focus of the timing rules from counting the days after the demand is made to a paying bank, to focus on the number of days after the deposit before which the depositary bank would become accountable. Thus, Regulation CC shifted the liability for speeding up the timely payments away from the last bank in the process—the paying banks—and shifted the burden onto the first bank in the process—the depositary bank. Henceforth, funds would be made available within a set number of days after the deposit, regardless of how many intermediary banks were involved in the presentation of the check to the paying bank.[27] As a result, Regulation CC required banks to dramatically speed up the release of funds to depositors and the return processes.[28] In this respect, the Act protected consumers from excessive delays in payment and helped relieve the problem of holdover float.

Under the federal law, the speed with which depositary banks must make funds from deposits available to its account holders is determined by an availability schedule that changes depending on the nature of the deposit and withdrawal.[29] Significantly, Regulation CC's permanent availability schedule does not eliminate the midnight deadline rules. Consequently, both sets of timing rules continue to co-

---

[24] The Expedited Funds Availability Act, 12 U.S.C. §§ 4001–4010 (1987).

[25] *Id.* The EFAA is found under Title IV of the Competitive Equality Banking Act of 1987. The Act was enacted on August 10, 1987 and was previously known as Section 601 of title VI of the Act of August 10, 1987.

[26] *See* 12 C.F.R. § 229.1(b)(2)–(3)(2012). Section 229.1(b)(2) states: "Subpart B of this part contains rules regarding the duty of banks to make funds deposited into accounts available for withdrawals, including availability schedules, disclosure of funds availability policies, payment of interest, liability of banks for failure to comply with Subpart B of this part, and other matters." Along the same lines, Section 229.1(b)(3) states: "Subpart C of this part contains rules to expedite the collection and return of checks by banks. These rules cover the direct return of checks, the manner in which the paying bank and the returning banks must return checks to the depositary bank, notification of nonpayment by the paying bank, endorsement and presentment of check, same-day settlement for certain check, the liability of banks for failure to comply with subpart C of this part, and other matters."

[27] 12 C.F.R. § 229 (2012).

[28] WARREN & WALT, *supra* note 22, at 169.

[29] *See* Appendix B for a chart of the availability schedules. The availability has numerous exemptions that allow the depositary banks to delay fund withdrawal. The situations include: new accounts where the account is open for thirty days or less; large deposits where deposits that aggregate more than $5,000 on one banking day; re-deposited checks where checks have been dishonored and a redeposit is attempted; repeated overdrafts where customer accounts are "repeatedly overdrawn"; "reasonable cause to doubt collectability" where "the depositary bank has reasonable cause to believe that the check is uncollectible"; emergency conditions where emergency conditions exist "beyond the control of the depositary bank, if the depositary bank exercises such diligence as the circumstances require"; "notice of exception" where notice is given to the customer at the time of deposit; "length of delay due to exceptions" where the bank can delay availability for "a reasonable period of time" of up to five business days for local checks and six days for non-local checks. *See* 12 C.F.R. § 229.13 (2012).

exist.[30] To co-exist, banks can continue to collect checks using the interbank collections process and are allowed to make a decision about whether to honor a presentment before the expiration of the paying bank's midnight deadline as long as they also do so before the depositary bank must make the funds available to the depositor in compliance with Regulation CC's Availability Schedule.

B. Check 21

In 2004, more than fifteen years after the passage of the EFAA, the second of the two major reforms was passed by Congress under the name, The Check Collection for the Twenty-first Century Act, commonly known as "Check 21." Among other things, Check 21 empowered the Fed to promulgate regulations to achieve its goals. The Fed did so by adding new provisions to Regulation CC.[31] Check 21 continued to speed up the check collection process by removing two impediments that were unaddressed by the first set of Regulation CC's provisions. First, Check 21 ushered in the demise of the requirement of privity among the collecting and paying banks. This allowed the depositary bank to present checks to the paying bank directly regardless of whether they were parties to a separate bank-customer relationship. Second, Check 21 created the innovation of the "substitute check."

Prior to Check 21, each bank that was negotiating checks in the collections process was still required to have privity with the next collecting bank in the chain. Moreover, Article 3 negotiation required each bank to become a holder in its own right, entailing physical delivery of the original check each time it was transferred throughout the collection process through the time of its presentment for payment to the paying bank.[32] Truncation was not allowed and electronic versions were allowed only under special arrangements.[33]

Check 21, however, allows depositary banks to convert an original check into a substitute check. Substitute checks can travel through the check-collection system in place of the original paper check—but they are still paper checks![34] The substitute check must be a paper reproduction of the original check that contains an image of the front and the back of the original paper check.[35] The substitute check is now the legal equivalent of the original check as long as it accurately depicts the front and the back of the check.[36] Substitute checks remain subject to U.C.C. Articles 1, 3, and 4, and other state law along with applicable federal law.[37]

There is a widely believed misconception that Check 21 actually requires check truncation and the creation of a new substitute check. It does not. Rather, it provides a structure within which banks have the option of making speedier presentments by removing legal and logistical impediments, such as

---

30 *Id.*; s*ee also* WARREN & WALT, *supra* note 22, at 168.

31 Even though this Article criticizes the reforms for certain failures, it agrees that they were necessary and overdue. The Article is neither opposed to the movement to reform the check collection timing rules nor to the changes that they were intended to usher into place. They were overdue given the availability of technology capable of speeding up the process. They were necessary because banks had little or no incentive to change the pace of collections under the U.C.C. midnight deadline rules. There are, however, very serious, presumably unintended, consequences that can be traced to the new rules.

32 U.C.C. § 3-201 (amended 2002).

33 Andrea McGlinn, Book Note, *Check Clearing for the 21st Century Act: The Impact on Consumers*, 9 N.C. BANKING INST. 179, 180 (2005).

34 *Check 21 Implementation Video*, ELECTRONIC CHECK CLEARING HOUSE ORGANIZATION, http://www.eccho.org/history_video (last visited Dec. 2, 2012).

35 Carl Felsenfeld & Genci Bilali, *The Check Clearing for the 21st Century Act—A Wrong Turn in the Road to Improvement of the U.S. Payments System*, 85 NEB. L. REV. 52, 84 (2006).

36 *See* McGlinn, *supra* note 33, at 181.

37 *Id.*

privity of contract among collecting banks and/or transporting the original check across long distances for collection. It simply places another arrow in the quiver of banks as they navigate the choppy waters between state and federal check collection timing rules. Check 21 gives collecting banks the opportunity to decide whether to take advantage of the federal regulations or not, depending upon their respective analyses of the associated costs and benefits.[38] One option still available is for banks to keep processing checks by negotiating them through the slow interbank collection system if they wish. What depositary banks must do, however, is make funds available to its customers whether or not the paying bank's midnight deadline has expired.

When a substitute check is created it is still in paper form and is still an Article 3 negotiable instrument. Check 21 does not require banks to deal with each other directly nor to create substitute checks. Banks can continue to just operate as they did under Regulation CC and Article 4 using the movement of the original paper check through the process that they want or they can use the check substitution.

C. The Regulation CC/Check 21 Interface

The purpose of the new regulations was to meet the Congressional objective of adding improvements to the check collection system by expediting the availability of funds for checking account customers and to ease the way for banks to use diligence to remove impediments to their ability to process and to pay remote collection items.[39]

By making the depositary bank responsible, instead of the paying bank, the EFAA places the emphasis on the bank that actually controls whether or not the funds are actually made "available" to the depositor—the depositary bank. This highlights the greatest difference in emphasis between the EFAA and the U.C.C., which otherwise overlap in various respects: the EFAA limits the time that the depositary bank has to make the decision to allow withdrawal of funds by the person entitled to enforce the instrument, whereas the U.C.C. limits the time the paying bank has to make the payment decision based on whether the item is properly payable by the person who issued it.

By speeding up the process, however, the EFAA exposes depositary banks to losses they did not face under the traditional midnight deadline regime. Specifically, banks now have much less time to make an informed decision about whether or not to allow customers to withdraw funds from check deposits. That fact increases the chances that funds associated with a check that has been dishonored will already have been released by a depositary bank before it receives notice of dishonor from the paying bank.

There were good reasons for Congress to reform of the check collection system. Along with the entrance of Congressional intervention has been a steady increase of the Fed's influence in the area of commercial regulation. The Fed, in fact, has been empowered by Congress to draft the regulations to accompany the new federal statutes governing check collections, beginning with Reg. CC, and continuing with Check 21 as well as its 2010 amendments.[40]

One of the most interesting aspects of the Federal movement to reform the check collection system is that it has not abolished the midnight deadline rules of Articles 3 and 4 of the U.C.C. Rather, the U.C.C. (which has also been revised extensively and often) has been allowed to co-exist with new Federal regulations despite the fact that the U.C.C. and federal reforms contain dramatically different and

[38] Felsenfeld & Bilali, *supra* note 35, at 91–92.

[39] 12 U.S.C. § 5001 (2006).

[40] In fact, the Fed actually took the initiative to actually draft Check 21 and sent it to Congress, which apparently rubber-stamped it.

potentially inconsistent timing rules. Of course, the Federal regulations trump state law and must be followed by banks whether or not they continue to satisfy the U.C.C. timing rules.[41] Moreover, there is great possibility for additional reform as technology improves because it will become more feasible to virtually make checks payable "on demand" as still required by both state and federal definitions.

The reforms that sped up the availability of funds following a deposit of a check are best understood in context, that of a buyer/consumer who uses a check to pay for a purchase of valuable goods or services from a seller who is willing to wait a brief period to collect the funds from the buyer's bank. The focus of the reformers was primarily on the seller's demand rights in the instrument. Of course, it is the seller in the underlying commercial transaction who is entitled to payment and who has agreed to take a check as a substitute for money with the understanding that the buyer has sufficient funds on deposit at its bank at the time when the check was issued.

The second party to the three-party bank check is the buyer or consumer in the underlying commercial transaction who issued the check as payment. Traditionally, rightly or wrongly, the buyer developed a reasonable expectation that there would be some delay before the money would be debited against the account from which the check was issued. Not only did these consumers expect a delay in payment, they perceived benefits from the delay, including continued earning of interest during the delay period, and continued use of funds.[42]

Regulation CC and Check 21 successfully reduced bank float and expedited the availability of funds to sellers. However, in a significant oversight, the regulators failed to consider the impact of the reform rules on consumers who were accustomed to using checks to pay for their purchases. The result was that low-income and minority consumers were left scrambling for alternative cash management strategies.[43]

---

[41] The mid-1950s until 1990 used U.C.C. Article 4 and the midnight deadline rules. From 1990 to 2004, we have had the EFAA and Regulation CC. From 2004 to the present we have had the Check 21 Act.

[42] Jeffrey M. Lacker, *The Check Float Puzzle*, 83 FED. RESERVE BANK OF RICHMOND ECON. Q. 1, 1–25 (1997).

[43] *See The Color of Debt: Credit Card Debt by Race and Ethnicity*, DEMOS, http://www.demos.org/sites/default/files/publications/FACTSHEET_TheColorofDebt_Demos.pdf (last visited Nov. 25, 2012) (noting that in 2007, thirty-nine percent of minority consumers used credit cards "to pay for basic expenses" such as "rent, mortgage payments, groceries, utilities or insurance because they did not have enough money in their checking or savings account"); *see also The Plastic Safety Net: Findings from the 2012 National Survey on Credit card Debt of Low and Middle Income Households*, DEMOS, http://www.demos.org/sites/default/files/publications/PlasticSafetyNet-Demos.pdf (last visited Nov. 25, 2012) ("Nearly half of young adults and forty-five percent of households earning less than $50,000 per year used credit cards to pay basic monthly costs like groceries and rent. Fifty-two percent of households with members lacking health insurance paid for necessities with credit cards."). By contrast, fifty-four percent of *all households* surveyed in a 2007 study reported using checks to cover basic month-to-month expenses. *See* PEW RESEARCH CTR., WHAT AMERICANS PAY FOR—AND HOW (2007). This information lends itself to the inference that less lower-income and minority consumers are using checks for their daily expenses. Moreover, the fact that low-income and minority consumers made the switch is not an accident. Over forty percent of households which relied on credit card debt for basic daily expenses such as rent did so because their checking accounts did not provide a sufficient financial cushion. *See* Demos, *Plastic Safety Net*. A survey of payday loan users in Texas turned up similar results regarding the type of expenses that the loans were used for. *See Short-term Cash, Long-term Debt*, Texas Appleseed, 9–12 (Apr. 2009), http://www.caction.org/CAN-Research/Reports/2009/Short-termCashLong-termDebt.pdf ("The majority of respondents need credit to cover basic recurring expenses, such as bills, food and rent, or mortgage payments."); *see also* PEW RESEARCH CTR., WHO BORROWS, WHERE THEY BORROW, AND WHY (2012) (2012 survey of consumers finding that sixty-nine percent used payday loans to cover recurring household expenses). In one survey, respondents' answers were particularly revealing. The respondents, explaining how they used payday loans for recurring expenses, stated:

Male borrower, Chicago:

IV. CONSEQUENCES OF FEDERAL REGULATORY REFORM

Although it was undoubtedly prudent for the Fed to take steps to reduce the inflationary effect that the traditional checking system had on the monetary system, in so doing it triggered a concomitant negative economic impact on consumers.[44] There were, in fact, some fears expressed prior to the passage

---

"Just need to get to the next paycheck. And I need, you know, either pay the bill to keep the lights on, or need some food, or whatever it is."

Female borrower, San Francisco:
"If I have bills to pay, or say I need food on the table, I am going."

Male borrower, San Francisco:
"Well, I was a little short and was thinking I could use some more money and I was at the ATM actually, and it was there, offering me a direct deposit advance. So, I thought I would try it."

[44] *See* FED. RESERVE BANK OF NEW YORK, *Float*, *supra* note 20. The Federal Reserve Bank of New York described the float problem as follows:

> For several reasons, float increased sharply in the 1970s. One was that the volume of checks processed by the Federal Reserve doubled during the decade, increasing holdover float. Also, high inflation meant that the average dollar amount of check increased. Finally, high inflation, coupled with high interest rates, provided an incentive for large companies to draw funds from far-away banks to try to benefit from transportation float. The practice of drawing funds from far-away banks was known as "remote disbursement."
>
> The Federal Reserve took action in 1973 to reduce transportation float by establishing new regional check-processing facilities throughout the Federal Reserve System. In addition, efficiency in the use of air charter service was improved. These measures helped reduce float from a daily average of \$2.7 billion in 1973 to a daily average of \$2.1 billion in 1975. However, between 1975 and 1979, float more than tripled (in nominal terms) to a daily average of \$6.6 billion, an all-time high. The Board of Governors of the Federal Reserve System believed that transportation float caused by remote disbursement had become a serious problem, and issued a policy statement in early 1979 to discourage the practice.
>
> As part of the Monetary Control Act of 1980s, the Federal Reserve System was instructed to charge banks for float. As a result of this legislation and greatly improved check processing efficiency, float was reduced to a daily average of \$2.5 billion in 1982, down about 60 percent (in nominal terms) from the 1979 level. To reduce float further, the Federal Reserve implemented procedural changes in the 1980s. Among these changes was the establishment of a nationwide noon-presentment policy in 1983 that allowed later delivery of checks to banks in cities with Federal Reserve check-processing offices. This policy also applied to high-volume institutions in more remote areas that had access to regional check processing centers. These actions significantly increased the number of checks that could be collected overnight, speeding the clearing process and reducing float. By 1985, float was reduced to a daily average of \$820 million, down almost 90 percent from its 1979 level. The amount of float averaged \$860 million through the rest of the 1980s.
>
> Developments in the 1990s
>
> In the 1990s, float has decreased further. One reason is that fewer paper checks are being sent to the Federal Reserve, reducing holdover float. The number of checks processed by the Federal Reserve decreased from 19 to 15.5 billion between 1993 and 1995. The number of checks processed in the United States continues to decrease, due largely to the rapid growth in electronic payments. For example, many employers now offer direct deposit of paychecks to their employees, speeding payment and reducing float.
>
> Also, the Federal Reserve has been installing new technology since the 1980s to reduce transportation float. Instead of having their accounts debited upon the physical return of checks, paying banks have the option of having their checks scanned and converted into electronic presentments at the Federal Reserve. The electronic presentments are transmitted from the Federal Reserve to the paying banks, and accounts are debited more quickly. The Federal Reserve is

of Check 21 about the potential dangers that it would pose for consumers.[45] One such fear was that the loss of float would result in more returned checks and thus more overdraft fees. It was estimated that by mid-2005, consumers could be bouncing seven million more checks and paying $170 million more in fees.[46] A survey suggested eight percent of consumers wrote checks "because they like the float."[47] This data suggested that consumers liked float just as much as the banks did.

The recent growth in risky behavior among consumers is confirmation of the dangers associated with the loss of float that was in the system prior to the enactment of Check 21 and the Regulation CC. News coverage during the economic downturn beginning in 2008 brings this mind as much has been made in the media of the dramatic increases in unaffordable mortgage debt, payday loans, and other high risk behaviors that consumers have been undertaking.

The primary thesis of this Article is that many of these risky behaviors are the result of Regulation CC. Upon losing the time previously built into the cumbersome and slow check collection process, consumers—especially those who had fewer viable alternatives—began seeking alternative sources of cash to address the impact of the loss of check transaction float on their ability to manage their scarce cash resources. These alternative sources are more expensive and thus detrimental to poor minority consumers eliminating the relative windfall they enjoyed as a result of the "transaction" float that was built into the old system.

There is little doubt that the primary motive for federal pre-emption of traditional state governance of the check collection process was, at some level, to protect consumers.[48] But the reforms are problematic because they addressed a problem by using an approach that failed to anticipate the pressure they would place on consumers to seek alternative ways to manage their cash. In particular, the reforms reflect an apparent failure on the part of both Congress and the Federal Reserve Governing Board to fully consider all of the implications of speeding up the check collection timing rules.

Certainly, there is no evidence that any affirmative steps were taken by either Congress or the Fed to more completely protect consumers with easy access to a mainstream alternative to replace the old slow-to-be-collected check. Consumers prefer and need a check that is collected more slowly than their traditional demand instruments are currently being collected under the new, faster availability schedules.

By removing all float, the federal regulators left consumers to their own devices to replace the element of time they once enjoyed under the old timing rules—and upon which they had heavily relied in their cash management calculus. Since the enactment of Regulation CC and the expedited availability schedules, consumers facing shrinking windows of time during which they can obtain funds to cover their checks have turned to three main alternative cash management sources: payday loans, credit cards,

---

continuing to investigate and implement new methods to speed the check-clearing process. As a result, float averaged only $774 million in 2000, and it will likely decrease even further as technology advances.

[45] Paul Katzeff, *Bank "Float" is Set to Fade-Out*, INVESTOR'S BUS. DAILY, Oct. 11, 2004, at A14; McGlinn, *supra* note 34, at 179; *see generally* Mark E. Budnitz, *The Check 21 Challenge: Will Banks Take Advantage of Consumers*, 58 CONSUMER FIN. L.Q. REP. 369 (2004).

[46] *See "Check 21" Law Benefits Banks But Will Mean More Bounced Checks & Fees for Consumers*, CONSUMERS UNION (Aug. 24, 2004), http://www.consumersunion.org/pub/core_financial_services/001332.html.

[47] *See* McGlinn, *supra* note 33, at 194.

[48] *See Frequently Asked Questions About Check 21*, FED. RESERVE BOARD OF GOVERNORS, www.federalreserve.gov/paymentsystems/check21_faq.htm# (last updated May 1, 2012).

and HELOCs. All of these alternatives were more expensive than their checks and deleterious to the economic well-being of the poorest, most vulnerable of all checking account customers.

Timeline data seem to indicate a relationship, between the enactment of the first of these federal reforms and the increase in the appetite for risk by consumers and consumption for financial products that allow them to leverage their current income, and thus, to manage their cash in order to make small dollar purchases. One compelling example of the temporal connection between the reforms in check collection timing rules and increases in the amount of risk-laden behaviors by consumers to make small dollar amount purchases is to look at the significant growth of the payday loan industry in the U.S. since 1990—the year the EFAA went into effect. There are also surprising data about the increasing use of credit card debt and home equity lines of credit ("HELOCs") in the same period.

A. Payday Loans

The most insidious risky practice that consumers have turned to following the 1990 rule changes is the use of payday loans. Much has been written about the payday loan industry in legal and economic journals, and newspapers since the mid-1990s. This scholarship falls into three main categories: articles that attempt to describe the industry itself, articles that discuss who payday loan customers are, and articles that try to propose solutions.[49] My treatment of the payday lending industry proceeds in three steps: first, I provide a brief history of payday lending, including a discussion of lending practices and industry trends since 1990. Second, I discuss how the payday lending industry has affected minority communities. Finally, I discuss broadly the deceptive nature of payday loans.

1. A Short History of Payday Lending

The modern U.S. payday lending industry can trace its roots back to early twentieth century salary buyers,[50] who offered to purchase someone's paycheck in advance and for a discount.[51] These salary buyers operated the early payday loan stores in order to meet the demand of a growing market of people, especially immigrants and migrants from rural to urban areas. Their customers were typically poor working-class people who had current supplemental cash needs but who were unable to qualify for small dollar amount short-term loans from banks because they were considered too risky. The payday lending industry began growing exponentially in the 1980s. This expansion is attributable to two factors: deregulation of the banking industry and a lack of short-term loan providers. The impact of deregulation was that interest rate caps imposed on lenders were removed. The retraction of mainstream, short-term loans meant that fewer such loans were provided, forcing consumers to turn elsewhere to satisfy those

---

[49] For a non-exhaustive list of articles providing treatment on the topic of payday lending, see, e.g., Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563 (2010); CHRIS GIANGRECO, ANDREA KOVACH, & MATT UNRATH, ALTERNATIVE SMALL DOLLAR LOANS: BUILDING THE BUSINESS CASE, 2 (2010), *available at* http://www.illinoisassetbuilding.org/sites/default/files/Alt%20Small%20Dollar%20Loans%20Report%20v2.pdf; PAIGE MARTI SKIBA & JEREMY TOBACMAN, DO PAYDAY LOANS CAUSE BANKRUPTCY? (2009); Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961 (2008); Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855 (2007); Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653 (2005); Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1 (2002).

[50] One scholar has even traced the origins of the payday lending industry back to biblical times. *See* Spector, *supra* note 49, at 969. Interestingly, in the same passage, Spector notes that since Biblical times as well, efforts to regulate payday lending could be frustrated by intricately designed lending systems. *See id.*

[51] Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 204 (2007).

financial needs.[52] By the 1990s, numerous check cashing stores opened. These stores worked solely on cashing checks.[53] The transition to lending against future checks was a natural next step for businesses that started out by cashing checks during better times.[54]

In a typical payday loan transaction, the borrower tenders a post-dated check and proof of employment to the lender for the amount of the loan, plus a fee.[55] The lender then gives the borrower the loan amount, minus the amount of the fee.[56] The lender will also generally agree to retain the check until the date when the borrower's loan matures.[57] This time period is generally fast approaching, typically falling on the borrower's next payday.[58] Alternatively (and commonly), the borrower can choose to refinance the amount of the loan for an additional two weeks if the borrower pays a refinancing fee.

The process for obtaining a payday loan is decidedly less rigorous than the application process for a loan from a mainstream financial institution. A payday loan applicant needs only to show that she has a bank account and that she is currently employed.[59]

In 1990, Regulation CC went into effect and ushered in the new availability schedules that reduced, if not eliminated the float period for consumers when they issued checks. This new norm also meant that consumers were presented with a new dilemma. On the one hand, they could continue writing checks just as they had before the reforms were instituted. However, doing so carried the real risk of bouncing checks more frequently as they were presented for payment before the funds were on deposit to cover them, leading to high returned check fees, potential social stigma, inability to access other banking services due to being seen as a credit risk, and the long-term effects of a poor credit history.[60] On the other hand, consumers could avoid the new fast checks by taking advantage of the ability to obtain cash by borrowing against their next paycheck through a new arrival on the cash management scene: the payday loan. Historical data show that consumers overwhelmingly chose this new option over the option of writing checks and incurring the risks associated with returned checks.

---

[52] *Id.* at 205.

[53] DONALD P. MORGAN & MICHAEL R. STRAIN, FEDERAL RESERVE BANK OF NEW YORK, PAYDAY HOLIDAY: HOW HOUSEHOLDS FARE AFTER PAYDAY CREDIT BANS 9 (2008), *available at* http://ssrn.com/abstract=1032621.

[54] *Id.*

[55] *See Payday Loans Equal Very Costly Cash: Consumers Urged to Consider the Alternatives*, FED. TRADE COMMISSION (Mar. 2008), http://www.ftc.gov/bcp/edu/pubs/consumer/alerts/alt060.shtm. The typical size of a payday loan is between $200 and $300, plus whatever finance charge the lender applies. *See* CONSUMER CREDIT RESEARCH FOUNDATION, THE PAYDAY LENDING FACTBOOK 2 (Dec. 2004).

[56] *See Payday Loans Equal Very Costly Cash*, *supra* note 55.

[57] *Id.*

[58] *Id.*

[59] *See* CONSUMER CREDIT RESEARCH FOUNDATION, *supra* note 55 ("The borrower presents identification (typically two forms, one with a photograph), the most recent bank statement, and the latest pay stub; all are typically required to obtain a loan. . .").

[60] *See, e.g.*, PEW HEALTH TRUST, UNBANKED BY CHOICE: A LOOK AT HOW LOW-INCOME LOS ANGELES HOUSEHOLDS MANAGE THE MONEY THEY EARN 11 (2010) (finding forty-four percent of banking customers were charged late fee, and eighteen percent of low-income customers in economically distressed neighborhoods of Los Angeles incurred late fee charges on their checking accounts). A similar trend in credit card late fees and rate hikes resulting from late payments prompted a Congressional response. *See, e.g.*, *The Credit Act: It's Working*, DEMOS, http://www.demos.org/sites/default/files/publications/Credit%20Card%20Act%20Successes%20-%20Demos.pdf (last visited Nov. 25, 2012). Specifically, DEMOS found that in 2008, fifty-two percent of credit card holders experienced a late fee, and fifty-three percent experienced a rate hike, as a result of missing a payment. *Id.* In 2012, after passage of the Card Act, which required that card issuers wait at least twenty-one days after a delinquent payment before charging a late fee or exacting a rate hike, instances of consumers experiencing late fees and rate hikes fell to twenty-eight and twenty-nine percent, respectively. *Id.*

The data referenced above is exclusively temporal, measuring the number of payday loan shops in existence after the check clearing reforms went into effect. Following those reforms, the number of payday loan shops, and consumer demand for payday loans, experienced unprecedented growth.[61] Specifically, consumers have increasingly sought short-term bridge loans secured by their next paycheck as a way of meeting very short-term cash shortages needed to pay for routine household purchases. This rise in use of payday loans has closely tracked a corresponding decline in the use of checks.[62] Below is a chart illustrating this temporal data.

Payday lenders appear to have grasped what banks have not: that consumers enjoy and need a replacement for float in their short-term cash management options. Further, as is common knowledge, the average American worker is customarily paid bi-weekly. This is close to the average length of time it traditionally would take to present and pay a check prior to the reforms. Check use, which still remains the leading method of payment behind cash, has continued to decline while the number of payday stores increased by more than 4800% as of 1997 in the years following the introduction of Reg. CC.[63] From

---

[61] *See CPSS–Red Book Statistical Update*, BANK FOR INT'L SETTLEMENTS (Apr. 2003) http://www.bis.org/publ/cpss54p2.pdf; *CPSS–Red Book Statistical Update*, BANK FOR INT'L SETTLEMENTS (Mar. 2008) http://www.bis.org/publ/cpss82p2.pdf; *CPSS–Red Book Statistical Update*, BANK FOR INT'L SETTLEMENTS (Sept. 2012) http://www.bis.org/publ/cpss104.pdf; *Profiting from Poverty*, NAT'L PEOPLE'S ACTION (Jan. 2012) http://www.npa-us.org/files/profiting_from_poverty_npa_payday_loan_report_jan_2012_0.pdf; *see also* Robin A. Prager, *Determinants of Locations of Payday Lenders, Pawnshops, and Check-Cashing Outlets*, FED. RESERVE BOARD (Jun. 2009), http://www.federalreserve.gov/pubs/feds/2009/200933/200933pap.pdf.

Year	Total Number of Transactions by Check (Millions)	Payday Loan Stores (Thousands)
1997	46,569.4	Approximately 2000
1998	45169.7	Approximately 5000
1999	43,812.1	Approximately 6000
2000	42,500	Approximately 8500
2001	41,222.6	Approximately 12000
2002	38,821.2	Approximately 14000
2003	37.281.9	Approximately 20000
2004	35,040.4	Approximately 21,000
2005	32,798.9	Approximately 22000
2006	30,557.4	Approximately 23,000
2007	27,955.4	Approximately 24500
2008	26,054.2	Approximately 24500
2009	24,464.9	Approximately 23000
2010	22,838.6	Approximately 19700
2011	21,276.9	Approximately 20000

The decline in payday lending stores which began around 2007 is attributable in part to increased regulation of payday lending in some states.

[62] There are very few alternatives to short term bridge loans. The examples commonly mentioned include pawn shops, loan sharks, and title loans. *See* Charles A. Bruch, *Taking the Pay Out of Payday Loans*, 69 U. CIN L. REV. 1257, 1268–69 (2001). In addition, the FDIC has implemented a small-loan pilot program among thirty-one banks nationally. Each of the banks agrees to make small loans and do not charge significant fees or interest. The borrower also has a longer amount of time to repay the loans up to three years. However, it is unclear whether or not this program will succeed in impacting payday lenders. A spokesperson for the payday loan industry notes that their customers are not likely to visit banks because "banks look down on our customers." It was also noted that many low and moderate income customers do not use banks because of the way they are treated. *See* Mark Davis, *Banks Test Small-Loan Program*, KANSAS CITY STAR, May 11, 2008, at D1.

[63] FEDERAL RESERVE BOARD, THE 2007 FEDERAL RESERVE PAYMENTS STUDY (2007), *available at* http://www.frbservices.org/files/communications/pdf/research/2007_payments_study.pdf.

this, it appears that consumers have turned to payday loans as a favorite way to replace the cash management function of float. The role of the payday loan as a cash management tool as opposed to a typical loan is borne out by the data that show that most payday loan store customers are repeat borrowers, taking out eight to twelve loans per year.[64]

Consumer dependence on payday lenders has been exacerbated by the fact that banks have been reluctant to enter into the small-short-term-loan business.[65] This reluctance can be traced to three related concerns. First, there is a large concern over the profitability over offering relatively low-interest loans. Many bank officials actually acknowledge that they believe offering payday loan-like products will be profitable only if they charge high interest rates. There are also concerns over the reputation of banks among a broad customer base if they become infected with the same taint that is attached to payday loans operators. A related concern is that offering a service similar to payday loans could come with tremendous amounts of criticism from "media, public policy officials, and consumer advocates."[66]

It has been estimated that ten million households borrow from a payday store every year.[67] Examination of the demographics of payday loan users reveals the depth of the problems they cause. According to the demographic data, the typical payday loan customer is forty years old and earns between \$30,000 and \$40,000 annually. Half of all customers have an average annual income of between \$25,000 and \$50,000.[68] Twenty percent have college diplomas and more than half have completed some college, and ninety-four percent have a high school diploma.

Even more troubling is the fact that payday loan customers are disproportionately drawn from politically and economically disadvantaged groups: racial minorities, women and military families who are deliberately targeted by payday loan operators.[69]

A 2011 study of the concentration of payday lending operations in several states found that

> In North Carolina, three times as many payday lenders per capita are present in African American neighborhoods as in White neighborhoods. In the state of Washington . . . they are twice as likely to be located in predominantly African American as White areas, and they also are concentrated in poverty zip codes. In California, they are eight times as concentrated in African American and Latino neighborhoods as in White neighborhoods. Even controlling on income, poverty, population, education, and other socioeconomic factors, the racial disparity persists. In Denver neighborhoods where the median income is below \$30,000, one check-casher exists for every 3,196 residents

---

[64] Richard J. Thomas, *Note: Rolling Over Borrowers: Preventing Excessive Refinancing and other Necessary Changes in the Payday Loan Industry*, 48 WM. & MARY L. REV. 2401, 2403 (2007).

[65] Some banks have begun to enter the market, but have only been doing so since around 2007. *See* Jim Puzzanghera *Credit Unions, Banks Grabbing a Share of Payday Loan Dollars*, L.A. TIMES, Mar. 11, 2012, http://articles.latimes.com/2012/mar/11/business/la-fi-banks-payday-loans-20120311.

[66] THE ANNIE E. CASEY FOUNDATION, LOW-COST PAYDAY LOANS: OPPORTUNITIES & OBSTACLES 10 (2005).

[67] Paige Merta Skiba & Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment and Default*, BERKELEY MIMEO (2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319751.

[68] GREGORY ELLIEHAUSEN & EDWARD C. LAWRENCE, CREDIT RESEARCH CENTER, MCDONOUGH SCHOOL OF BUSINESS, GEORGETOWN UNIV., PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND 28 (2001), *available at* http://faculty.msb.edu/prog/CRC/pdf/Mono35.pdf.

[69] Skiba & Tobacman, *supra* note 67.

> compared with one check casher for every 27,416 residents in neighborhoods where the median income is between $90,000 and $120,000.[70]

Given those data, the usage rates among minority groups are hardly surprising. One 2009 survey of payday loan customers in Texas found that fifty-nine percent of borrowers were women, and forty percent were single women.[71] The same study found that forty-four percent of borrowers were Latino, while thirty percent were African American.[72] A separate study conducted in 2012 found that African Americans were twice as likely to have used payday loans, despite their considerably smaller segment of the population.[73] That study found that, overall, African Americans constituted twenty-three percent of payday loan users, while comprising only twelve percent of the population.[74] Latinos, while comprising sixteen percent of the population, constituted fourteen percent of payday loan users.[75] Sadly, military personnel and their families are also frequent targets, and users, of payday loans.[76]

2. The Disproportionate Impact of Payday Lending on Minority Communities

That payday loan customers are drawn disproportionately from minority groups is not an accident. In 2007, Bill Harrod, a former manager at an Ohio-based payday lending store, resigned his position "as a matter of conscience."[77] Mr. Harrod's conscience was offended by the fact that his employer, Check N' Go, had instructed him to target his marketing towards African American communities, despite the potential to market their services in more diverse areas.[78] He was even instructed to focus his efforts to market their lending services sourced in Ohio to black communities in Maryland, a state where such loans were prohibited.[79] As described by Mr. Harrod, the industry's deceit of the African American community was deliberate and recognized no boundaries of decency and fair dealing:

> I was instructed to start attending services at Unity Baptist Church—neither my bosses nor the lobbyists could do this because they were not black—to gain favor with the minister there and convince him to support us publicly. I was instructed by my boss to offer the church $800 to send several children to summer camp in return for the pastor testifying against . . . on reducing payday loan interest rates. I did this. But in the end, the minister walked out of the Council chamber without testifying because he was embarrassed at what he had been asked to do. I was told to pressure him to go back into the room, but he wouldn't do it.[80]

---

[70] Charis E. Kubrin et al., *Does Fringe Banking Exacerbate Neighborhood Crime Rates? Investigating the Social Ecology of Payday Lending*, 10 CRIMINOLOGY & PUB. POL'Y 439 (2011).

[71] *Short-Term Cash, Long-Term Debt*, *supra* note 43, at 15.

[72] *Id.* at 16.

[73] WHO BORROWS, WHERE THEY BORROW, AND WHY, *supra* note 43, at 13.

[74] *Id.* at 35.

[75] *Id*; *see also* Kubrin et al., *supra* note 70.

[76] *See* Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653 (2005).

[77] Press Release, Ohio Coalition for Responsible Lending, Payday Lending Industry Insiders Tell All: Unsavory Details Emerge about the Debt Trap and Much More 1 (Sept. 11, 2007), *available at* http://www.cohhio.org/pdf/nr_09112007.pdf.

[78] *Id.*

[79] *Id.*

[80] *Id.* at 4.

On this point, Professor Creola Johnson has identified four advertising and marketing ploys that lenders use to victimize communities of color.[81] First, lenders frequently employ African American celebrities to establish trust and rapport with the community they are targeting.[82] Second, lenders target African American communities by partnering with leaders in the African American community, including local church leaders. Third, lenders hire minorities into sales positions for the purpose of soliciting business in the local minority community, as was the case with Mr. Harrod.[83] Fourth, lenders design marketing content that combines racial and religious imagery in order to appeal to faith-based minority targets.[84]

As a result of the advertising and business tactics of the payday lending industry, payday lending stores are more likely to be situated in areas with large minority populations,[85] and thus payday loan customers are more likely to be minorities.[86] Due to the nature of payday loans, the eventual negative effect is that minorities are ultimately more likely to become trapped in a vicious cycle involving payday loan debt than non-minorities.[87]

Of course, concerns about poverty and economic development have long been of prime importance to African American communities, the intransigence of which have been vexing to generations of community activists who have worked tirelessly to address these concerns.[88] In the aggregate, payday loans damage communities by perpetuating the continuation of a cycle of poverty, luring people to borrow money against their future salaries just to pay for current every day needs for their households. One study of payday lending practices in California found that payday loan operators sapped $247 million in fees annually from primarily minority communities.[89] Another study, conducted across multiple states and regions, found that payday loans extracted $3.1 billion in fees from borrowers, many of whom are minority or lower-income consumers.[90] Without financial resources, it is nearly impossible to reinvigorate a community. For instance, without a reliable customer base, businesses will not want to move to a particular community. On a macro level, payday loans therefore reduce the overall financial well-being of minority communities, thereby retarding economic development and postponing social justice.

3. Payday Lending and Bankruptcy

[81] *See* Creola Johnson, *The Magic of Group Identity: How Predatory Lenders Use Minorities to Target Communities of Color*, 17 GEO. J. POVERTY LAW & POL'Y 165, 168 (2010).

[82] *Id.* at 171.

[83] Johnson, *supra* note 81, at 174–75.

[84] *Id.* at 175–76.

[85] *Id.*

[86] *Id.*

[87] *See* Johnson, *supra* note 81, at 186–88.

[88] *See, e.g.*, ETHAN COHEN-COLE, CREDIT CARD REDLINING (2009) (describing "disinvestment" in urban areas dating back to World War II and discrimination in access to credit as contributing to the "economic malaise" which now faces many minority population centers across the country). This issue can be traced as far back as the end of the Civil War and Reconstruction. It was during this time that America first faced problems of viability relating to African Americans on a grand scale. *See, e.g.*, The Freedmen's Bureau Bill, Act of March 3, 1865, ch. 90, 13 Stat. 507 (establishing Freedmen's Bureau during Reconstruction era). As anyone who has driven through the inner city of any major American metropolis knows, it is a problem which has not been answered adequately, and which is only exacerbated when financial institutions deviously swindle millions of dollars from those communities.

[89] Wei Li et al., *Predatory Profiling: The Role of Race and Ethnicity in the Location of Payday Lenders in California*, CENTER FOR RESPONSIBLE LENDING (Mar. 26, 2009), http://www.responsiblelending.org/california/ca-payday/research-analysis/predatory-profiling.pdf.

[90] *Profiting from Poverty*, NAT'L PEOPLE'S ACTION (Jan. 2012), http://www.npa-us.org/files/profiting_from_poverty_npa_payday_loan_report_jan_2012_0.pdf.

Another major problem with payday loans is that they are deceptive. Payday lenders frequently advertise their loan products as "short-term,"[91] yet it is clear that this cannot possibly be the case. Cameron Blakely, a former manager of a payday lender in Washington, D.C., explained how his employer profited from its payday loan business:

> The secret to the success of the payday loan is its deceptive design. Specifically, we made the process very simple and easy at the front end to get people into the loan. But at the back end, we made it very difficult for customers to get out of the loan. It became a situation where our borrowers were like indentured servants, but with indefinite terms of servitude. They would work and work. But each payday, we'd claim a piece of their paycheck. Every paycheck. Not only was it hard to escape, but most of our customers were not fully aware of the desperate situations they were in. They were so confused that sometimes they would say that they just couldn't live without that extra payday loan cash coming in—when, in reality, they were not getting any more money out of the loan. Instead, they were paying money to us in fees over and over again. And that is what was making their paychecks even shorter than usual.[92]

Consumers get trapped in a debt cycle using payday loans in many ways. One way, of course, is a simple inability to repay the loan. At the other end of the spectrum is the situation caused by payday lenders who fail to explain to borrowers the consequences of making only minimum payments—namely that minimum required interest-only payments will not ever pay down the principal outstanding on the loan.[93] In this manner, payday lenders deceive consumers into believing they are paying off their loans when in reality they are not.

There is also a body of scholarship that suggests that payday loan borrowers have a higher than average likelihood of filing a personal bankruptcy. A 2001 study found that that 15.4% of payday loan users had filed a bankruptcy petition.[94] During the same survey period, only 3.7% of the total adult population had filed bankruptcy petitions.[95] Moreover, sixty percent of payday loan customers had also maxed out their credit cards.[96] Another study of bankruptcy petitions in New Mexico found that eighteen percent of individuals filing bankruptcy petitions had used payday loans.[97] These studies only establish correlation, and therefore standing alone do not support the proposition that payday loans cause bankruptcy. It is possible that some of these data capture consumers who were well on the way towards bankruptcy petition before ever taking out a payday loan and may have even postponed the

---

[91] *See How it Works*, CASHNETUSA, http://www.cashnetusa.com/how-it-works.html (last visited Nov. 2012) (describing payday loan as " short-term loans with a small dollar amount that are usually repaid upon your next payday.").

[92] Press Release, Ohio Coalition, *supra* note 77, at 3. Using tactics like this, Mr. Blakely's employer managed to extract nearly $15,000 in fees to service a loan for $900. That $15,000 represents an opportunity cost between servicing fees and everything else a consumer may spend money on. In other words, the servicing fees which payday lenders extract from consumers is money which otherwise could have been spent on goods and services which the consumer actually wants. This may seem trivial when only discussing a single consumer, but payday lending is a multi-billion dollar industry, and these fees are the only profit center for the industry. In this regard, the consumer protection issues I have been discussing tie directly into concerns over the national economy. It is difficult to imagine a productive economy in which consumers spend all their money servicing loans.

[93] Nathalie Martin, *supra* note 49, at 599.

[94] ELLIEHAUSEN & LAWRENCE, *supra* note 68.

[95] *Id.*

[96] *Id.*

[97] Nathalie Martin & Koo Im Tong, *Double Down and Out: The Connection Between Payday Loans and Bankruptcy*, 39 SW. L. REV. 785, 803 (2010).

bankruptcy because of the payday loan's usefulness as a last resort. Still, there appears to be a strong inference that payday loans increase the likelihood of future bankruptcies. This is especially true given the evidence that suggests that the payday loan industry preys on financially distressed individuals.

B. Credit Cards

Credit card usage has increased substantially since the 1990 reforms, despite only moderate increases in the number of credit card users. There are data, along with anecdotal evidence compiled in other studies that suggest that credit cards have become an increasingly important cash management tool following the 1990 check collection reforms.

In 1990, there were 122 million cardholders in the United States and 1.012 billion cards in circulation.[98] Credit transactions were valued at $466 billion, and outstanding consumer credit card debt was $243 billion.[99] In 1997, outstanding credit card debt was approximately $526 billion.[100] Three years later, in 2000, there were 159 million credit card holders and 1.425 billion credit cards in circulation;[101] credit card purchases totaled $1.242 trillion, and the total outstanding debt was $680 billion.[102] Eight years after that, in 2008, there were 176 million card holders and 1.493 billion credit cards in circulation;[103] credit card purchases totaled $2.153 trillion, and outstanding consumer debt stood at $976 billion.[104] The Census Bureau projects that for 2011 there were 183 million people with credit cards and 1.278 billion credit cards in circulation.[105] The Bureau further estimates that credit transactions for 2011 totaled $2.044 trillion, and total consumer outstanding debt was $897 billion.[106]

Though I ultimately conclude that credit card use is a significant problem for consumers (and minorities in particular), I also recognize that credit cards do provide some important benefits for consumers. First, for many consumers, credit cards may be the only available source of credit.[107] Also, credit cards allow consumers greater cash management flexibility because the ability to use credit is less tied to receiving a paycheck than payday loans or cash.[108]

Despite these possible benefits, credit cards also pose significant problems for consumers. First, credit card agreements are quintessential adhesion contracts in which the consumer's only role in the

---

[98] *Banking Finance and Insurance*, U.S. CENSUS BUREAU, http://www.census.gov/prod/2002pubs/01statab/banking.pdf (last visited Nov. 25, 2012)

[99] *Id.*

[100] *Legislative Update*, AMERICAN BANKRUPTCY INSTITUTE, http://www.abiworld.org/AM/PrinterTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=53197 (last visited Dec. 9, 2012).

[101] *Statistical Abstract of the United States: 2011*, U.S. CENSUS BUREAU, http://www.census.gov/compendia/statab/2011/tables/11s1187.pdf (last visited Nov. 25, 2012).

[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *Id.* The Census Bureau estimates that there will be 160 million cardholders for 2012, and outstanding consumer credit debt will fall to $870 billion. *See* U.S. CENSUS BUREAU, http://www.census.gov/compendia/statab/2012/tables/12s1188.pdf.

[107] *See* David S. Evans, *The Growth and Diffusion of Credit Cards in Society*, 2 PAYMENT CARD ECON. REV. 59, 64 (2004). Often other types of unsecured loans are difficult to obtain since the lender has to rely entirely on the predicated ability of the borrower to pay instead of securing additional collateral.

[108] *Id.*

contractual process is to accept or decline the terms as offered.[109] The fear that credit card companies will use this imbalance in bargaining power to their advantage is not merely conjectural: scholars and lawmakers have already identified several ways in which credit companies insert one-sided, adhesive terms into their agreements, often to the detriment of consumers.[110] Among others, these include provisions that allow the credit card company to alter the terms of the agreement at any time for any reason or that allow them to assess unreasonable penalty fees.[111] Inclusion of such terms make credit cards a risky cash management solution because the credit card debtor is in a considerably inferior position to that of the lender, which is both more sophisticated economically and holds a superior relative position in all negotiations.[112] Subsequently, in May of 2009, credit card reform legislation passed that greatly limited: a) the card companies' ability to change individual interest rates (requires 45 day advance notice); b) who can receive a credit card (individuals under 21 must prove that they can repay the money or a parent will pay); and c) how much time people have to pay their bills.[113]

The consumer risk associated with large credit card debt was amplified by amendments to the Bankruptcy Code passed by Congress in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (hereafter "BAPCPA"). Ostensibly, the purpose of BAPCPA was to "improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors."[114] Congress passed BAPCPA in response to lobbying efforts by the credit and financial sectors feeling that many consumers were spending recklessly and then taking advantage of lax bankruptcy rules to escape their debt obligations.[115] The 2005 amendments to the Bankruptcy Code specifically targeted consumer bankruptcy filings in order to reduce the losses incurred by the credit industry as a result of the ability of credit card holders to discharge their debts in Chapter seven proceedings.[116] Following the amendments, bankruptcy is a less viable option for many consumers, meaning that credit card debt is considerably more likely to become permanent.[117]

When race is factored into the equation, the problems associated with credit cards are exacerbated. Traditionally, minority access to credit was well below that of whites.[118] When minorities are offered credit card agreements, they are frequently on less favorable terms than white customers receive.[119] Specifically, poor and minority customers were found by one recent study to be more likely to

---

[109] *See* Eric A. Zacks, *Unstacking the Deck? Contract Manipulation and Credit Card Accountability*, 78 U. CIN. L. REV. 1471, 1474 (2010); Mo Zhang, *Contractual Choice of Law in Contracts of Adhesion and Party Autonomy*, 41 AKRON L. REV. 123, 123–24 (2008).

[110] *See* Zacks, *supra* note 109, at 1477–78.

[111] *Id.*

[112] This imbalance of bargaining strength and susceptibility to fraud were one of the things which motivated Congress to pass the CARD Act in 2009. The CARD Act requires, *inter alia*, that credit card companies maintain interest rates as stated in the initial contract for one year, and that 45 days written notice be given if a company wishes to increase a cardholder's interest rate or fees. *New Credit Card Rules Effective Feb. 22*, FEDERAL RESERVE BOARD, http://www.federalreserve.gov/consumerinfo/wyntk_creditcardrules.htm (last updated Mar. 2010).

[113] *Id.*

[114] H.R. REP. NO. 109-31(I) at 2 (2005).

[115] *See Bankruptcy Abuse Prevention and Consumer Protection Act*, CCHGROUP (Apr. 21, 2005), http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf.

[116] *Id.*

[117] *Id.* at 2.

[118] DEMOS, *supra* note 43.

[119] *Id.* (characterizing credit agreements offered to minorities following deregulation of credit industry as "economically detrimental."). *See also* Jennifer Wheary & Tamara Draut, *Who Pays? Winners and Losers of Credit Card Deregulation*, DEMOS, 1, http://www.demos.org/sites/default/files/publications/whopays_Demos.pdf (last visited Nov. 25, 2012) (noting that low wealth and minority customers receive higher interest rates than other consumers).

pay greater than twenty percent interest on their credit card bills,[120] and twice as many African Americans paid twenty percent or greater interest than whites.[121]

All things considered, it is not surprising that more minorities default on their credit card bills.[122] Such defaults can have terrible consequences for a consumer. When a consumer defaults on a bill, it adversely affects her credit rating and the all-important credit score—both of which can lead to fewer future borrowing opportunities and perpetuation of the cycle of poverty.[123] That, in turn, can make it difficult to obtain additional credit.[124] When additional credit is available at all, it is often at even higher interest rates.[125] That leads to a potential debt cycle, and due to BAPCPA, that debt is increasingly difficult to discharge. A poor credit rating can also negatively affect current and future job prospects.

C. Home Equity Lines of Credit (HELOCs)

HELOCs are a form of credit that is tied to the equity a consumer has in his or her home, and which collateralizes the consumer's home as security for the instrument.[126] In 1991, 282,000 U.S. households had a home equity loan. This number increased at a gradual pace until 1997.[127] In 1997, the number of HELOCs totaled 433,000,[128] and in 1998, this number increased substantially to 753,000. By 2000, there were 1,272,000 households with HELOCs.[129] Industry sources estimated that by early 2010 there were 5.4 million HELOCs.[130] HELOCs were preferred by consumers because they were a more affordable type of credit than credit cards.[131]

Like the other forms of credit discussed in this article, however, HELOCs pose substantial risks to consumers which render them less than ideal cash management devices.[132] There is evidence that, over time, creditors offering HELOCs have been engaging in predatory conduct. Specifically, the main predatory practice that HELOC lenders use is the offering of credit itself, specifically offering a HELOC to homeowners who cannot be reasonably expected to repay the loan.[133] Lenders encourage consumers to take out HELOCs using several strategies. Some lenders, for instance, instruct consumers to lie on

---

[120] *Id.* at 6.

[121] *Id.*

[122] *Id.*

[123] *The Plastic Safety*, DEMOS, http://www.demos.org/sites/default/files/publications/PlasticSafetyNet-Demos.pdf (last visited Nov. 25, 2012).

[124] *Id.*

[125] *Id.*

[126] *Home Equity Lines of Credit: Who Uses Them?*, U.S. CENSUS BUREAU (Sept. 2007), http://www.census.gov/prod/2007pubs/c2kbr-37.pdf.

[127] *Id.*

[128] *Id.*

[129] *Id.*

[130] *See* Paul Calem et al., *Credit Cycle and Adverse Selection Effects in Consumer Credit Markets—Evidence from the HELOC Market* (2011), http://www.phil.frb.org/research-and-data/publications/working-papers/2011/wp11-13.pdf.

[131] Marc Eisenson & Nancy Castleman, *When Mining Your Home for Money, Beware of Fool's Gold*, GOOD ADVICE PRESS, http://www.goodadvicepress.com/omhomeequity.htm (last visited Oct. 21, 2012).

[132] For details on the risk associated with Home Equity Lines of Credit, *see infra* notes 140–41 and accompanying text. Generally speaking, wealthier consumers are more likely to take out a HELOC than other lower income consumers. *See* Rebecca N. Morrow, *Billions of Tax Dollars Spent Inflating The Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 FORDHAM J. CORP. & FIN. L. 751, 795 (2012); *but see* Rashmi Dyal-Chand, *Exporting the Ownership Society: A Case Study on the Economic Impact of Property Rights*, 39 RUTGERS L.J. 59, 75 (2007) (describing 2001 Census study finding that 810,000 out of 4.3 million Americans who took out a HELOC were lower-income consumers).

[133] *Id*; *see Putting Your Home on the Loan Line is Risky Business*, FED. RESERVE BOARD (Apr. 8, 2008), http://www.federalreserve.gov/pubs/riskyhomeloans/.

their applications about how much they earn, thereby increasing their rates of approval.[134] Other lenders advise homeowners to convert their current mortgages into new, longer term mortgages without explaining the total amount by which principal debt will increase over the life of the loan.[135] Still, other lenders offer consumers a HELOC based on an inflated value of the home and/or the amount of the consumer's equity.[136] This is especially risky after the housing bubble burst because home prices have decreased dramatically, making it more difficult for consumers to recoup the value of their home or to maintain the ratio of loan to equity that the loan agreement may require.[137]

Banks are aggressive about protecting themselves against the risks associated with HELOCs. During the 2008 housing bubble, as home prices fell and home equity levels declined, many banks froze or reduced their HELOC lines.[138] This means that consumers who depended on HELOCs as ax cash management strategy may now need to look elsewhere. In addition, defaulting on a HELOC brings with it the very real likelihood that the consumer's home will be foreclosed upon.[139] For these reasons, HELOCs are not advisable as a short-term cash management strategy for consumers looking for a replacement for the float that was built into the pre-reform check clearing.

Finding themselves squeezed on all sides, some consumers are imbibing a mixture that combines a HELOC, credit cards, and payday loans. To say that this is a potentially lethal financial cocktail for the unsophisticated population of working poor is an alarming understatement.

V. TWO RECOMMENDATIONS

A. The Statutory Definitions of "Check" Under Both the U.C.C. and Regulation CC Should Be Amended to Remove the Requirement That They Are Payable on "Demand"

The first recommendation is for both the re-drafters of the U.C.C. and Congress to change the definition of "check" to include drafts drawn on banks that are either time instruments or instruments that are payable on demand. As a result, checking account customers would have the option of issuing checks with short-term future due dates[140] in addition to traditional bank drafts that are payable on demand.[141] The benefit to bank customers who use short-term time drafts instead of those that are payable on demand would be that they would have control over the date on which the bank would debit

---

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] *Id.*

[138] Carolyn Bigda, *When HELOC Freezes Over*, CNN, http://money.cnn.com/2008/04/18/real_estate/heloc_freeze.moneymag/index.htm (last visited Oct. 21, 2012).

[139] Eisenson & Castleman, *supra* note 131.

[140] To be clear, this Article refers to "short term" due dates in its recommendations because its goal is to replace check float and the corresponding self-help solutions which consumers lost after the implementation of the federal regulations. It is entirely possible, however, that under the new definition that this Article advocates for, parties to checks would be able to agree to dates that are either short-term or long-term.

[141] Delayed debit cards have existed in Europe as well. Many European countries have credit cards that are linked to bank accounts. Outstanding balances would be paid off in full at the end of the month from that account. This type of activity is now much less common. Finland, for example, used Visa cards solely as delayed debit cards until 2001. However, Visa customers can now use the cards as normal credit cards. *See* JOHN KELLY & AISLING REILLY, CREDIT CARD DEBT IN IRELAND: RECENT TRENDS 1 (2005); President Bush stated that "[o]nce this crisis is resolved, there will be time to update our financial regulatory structures. Our 21st century global economy remains regulated largely by outdated 20th century laws." Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 57 (2009).

their accounts to pay checks that are deposited when issued but prior to the date when they are payable. This would give parties to checks control over the timing of the payment of the checks in the cases where their checks are issued with due dates; and once again allow them to issue checks that would not be paid immediately. This is better because it opens the opportunity to allow checking account customers to bargain for the same amount of time that they once had, with fingers firmly crossed, under the old, pre-reform, slow check collection timing rules.

I believe that having this option would appeal to most checking account customers, especially the working poor. My preliminary research reveals that this recommendation has great appeal to another important group of users of checks—business owners. This relatively financially powerful constituency has relied very heavily upon checks because they offer business owners controls when managing their cash needs, working capital, and record keeping.

B. Regulation CC Should Require Banks to Offer Checking Customers a New Check With a Future Due Date and That Can Be Deposited When Issued But Not Payable Until Due

Payday loan store operators seem to recognize that consumers need this option and yet community and commercial bankers and their federal regulators do not. Therefore, my second recommendation is for Regulation CC to be amended adding a provision requiring the creation of a new bank product in the form of a check with a due date draft—or a check that is payable on a definite future date rather than on demand.[142] This new check would have two date lines: one for the date when the check was issued (this is the purpose of the current date line on demand instruments); and the new, second line for the date when the check will be due and properly payable by the paying bank.

This new category of check transactions would also match the expectations of parties who can negotiate freely to use, or to not use checks with a future due date. This new check will provide many consumers with a much-needed alternative to payday loan stores, credit cards, HELOCs, and other devices; thus ensuring benefits to the economic and financial integrity of consumers who are clearly demanding better alternatives and more flexible bank products.

It also has the benefit of simplifying the law of negotiable instruments, both state and federal, by eliminating the unnecessary exception to the general rule that parties to all instruments have the flexibility to enter into commercial transactions confident that they can bargain for the most favorable terms they can muster, including whether they must be able to pay on demand or whether they will have until a future date to make payment according to their private transactional reasons and bargaining power. With today's technology making it easier for banks to accommodate the tracking involved with sorting checks, the burden of implementation is far outweighed by the burdens on consumers, especially poor and minority consumers who have a clear need for this bank solution.[143]

VI. POTENTIAL OBJECTIONS

---

[142] *See* Appendix C for an example of what this new instrument may look like.

[143] In general, my proposal is for a way to replace the float once enjoyed by consumers who used checks to pay for purchases with the expectation that the presentation would be delayed for several days. The replacement proposed, therefore, would probably continue to be a very short term item with a due date that would arrive in the very near future—say, seven to twenty days out—when the item will become due; and prior to which it is not yet properly payable. *See* Appendix C: New proposed check with two date lines, one for the date of issuance that is currently featured on checks; and another for the new date due that can be either the same as the issuance date for demand checks, or with a date at a definite time in the future for checks that are time instruments under the new proposed redefinition of "check" for both Article 4 and Regulation CC.

I have made two recommendations for changes in both the law and banking practices to help consumers navigate the post-reform checking landscape more successfully than they have heretofore. I assume that helping consumers in these ways would improve the track record of the reforms themselves, which are justified only to the extent that this federal intervention in states' jurisdiction over the commercial lives of their citizens is based on the federal government's interest in protecting consumers. Obviously, these recommendations are not minor, and they may be met with some criticism or objections. There are a number of foreseeable reasons that seem to explain why banks may balk at having to live with the recommendations, if implemented. This section attempts to address what I feel could be some of the more vigorous objections to my recommendations.

A. The "Redundancy" Objection

One possible objection may attack the necessity of the new instrument on the grounds that banks already offer overdraft protection for customers who write checks against insufficient funds. There is, however, an important distinction between offering a service to remediate a wrong and one that offers an option to engage in a positive transaction. This is especially important for poor and marginalized consumers who may not qualify for overdraft protection nor benefit from the service if it requires them first to be humiliated and admonished by a fee for being allowed to avoid harsher penalties.

This new time draft would also not be redundant insofar as it is additive by increasing the number of payment methods that are available to buyers and sellers who could consider using this new payment instrument for their transactions at their option. Increased availability of options for completing and paying for their obligations is essential to the freedom of the parties to contracts to engage in commercial transactions that allow them to participate in a vigorous marketplace and to be creative in the way they agree to terms.

B. The "Implementation" Objection

Another potential objection to using the new time check is that the product could be difficult to implement. How would a bank process checks that are due on various different future dates? In today's technological environment, I do not think that this would be hard at all. Banks have been forced to ramp up their use of sophisticated technology in order to achieve the objectives of rules of regulators and judges for various other purposes. In fact, the federal regulation that first required expedited check collection stated that the law was timely because the banks had the available technology to implement the changes and that additional regulations would follow as technology improved over time. This same technology can be employed for this purpose, as well.[144]

Modern pre-printed checks are embedded with Magnetic Ink Character Recognition software (MICR codes) that allow banks to encode information into checks and to retrieve it later. For example, checks are now pre-printed so that their MICR lines are populated with information such as the bank's American Banking Association routing number, the customer's checking account number, and the check number. Additional information can be added to the check throughout its life as well, such as when the amount of the check has been added after it has been presented and paid; or when additional bank endorsements are made on the back of checks during the collection process. Using this existing technology, MICR code positions could be dedicated for use whenever a check that has been deposited has a due date that is different from its issuance date.

[144] Expedited Funds Availability Act (E.F.A.A.), supra at 24.

With today's technology, a check that is issued today but not properly payable until two weeks from now could be deposited for collection today (instead of waiting two weeks to deposit a post-dated check), and the paying bank could input the payment date information that would result in the payment of the item on the future date instead of immediately. Banks could program available positions in the MICR line or use other technology already being used during the process of posting checks to correspond to the due date for the time instrument.

C. General Business Objections

A final, practical objection is that banks simply may not be sure that a suitable business model can be developed. Banks currently earn substantial revenue from the fees they charge when a consumer has written a check with insufficient funds. Banks will charge fees ranging from $15 to $40 per check to avoid bouncing the check. Bank service fees are a major source of revenue for banks with $32.6 billion in fees collected in 2003.[145] Banks will want to charge a fee for the service, no doubt, so vigilance should be used to make sure that such fees are reasonable and subject to limitations akin to those that govern fees for stop payment orders. In general, however, I have no objection to a reasonable fee for this new service.

No matter the precise reason, banks will undoubtedly need to be prodded to offer this option in the form of a new check with a future due date, especially given the fact that they have not offered it on a voluntary basis heretofore. It is for this reason that my second recommendation calls for a new federal regulation to compel banks to make this new check available and to honor them according to their terms, including a term specifying timing of payment.

VII. SUMMARY AND CONCLUSION

Check collection reform at the Federal level was necessary because of the length of time that it took to collect checks under the U.C.C., but because the traditional check is a demand instrument and, therefore, payment is due immediately to the person entitled to enforce it. An instrument that is due immediately should be capable of being paid without delay, and certainly in less than two weeks, or even one week. Demand instruments are due immediately, and yet it was impossible for payees to receive payment immediately using the traditional system of slow bank collections.

It is axiomatic to say that a law that is incapable of being enforced is bad law. Similarly, a right that cannot be enjoyed is a wrong. The reason the reforms to the check collection timing rules are problematic is not because they are not necessary—they were. Rather, the problem is that they were implemented as though they existed in a vacuum and without a full understanding of all of the formal and informal dynamics within the old system. I think that it is very important to consider that consumers were accustomed to, and continued to need, checks that were collected more slowly than they were under the new expedited collection regulations ushered in by the reforms. The Federal Reserve Governing Board failed to provide for the ongoing demand by consumers for a financial product that was a replacement for the old slow-to-be-collected check, but that was still a check, not something else! Specifically, consumers needed a check that was not payable immediately.

The controlling law governing the creation of different types of negotiable instruments, including checks, is still U.C.C. Article 3. Under Article 3, there is no requirement that checks must be payable on demand. Although they are never created as such, consumer transactions could be completed

---

[145] *See* Thomas P. Lehman, *Contrasting Payday Loans to Bounced Check Fees*, CONSUMER CREDIT RESEARCH FOUNDATION, http://www.creditresearch.org/editor/assets/files/050608ContrastingPdayLoans.pdf (last visited Nov. 25, 2012).

using checks that are issued on demand with due dates just as readily as when they are issued without due dates.

Clearly, consumers' behavior changed dramatically in ways that have hurt the U.S. economy and have contributed to the current economic crisis. These changes are traceable, at least in part, to consumer demand for short amounts of time delays between the time of their transaction and the time when payment is completed. What payday loan store operators seem to understand is that consumers need a relatively short amount of time before they have money in their accounts that is roughly equivalent to the time between their pay checks (in the United States, this is two weeks).

Banks in the United States have failed to compete with payday loan store operators even though it is clear that there is a huge demand for short-term financial relief in the checking account customer base. The solution is not to go back to a slower collection system for demand drafts, but a reasonable response that gives consideration to a variety of factors.

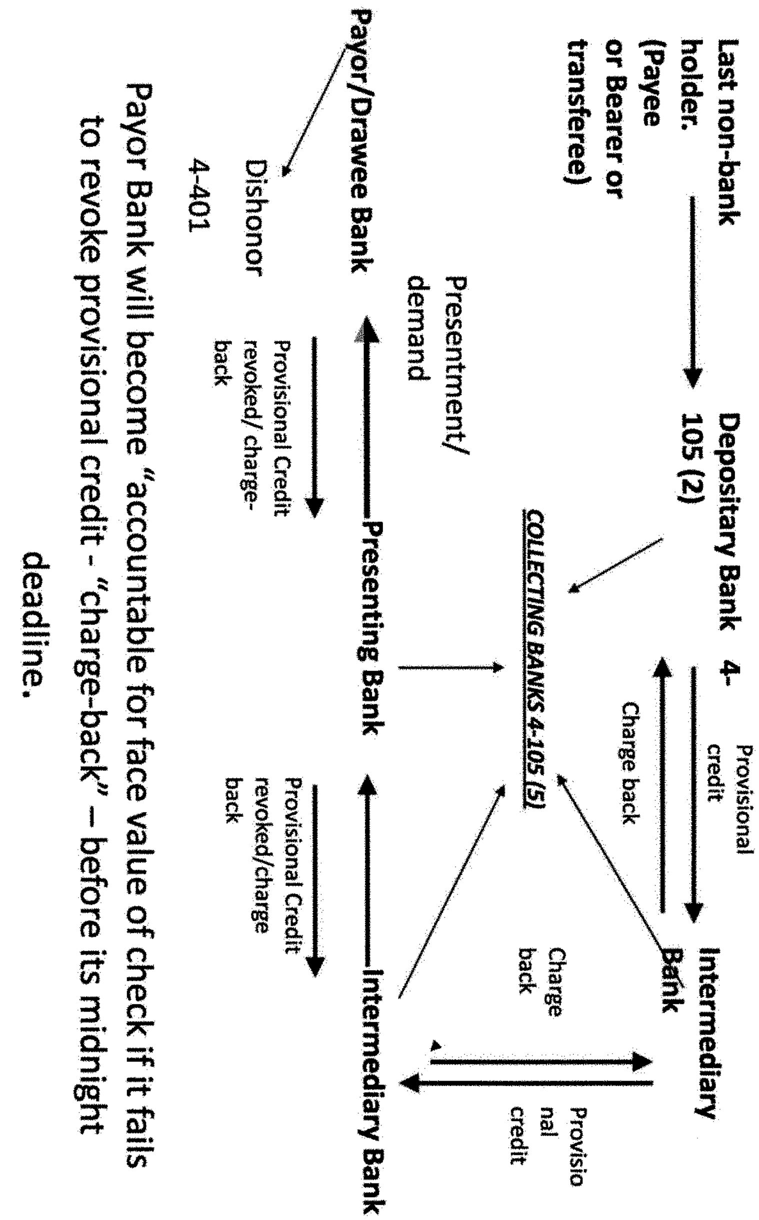
The first recommendation is to change the definition of "check" under the applicable U.C.C. and Federal regulations. The change would remove from the definition the exception that makes all checks "payable on demand." Implementation of this recommendation would require the re-drafters of the U.C.C. and the Federal Reserve Governing Board to redefine "check" under the U.C.C. and Regulation CC, respectively, to accommodate the need to allow consumers to bargain for the inclusion of a due date term when issuing personal checks. Consequently, checks would become like all other negotiable instruments—payable either "on demand," or "at a definite date" at the option of the parties. This approach is already authorized by existing U.S. laws of negotiable instruments. It would also match the expectations of parties who can negotiate freely to use or to not use the new payment instrument. It will provide many consumers with a much needed alternative to payday loan stores.

The second recommendation is for Regulation CC to be amended to require banks to offer a new service that would recognize and honor the timing of payment terms of any check that had a due date just as easily as they do for checks that are payable on demand.

Both of these changes will go far to improve the prospects of consumers who are clearly demanding better alternatives and more flexible bank products.

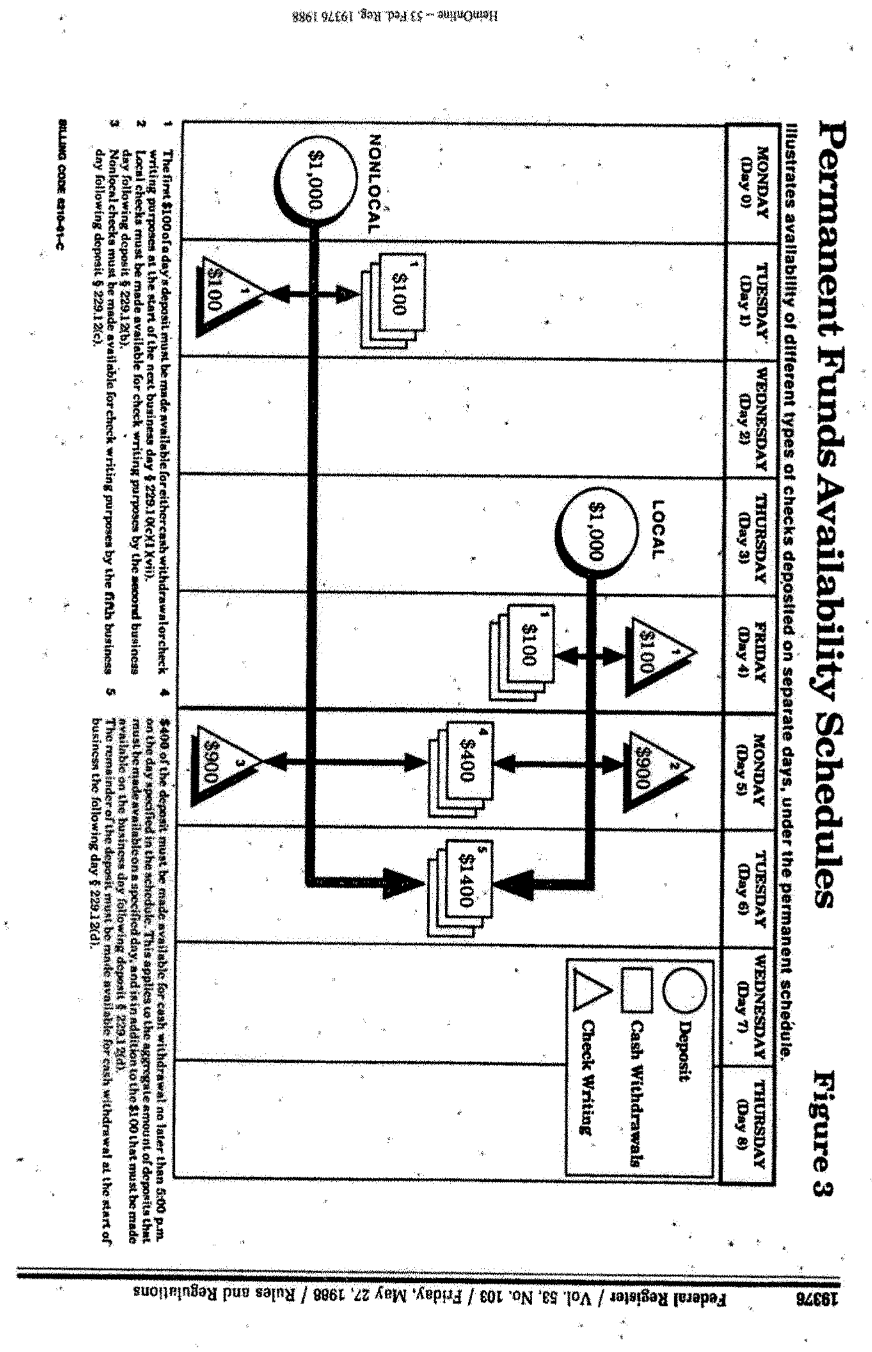
APPENDIX A

Forward Check Collection Process



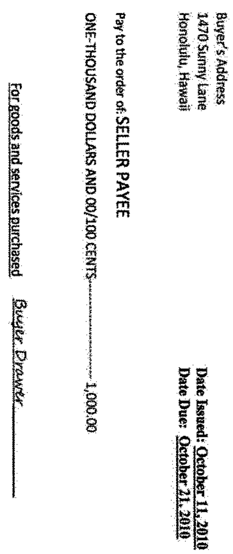
APPENDIX B

Regulation CC Availability Schedule



APPENDIX C

Example Bank Draft



Buyer's Address
1470 Sunny Lane
Honolulu, Hawaii

Date Issued: October 11, 2010
Date Due: October 21, 2010

Pay to the order of: **SELLER PAYEE**

ONE-THOUSAND DOLLARS AND 00/100 CENTS------------------ 1,000.00

For goods and services purchased

Buyer Drawer