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## Legal Guidelines for Check Truncation, 2 Computer L.J. 115 (1980)

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# Legal Guidelines for Check Truncation

by GEORGE C. WHITE, JR.\*

## INTRODUCTION

Check truncation<sup>1</sup> is generating considerable interest within the financial services industry.<sup>2</sup> Check truncation can occur at any of the various processing points, but truncation at the first point offers the greatest cost reduction, though it is harder to accomplish because it requires greater cooperation on establishing industry standards. This article identifies the rationale for check truncation at the first processing point, describes the evolving check truncation environment, and proposes the use of the National Automated Clearing House Association Rules as legal guidelines for the check truncation environment.

There are numerous reasons why different types of check truncation are being actively explored. Individual financial institutions are considering check truncation or a "check safekeeping service" for reasons such as:

1. Rising postage rates and clerical expenses require lower cost alternative services, such as the non-return of checks.

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1. "Check truncation" is used herein to refer to the non-return of checks to the customer who issues them.

2. The operational aspects of check truncation can be reviewed in these recent publications: AMERICAN BANKERS ASS'N, CHECK SAFEKEEPING: A TASK FORCE REPORT ON CHECK TRUNCATION (1978); Azzarone, *Truncation Efforts Aim at Stopping Check Movement: Standards Proposal Expected This Month*, BANK SYS. & EQUIP., Dec. 1978, at 42; White, *What Every Marketing Officer Should Know About Check Truncation*, BANK MARKETING, Dec. 1978, at 20; White, *Assessing Check Truncation Opportunities*, BURROUGHS CLEARING HOUSE, Sept. 1979, at 11.

2. Both individual and corporate customers are accepting truncation, and more financial institutions are beginning to experiment with truncation on segments of their customers.
3. Acceptance of truncation by customers has been enhanced by features such as providing the serial numbers of checks on statements, offering the option of duplicate checks, and having the capability of retrieving copies of checks upon request.
4. Customers are continuing to use checks even though electronic alternatives exist, such as telephone bill payments and preauthorized payments through automated clearing houses.

Two other factors make it feasible for truncation to occur at the first processing point. The national financial communications networks now in place, such as the automated clearing houses (ACHs), Bankwire, and VISA and Interbank (Master Charge) card networks, could handle truncated check data. Further, the Federal Reserve System plans to establish an explicit pricing schedule for check processing and to end its subsidization of the check processing mechanism. These processing charges will provide an economic incentive for check truncation.

Financial institutions offering check truncation to consumers at selected branches are now sharing their experiences in gaining customer acceptance.<sup>3</sup> The use of truncation by a customer's own financial institution is expected to increase in the early 1980s, and will probably be offered at lower fees than conventional checking accounts to encourage broader participation. Each financial institution will develop its own strategies in deciding how to offer such truncation.

## I. ROLE OF THE FEDERAL RESERVE SYSTEM

The speed with which check truncation is implemented depends greatly on the actions of the Federal Reserve System. The Federal Reserve currently subsidizes the check processing mechanism by offering free check collection and other payment services. The Federal Reserve's cost for check collection services for the over twelve billion checks (about forty percent of all checks) it handled during 1978 amounted to over \$800 million, or almost seven cents per check. Half of this expense—\$412 million—was for the processing and phys-

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3. See, e.g., Asher, "Courtesy Check Storage" Beats Check Truncation, *BANKING J.*, June 1979, at 90; Wink & Davis, *Free Check Storage*, *BANK AD.*, Aug. 1979, at 22.

ical movement of checks.<sup>4</sup> The other half was for "Fed float"—the implicit cost of paying out funds in the process of collection before the checks are actually presented to the bank on which they are drawn.<sup>5</sup> By 1979, the high level of Fed float (\$6.6 billion daily average) and high cost of funds had increased the total Federal Reserve costs for check processing to about nine cents per check.

A November 1978 Federal Reserve proposal recommended charging deposit institutions for check collection costs.<sup>6</sup> This charge is not expected to be implemented until some time in 1980, after other issues of membership in the Federal Reserve, such as the paying of interest on all or a portion of reserves, are resolved. It is clear, however, that continued implicit pricing of check collection services by the Federal Reserve is a disincentive to implementation of any truncation scheme and the utilization of the expected, lower-cost ACH capability.<sup>7</sup>

## II. AUTOMATED CLEARING HOUSES

It is ironic that, though ACHs were originally intended to be an alternative for checks in a so-called "checkless society," they may get their most significant volume of transactions from truncated checks rather than from new types of payment transactions such as direct deposits. While various electronic financial networks have been implemented, the automated clearing house network is the most relevant because it has the broadest level of participation,<sup>8</sup> and

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4. Federal Reserve System, Proposal for Pricing of Federal Reserve Check Collection and Automated Clearing and Settlement Services (Nov. 17, 1978) [hereinafter cited as Federal Reserve Pricing Proposal].

5. The amount of float involved is \$5.7 billion, worth \$414 million at the average 90-day bill rate. New York Clearing House Ass'n letter to Federal Reserve System concerning the Federal Reserve Pricing Proposal, Feb. 28, 1979, *supra* note 4, at 3. Of course, the Federal Reserve could delay funds availability schedules to eliminate this float, but it has not done so.

6. Federal Reserve Pricing Proposal, note 4 *supra*. The Federal Reserve System has proposed a pilot project for the transmission of data from checks. While this experiment has been referred to erroneously as check truncation, it is actually electronic presentment of large dollar transactions and not truncation, since checks are still returned and must be reconciled with the transmitted data.

7. G. White, Federal Reserve Pricing for Checks and Automated Clearing House Transactions (paper presented at the Fed. Reserve Pricing Seminar, Payment Sys. Research Prog., Mar. 8, 1979).

8. The automated clearing house network connects over twelve thousand financial institutions nationwide.

operates under legal rules and guidelines which could be adapted to the check truncation environment.

There are thirty-two ACH associations throughout the United States, all of which are members of the National Automated Clearing House Association (NACHA).<sup>9</sup> All but the New York Automated Clearing House are operated by the Federal Reserve System. During 1978, an electronic, interregional ACH exchange was implemented, so that all ACHs are electronically interconnected through the Federal Reserve System's wire network.

The ACHs use the nine character routing/transit numbers as the "address" of a financial institution, similar to the check processing system, *i.e.*, nine MICR (magnetic ink character recognition) figures on the bottom lower left of personal checks. ACHs simply sort payment messages by the routing/transit number addresses, and either transmit or physically deliver payment transactions<sup>10</sup> to the account identified in the ACH data for crediting or debiting.

No ACH transaction can take place unless the customer has authorized the crediting or debiting by each originating organization, and has also furnished the financial institution's address and checking or savings account number. Customers must specifically preauthorize each type of credit to or debit against their financial accounts. A customer may authorize a credit through the ACH capability, such as wages or salary, dividends, interest payments, or Social Security payments, in varying dollar amounts. Debits can be authorized for repetitive, equal payments such as mortgage payments, insurance premiums and installment loans. The customer must be given a week's notice if the debit amount is to vary. Consumers may grant debit authorization for variable amount transactions, such as cash or travelers' cheques dispensed through automated teller machines. These transactions are then individually authorized as to amount when initiated by the consumer. Checks which the consumer had authorized his financial institution to truncate are also subject to specific authorization, similar to the transactions initiated at automated teller or cash dispensing machines. This authorization can be accomplished by unique coding on the checks themselves.

The standard NACHA 94-character record formats used by the ACH infrastructure for transactions among its participating depository financial institution members are a key factor in under-

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9. See Hamilton, *An Update on the Automated Clearinghouse*, FEDERAL RES. BULL. 525 (1979); see generally SUREPAY UPDATE (National Automated Clearing House Ass'n bimonthly newsletter).

10. Payment transactions are combined or "batched" on magnetic tape.

standing the adaptability of the NACHA rules to check truncation. The NACHA "Company/Batch Header" (record type "5") and "Entry Detail" (record type "6") record formats that would be used to transmit truncated check data are illustrated in Figure I. Standard NACHA file and batch header and control formats (record types "1", "8" and "9") are used to ensure proper balancing and handling of payments.

FIGURE I

NACHA FORMATS FOR TRUNCATED CHECKS

NATIONAL AUTOMATED CLEARING HOUSE ASSOCIATION (NACHA) FORMATS FOR TRUNCATED CHECKS  
 ILLUSTRATION OF A DIVIDEND PAYMENT BY CHASE MANHATTAN BANK DEPOSITED AT  
 AMERICAN NATIONAL BANK & TRUST COMPANY OF NEW JERSEY

NACHA HEADER NACHA COMPANY/BATCH HEADER RECORD (Record type "5")

T	SVC.	COMPANY	COMPANY	COMPANY	STD.	COMPANY	CO.	EFFECT.		ORIG.		
P	CL.	NAME	DISCRETIONARY DATA	IDENTIFI-	ENT.	ENTRY	DESC.	ENTRY		INST.	BATCH	
E	C.D.	(TRUNCATING ORG)		CATION	CL.	DESC.	DATE	DATE	RES.	ROUT/ TRAN.	NUMBER	
0	000	0000011111111112	222222222333333334	4444444445	555	5555566666	666666	777777	777	7	88888888	88999999
1	234	5678901234567890	12345678901234567890	1234567890	123	4567890123	456789	012345	678	9	01234567	8901234
5	225	AMER NAT B&T - NJ	WATCHUNG PLAZA BR	9123456789	TRC	TRUNCATED	NOV 15	791116		1	02120233	0123456

NACHA DETAIL NACHA ENTRY DETAIL RECORD FORMAT (Record type "6")

T	RECV.	DEPOSITORY FIN.	INDIVIDUAL	INDIVIDUAL NAME	I				
P	INST.	INST. ACCT.	IDENTIFICATION	(DEPOSITING ACCT.	DN				
E	(ROUT./	NUMBER	NUMBER	OR NAME)	TD				
C	TRAN.)				D				
D		AMOUNT			TRACE NUMBER				
					(ROUT./TRAN.)				
0	000	000000111	1111112222222222	3333333333	44444444455555	55555666666666666666777777	777	7	888888888888999999
1	234	456789012	34567890123456789	0123456789	012345678901234	5678901234567890123456	789	9	012345678901234
6	27	021000021	9017000010	6000	94012917	2523187082			021202331234567

The NACHA Company/Batch Header and Entry Detail records are an efficient means of reducing the data transmission volume.

Rather than transmitting complete data for each individual ACH transaction, repetitive data applicable to a group of transactions can be shown only in the Company/Batch Header (*e.g.*, "Company Name," the transaction initiator or depositing party for truncated checks, date) and specific payment data in the Entry Detail record (*e.g.*, account number, check serial number, amount).

The name of the depositing party ("Individual Name" in the NACHA Entry Detail Record) could be obtained at the point of truncation. In most cases, the name would be that of the person or organization to whom the check is made payable. However, when checks are endorsed to a third party, or when a non-truncating financial institution deposited checks with a correspondent bank, the name would be the depositing party at the point of truncation.

Information about the depositing party of a check to be truncated is most important to the drawee bank to enable it to describe a truncated check transaction to its customer. The depositing party's name is also helpful to the truncating institution if a truncated item is rejected for insufficient funds or stop payment order, or if it needs to retrieve a copy of the check.

### III. CHECK TRUNCATION ENVIRONMENT

A consensus seems to be developing on how check truncation at the first processing point will evolve. The scenario envisioned is as follows:

Those checks that individual consumers and corporate customers are willing to have truncated will be uniquely encoded in the MICR data at the bottom. This truncation coding will permit those checks eligible for truncation to be automatically separated from the other checks at a financial institution participating in truncation, and the MICR data arranged for transmission through ACHs. There are several different MICR codes being considered by the banking industry to identify checks eligible for truncation. Figure II shows

FIGURE II

DAY TO THE ORDER OF \_\_\_\_\_

**CHASE** The Chase Manhattan Bank, N.A.  
1 Chase Manhattan Plaza, N.Y., N.Y. 10015

FOR \_\_\_\_\_

⑆02⑆0000⑆2⑆⑆998⑆ ⑆7⑆99⑆8⑆⑆⑆⑆ ⑆333

one of the approaches being recommended by the American National Standards Institute's Check Standardization Committee.

The unique MICR combination of an MICR "on-us" symbol and a dash would be the indicator to the check processing MICR reader/sorter equipment that a particular check is eligible for truncation. An MICR code in a fixed location is also being considered.

By restricting the truncation code to the portion of a check under the control of the individual financial institution, rather than using common areas such as the routing/transit "address" number, would mean that only those institutions interested in participating in truncation would be affected. Just as customers will decide whether to participate in truncation, financial institutions will also elect whether or not to take part. Initially, many institutions may not participate, but they could begin whenever they desired.

Some checks would not be truncated at the first processing point based on criteria such as being greater than a particular dollar amount, consumer checks payable to other individuals, or checks for cash. In addition, some financial institutions may offer customers the option of selectively overriding the truncation code for particular checks, such as those for tax purposes, so that those checks would be returned to the customer.

Recipients of large volumes of checks, such as department stores and utilities, will probably seek the approval of their customers to permit truncation of checks payable to them regardless of whether the customer has other checks being truncated. The name of the depositing or endorsing party will then be captured to enable a description of truncated checks to be provided on the customer's account statement. Finally, participating financial institutions must have the operational capability of retrieving check copies on the request of customers. Each of these points is discussed in more detail below.

#### *A. Choice to Participate in Truncation*

It is widely agreed that customers will have the option of selecting check truncation. Though some financial institutions will elect to offer only total truncation for all checks drawn on an account, as credit unions are doing with share drafts, most institutions are expected to offer customers a choice, at varying prices, of whether all, a portion, or none of their checks will be truncated. Of course, the lowest priced service will involve total truncation with a separate fee charged for each check copy requested.

Some financial institutions are considering issuance of two types of checks, one with the MICR code indicating eligibility for truncation and one non-coded for use when the check writer desires



that the check be returned, such as for medical expenses, contributions, tax payments or gifts. Credit unions have found it particularly helpful to use two-part checks, so that the check writer always has an exact duplicate of the actual check, thereby reducing the need and expense of requesting check copies at a later time.

### *B. Retrieval of Checks or Copies*

No financial institution should participate in check truncation without the capability of retrieving checks when needed. Previous, highly publicized truncation efforts at several smaller financial institutions (*e.g.*, The First Women's Bank in New York City) apparently had to be terminated because of the inability to retrieve check copies upon request. Other banks, however, now offering truncation with corporate account reconciliation services, and the processors of credit union share drafts do have truncated check retrieval capabilities.<sup>11</sup> As already noted, duplicate copies of checks created at the time of issuance reduce the need for check retrieval.

### *C. Selective Truncation*

Consumer studies indicate that while particular consumers may generally accept check truncation, others would like the return of certain checks which can be specified at the time of issuance.<sup>12</sup> While these checks could later be requested and retrieved, probably for a higher fee, a means of designating certain checks to be returned is desirable, since the consumer may use the actual checks in determining tax-related payments. Additional codes which would override the truncation indicator, such as optically scannable marks, appear to place too much of a burden (special check processing equipment) on the truncating bank for the benefit of the customer of the bank on which the check is drawn. One option that would enable the return of selected checks is to have a perforation around one of the unique MICR truncation identifiers. Punching it out on the checks to be returned would remove that truncation identifier, and the checks would be processed in the traditional manner. Another possibility is for the customer to utilize two types of checks, one group with the truncation indicator and the other without.

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11. Banks truncate credit card sales drafts at the first processor and retrieve copies of these transactions on request from customers.

12. See, *e.g.*, Greguras & Wright, *How the New EFT Act Affects the Financial Institution/Consumer Relationship*, 11 U.C.C.L.J. 207, 262 (1979).

*D. High Value and Other Selected Checks*

While check truncation at the first processing point can be applied to many checks, those checks greater than a particular dollar amount, payable from one individual to another, or for cash might be excluded to avoid potential fraud problems. These checks would be returned to the drawee bank for signature verification. Experience will dictate the limits that must be established in this area.

*E. Name of Depositing or Endorsing Party*

The financial institution which truncates a check has the account number of the depositing party on the deposit slip for each check, as illustrated in figure III. While this information does not generally accompany deposit data for debiting a drawer's account, it can be maintained for the actual checks so that the deposit can be reversed in the case of insufficient funds. In a widespread check truncation environment, the name of the depositing party would, in all probability, be part of the ACH record. Most deposit accounting systems have abbreviated name files for both savings and demand deposit accounts, which could be used to produce identifying information. If no industry standards are specified for describing truncated checks, consumers will receive statements with the name of the depositing party identified for some transactions and simply the name of the second or third endorsing financial institution for others.<sup>13</sup>

*F. Truncation Initiated by the Check Recipient*

While check truncation is most often sought by financial institutions, large businesses, such as utilities and department stores, could request permission from their customers to truncate remittance checks. This would entail some operational requirements for the organizations, such as providing a mailing truncation address different from the address for regular payments, or providing a box on the bill stub which the customer could check to grant permission. It is highly probable that large billers, particularly national billers, will initiate truncation when the Federal Reserve System begins

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13. G. White, Check Standardization for More Automated Handling and Truncation at the First Processing Point (report of the American Nat'l Standards Inst., Check Standardization Comm. (X.9.B), presented at the Bank Ad. Inst. Second Ann. Check Processing Conf., Chicago, IL, Mar. 14-16, 1979).


FIGURE III

**Checking Deposit**

GEORGE C. WHITE, JR.  
CAROL H. WHITE

Date November 5, 1979 No. of Items 7  
H.O. Use only

Deposited in The Chase Manhattan Bank, N.A. and accepted  
subject to the provisions of the Uniform Commercial Code.

 **CHASE**  
The Chase Manhattan Bank, N.A.

⑆ 998 00 7 199 18 ⑆ 5

FD-36 (Rev. 6-77)

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**Checking Deposit**

Cash	Dollars (Cents)	Below for Chase H.O. use only	
		Type	Encl.
		Del.	Chkd.
<b>Checks (List Separately)</b>			
1	35.00	0	
2	97.61	2	
3	151.20	4	
4		6	
5			
6			
7			
<b>Total Deposit</b>			
		283.81	

D-8789  
2345

D-8789  
2345

D-8789  
2345

D-8789  
2345

EXHIBIT III

charging the depositing financial institution for check collection costs, since they will, in turn, generally pass those charges on to the depositing party.

In its response to the Federal Reserve System's proposal on pricing, the New York Clearing House Association recommended that consideration be given to making both the depositing financial institution and the institution on which payment is drawn share the anticipated processing charge equally to create an economic incentive for both parties to utilize the electronic capability of check truncation.<sup>14</sup>

#### IV. APPLICABILITY OF THE NATIONAL AUTOMATED CLEARING HOUSE ASSOCIATION (NACHA) RULES AND GUIDELINES

It appears that the present contractual provisions for ACH transactions covered by the NACHA Operating Rules<sup>15</sup> can be made applicable to truncated check transactions with minimal changes, since:

1. "Authorization to pay" by the customer is the basis for ACH transactions, as it is for check truncation.<sup>16</sup>
2. A check with an industry-accepted truncation indicator would be considered an "authorization to pay" under NACHA Rules.<sup>17</sup>
3. Under the NACHA Rules, the initiator of an ACH transaction must furnish the "authorization to pay" on demand or reverse the transaction, thereby assuring the ability to retrieve a truncated check, or face potential loss.<sup>18</sup>

While the Operating Rules of NACHA did not envision the transmission of specific payment data from truncated checks, the fact that they were designed to handle the electronic version of payments generally completed by paper checks makes them adaptable to the transmission of truncated check data. The NACHA Rules are based upon an authorization by the customer, whether there is to be a credit to, or a debit against, the customer's deposit account.<sup>19</sup> The NACHA Rules also provide for a description of the depositing party on account statements for verification that the correct party was paid, for retrieving a copy of the authorization on request, and for

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14. New York Clearing House Association letter to Federal Reserve System concerning Federal Reserve Pricing Proposal, February 28, 1979..

15. NATIONAL AUTOMATED CLEARING HOUSE ASS'N, OPERATING RULES (1979 rev. ed.) [hereinafter cited as NACHA OPERATING RULES].

16. See text accompanying note 21 *infra*.

17. See note 26 *infra* and accompanying text.

18. NACHA OPERATING RULES, *supra* note 15, at § II.A(a).

19. See text accompanying note 21 *infra*.

reversing incorrect transactions.<sup>20</sup>

It is important to remember that truncation will evolve only among those customers willing to have either all or selected checks truncated, and that only some financial institutions will participate in truncation at the first processing point. Though the principles of the NACHA Rules can control the truncation environment, it would be preferable if they specifically addressed the handling of data from checks being truncated. The proposed approach would not inhibit participating financial institutions from making unilateral contracts among themselves for high volumes of transactions or within geographic location, but these agreements would probably also be patterned after the NACHA Rules.

#### A. Definitions

The following definitions are relevant to truncated checks:

1. "Authorization" is defined as "a process between an originating company and its employee/customer whereby the employee/customer authorizes the company to originate entries affecting an account and coincidentally authorizes the receiving depository financial institution to accept such entries."<sup>21</sup> A check with a standard truncation indicator would be an authorization to pay.
2. "'Company' means a person who initiates entries drawn on or payable to the deposit accounts of the Company's Customers."<sup>22</sup>
3. "'Customer' (sometimes referred to as 'depositor') means a person who authorizes a Company to initiate entries, and a Receiving Depository Financial Institution [RDFI] to debit or credit such entries, to his account with such [RDFI]. . . ."<sup>23</sup>
4. "'Entry' means an order or request . . . for the deposit (credit) or payment (debit) of money. Each debit entry shall be deemed an 'item' within the meaning of Article 4 of the Uniform Commercial Code and that Article shall apply to such entries except where such application is inconsistent with these rules, in which case these rules shall control."<sup>24</sup>
5. "'Originating Depository Financial Institution' [ODFI]—

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20. See note 28 *infra* and accompanying text.

21. NATIONAL AUTOMATED CLEARING HOUSE ASS'N, OPERATING GUIDELINES 61 (1979 rev. ed.).

22. NACHA OPERATING RULES, *supra* note 15, at § I.D.

23. *Id.* § I.E.

24. *Id.* § I.F.

a Participating Depository Financial Institution is an [ODFI] with respect to entries (1) it transmits directly or indirectly to its Automated Clearing House, and (2) on which it is designated as the [ODFI] . . . ."<sup>25</sup>

In a truncation environment, the check being truncated would be a debit entry; the "Company" would be the depositing organization, generally the payee; the ODFI would be the financial institution where the check is truncated, and the RDFI would be the customer's own financial institution on which the check is drawn.

#### *B. Authorization to Pay*

The customer's agreement to truncate will be evidenced by the use of the industry standard truncation indicator in the MICR data field of the checks. Using this indicator would be considered having "executed an authorization," as required by the NACHA Rules.<sup>26</sup>

#### *C. Notice of Change in Transaction Amount*

Notice must be provided of any change in the authorized amount of a transaction before it may be handled by an ACH, except for those transactions in which the customer changes the amount, such as those initiated from automated teller machines.<sup>27</sup> Since a customer would choose the amount of a check as with an automated teller machine transaction, this notice requirement would not generally be applicable in a truncation environment.

#### *D. Check Retention and Retrieval*

With a truncated check being the authorization for an ACH transaction, the rules require that the original, a microfilm, or other equivalent copy be maintained. The burden would be on the truncating financial institution (Originating DFI) to retrieve the check upon request. It is likely that an industry-wide standard minimum

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25. *Id.* § I.K.

26. Prior to the initiation of the first credit or debit entry by a Company to a Customer's account with a Receiving DFI,

(a) such Customer shall have executed an authorization authorizing the initiation of one or more such entries to such account by such Company,

(b) an originating DFI shall have entered into an agreement with such Company for the processing of such entries, . . . and

(c) such Company shall have delivered or sent notification . . . through an originating DFI to its Automated Clearing House for distribution to the appropriate receiving DFI that such Company intends to initiate one or more entries to such account pursuant to the previously executed authorizations of such Customers . \* \* \*

*Id.* § II.A.

27. *Id.* § II.C.

fee would have to be developed to compensate the truncating bank for this retrieval. The NACHA Rules recognize the need for a reasonable charge in order to obtain a copy of a truncated check.<sup>28</sup>

In addition to the payment authorization and record of each ACH transaction maintained by the Originating DFI, each ACH must maintain transactional data for a year to provide an audit trail of transactions.<sup>29</sup>

### *E. Warranties*

The Rules were written for transactions which the customer authorized. The customer's own financial institution, however, was not a party to the authorization, such as for an employer depositing a salary payment or an insurance company debiting for a policy premium payment. Therefore, warranties were included in the Rules which provide that the Originating DFI or its customer has the authority to initiate the ACH transaction.<sup>30</sup> Checks eligible for truncation have similar requirements. Traditionally, a customer's own financial institution may check the signature(s) on a particular check. In a truncation environment, however, the customer's financial institution (Receiving DFI) must depend on the truncating institution (Originating DFI) to truncate check data properly, and must be protected by warranties. Such warranties are already pro-

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28. A company that initiates an entry to a Customer's account shall retain the original or a microfilm or other copy equivalent to a microfilm record of each authorization of such Customer authorizing the initiation of such entry for a period of six years after termination or revocation of such authorization, . . . and shall, upon request of its Originating DFI, furnish such original or such copy of such authorization to such Originating DFI either for the use of such DFI or for such DFI to furnish to the Receiving DFI pursuant to a request of the latter . . . .

*Id.* § II.E.

Each Originating DFI shall, upon the written request of a Receiving DFI for an authorization relating to an entry transmitted to such Receiving DFI by such Originating DFI, obtain from the Company . . . and furnish to such Receiving DFI the original or a copy of such authorization.

*Id.* § IV.B.

Each Participating DFI shall retain a record of all entries, return entries, and adjustment memoranda . . . transmitted by it to or received by it from its Automated Clearing House for a period of six years after the date of such transmittal or receipt and shall, at the request of its Customer, or of any other Participating DFI or Automated Clearing House which originated, transmitted or received any such entry, furnish to such person a printout or other reproduction of the pertinent information relating to such entry. A Participating DFI may impose a reasonable charge for furnishing such information . . . .

*Id.* § III.C.

29. *Id.* § V.G.

30. See note 31 *infra*.

vided in the Rules.<sup>31</sup>

*F. Descriptive Account Statement*

The Rules require that a description of ACH transactions be provided to customers.<sup>32</sup> The required description includes: the date the check was posted to the depositor's account; the dollar amount of the entry; and the company name.<sup>33</sup>

NACHA rules presently require that the "Company Name"—the depositing party in a truncation environment—be furnished to the customer. Most check truncation services presently furnish only the check serial number to the Customer. The company name could be obtained by the truncating financial institution by capturing the account number of the depositing party and automatically converting this number from internal abbreviated name files for inclusion in the NACHA data being transmitted. This, however, would require changes in the conventional check processing systems of truncating institutions. A simpler option would be for the truncating financial institution to be, in effect, the "Company" in a check truncation environment and for its name as endorser to be used in the 15-charac-

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31. Each Originating DFI shall be deemed to warrant to each Receiving DFI, Automated Clearing House and Association that

(1) each credit entry transmitted by such Originating DFI to an Automated Clearing House is timely, in accordance with an authorization executed by a Customer and held by a Company authorizing the initiation of such entry to such Customer's account by such Company, . . . .

(2) each debit entry transmitted by such Originating DFI to an Automated Clearing House is for a sum due and owing to a Company from a Customer, or for a sum specified by a Customer to be paid to a Company; [and]

(3) each debit entry transmitted by such Originating DFI to an Automated Clearing House is in accordance with an authorization executed by such Customer authorizing the initiation of such entry to such Customer's account by such Company, . . . .

\* \* \*

Each Originating DFI breaching any of the foregoing warranties with respect to any authorization or entry shall indemnify every Receiving DFI, Automated Clearing House and Association from and against any and all claims, demands, loss, liability or expense, including attorney's fees and costs, resulting directly or indirectly from the debiting or crediting of such entry to a Customer's account, including without limitation any claims, demands, loss, liability or expense based on the ground that the debiting of such entry to such account resulted directly or indirectly in the return of one or more items or entries of such Customer for insufficient funds, or on the ground that an authorization of a Customer did not authorize the initiation of entries as defined in these rules.

*Id.* §§ IV.A & IV.C.

32. "A Receiving DFI shall send or make available to each of its depositors information pertaining to each credit and debit entry made to the depositor's account . . . ." *Id.* § VI.D.

33. *Id.* app. D.



ter NACHA record. This financial institution's name would be the last endorser before truncation. In cases where larger handlers of checks, such as utilities, department stores, and credit card organizations, truncate their own checks, or the checks are handled by processing agents such as through bank lock box services, the name of the depositing company could be readily associated with the checks being truncated.

### *G. Returns*

A truncated check rejected by the RDFI because of an invalid account number, insufficient funds, stop payment order, closed account or other reason would be returned to the truncating financial institution.

Each returned entry shall . . . be delivered or sent by midnight of the banking day following the banking day of receipt by the Receiving DFI or following settlement date, whichever is later, to its Automated Clearing House for distribution back to the Originating DFI and settlement. . . .<sup>34</sup>

Each Originating DFI shall accept returned entries delivered or made available to it in accordance with these rules.<sup>35</sup>

About one to three percent of preauthorized ACH debit transactions, such as insurance premium payments, are returned, primarily for insufficient funds. Depending on the reason for rejection, the physical check can then generally be presented again through the ACH or the check collection system. The current ACH experience is that approximately half of the transactions rejected for insufficient funds are accepted on resubmission. In a truncation environment, a similar acceptance rate could be expected for items rejected for insufficient funds.

### *H. Error Resolution and Stop Payment Rights*

A customer has a maximum of forty-six days to reverse erroneous transactions under the NACHA Rules.<sup>36</sup> Time is allowed for the

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34. *Id.* § VII.A.

35. *Id.* § VII.D.

36. Upon written notice by its depositor sent or delivered to a Receiving DFI within fifteen calendar days following the date such Receiving DFI sends or makes available to such depositor information pertaining to a debit entry made to such depositor's account . . . that such debit entry was in error, such Receiving DFI shall, without responsibility for the truth or accuracy of such notice, credit the amount of such debit entry to such depositor's account. If such notice was sent or delivered within forty-six calendar days after such debit entry was made to such depositor's account, the Receiving DFI may deliver or send an adjustment memorandum in the amount of such debit entry and . . . by midnight of the banking day following the banking day of receipt of such notice to its Automated Clearing House for distribution back to the

customer to receive the monthly account statement and to review it for accuracy. This right was included to encourage consumers to participate in preauthorized debit payment services. It is equally important in protecting the Receiving DFI participating in truncation, since the customer has the right to review truncated check transactions on a monthly bank statement—a consumer protection not offered by the Uniform Commercial Code.

## V. CONCLUSION

The current major problem facing check truncation is to expand the number of financial institutions which offer a truncation option to both individual and corporate customers.<sup>37</sup> The NACHA Rules and Guidelines are a consistent and secure framework for such transactions. The expanded usage of truncation will ultimately determine the sufficiency of the Rules. Once the Federal Reserve System begins to explicitly charge for check processing, there will be greater economic motivation for financial institutions to participate in check truncation. In the near future, with greater participation in truncation, customers will have enhanced descriptive account statements for truncated check data and other electronic forms of payments, and financial institutions will be able to handle such payment transactions more efficiently than those based on the physical movement of negotiable checks. It is at that time that these proposed legal guidelines will be tested.

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Originating DFI and settlement. A Receiving DFI may treat a notice as timely when, in its reasonable judgment, it appears to have been sent within the period of time prescribed above.

*Id.* § VII.A. An Automated Clearing House receiving an adjustment memorandum is then required to "transmit such adjustment memorandum to the Originating Automated Clearing House . . ." *Id.* § VIII.B. The Originating Automated Clearing House, when it receives an adjustment memorandum, "shall deliver or make available such adjustment memorandum to the Originating DFI by midnight of the banking day following the banking day of receipt of the adjustment memorandum from the Receiving Automated Clearing House." *Id.* § VIII.C; *see also id.* §§ VIII.D-F.

37. The American Bankers Association's Check Safekeeping Task Force is planning to conduct a pilot test for truncation of dividend checks at the first processing point about the second or third quarter of 1980. The plans for this pilot effort were being developed in 1979 and early 1980 with participation likely to include several financial institutions in each of the twelve Federal Reserve Districts.

