

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. **9826**
April 3, 1985]

**CHECK COLLECTION AND WIRE TRANSFERS OF FUNDS
Proposed Amendments to Regulation J**

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued for comment proposed amendments to update Regulation J, governing check collection and wire transfer of funds.

Comment is requested by May 21.

The proposed amendments to the regulation would:

- allow a financial institution or other party that does not deal directly with a Reserve Bank to bring action against the Bank if, during the collection process, the Reserve Bank mishandles a check.
- establish a two-year limitation period for suits against a Reserve Bank that improperly collects a check or mishandles a wire transfer.
- permit Reserve Banks to collect checks drawn on payors located in foreign countries.
- clarify a Reserve Bank's liabilities regarding wire transfers of funds.

In addition, the Board requested comment on several technical amendments to its regulation.

Enclosed, for depository institutions and certain others in this District, is the text of the Board's proposal. Comments thereon should be submitted by May 21, 1985, and may be sent to James O. Aston, Vice President, who will forward them to the Board of Governors. Copies of the enclosure will be furnished to others upon request directed to our Circulars Division.

E. GERALD CORRIGAN,
President.

Proposed Rules

Federal Register

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL RESERVE SYSTEM

12 CFR Part 210

[Docket No. R-0544]

Regulation J; Collection of Checks and Other Items and Wire Transfers of Funds; Proposed Amendments

AGENCY: Board of Governors of the Federal System.

ACTION: Request for comment on proposed rule.

SUMMARY: The Board seeks comment on proposed amendments to Regulation J that would:

(1) Permit the owner or other subsequent holder of a check or other item injured by a Reserve Bank's alleged failure to exercise ordinary care or act in good faith in collecting an item to bring an action against the Reserve Bank, regardless of whether that person in a "sender" as currently defined in Regulation J;

(2) Establish a two-year limitation period for actions against a Reserve Bank for alleged mishandling of items under Subpart A or wire transfer items or requests under Subpart B, and for actions against paying banks for failure to comply with the notification of nonpayment requirements of Subpart A;

(3) Permit Reserve Banks to require any prior indorser to defend a breach of indorsement warranty suit, even if the Reserve Bank has not been sued directly;

(4) Authorize depository institutions to deposit with Reserve Banks for collection instruments drawn on payors located in foreign countries where the Reserve Banks have made arrangements for their collection;

(5) Clarify that Reserve Banks are not liable for consequential damages in handling wire transfers of funds;

(6) Add the Northern Mariana Islands to the Twelfth District for collection purposes;

(7) Adopt the definitions of the Uniform Commercial Code for terms

that are used but not defined in Regulation J.

DATE: Comments must be received by May 21, 1985.

ADDRESS: Comments, which should refer to Docket No. R-0544, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, D.C. 20551, or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments may also be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in § 261.6(a) of the Board's Rules Regarding Availability of Information, 12 CFR 261.6(a).

FOR FURTHER INFORMATION CONTACT: Joseph R. Alexander, Attorney, Legal Division (202-452-2489), or William S. Brown, Manager, Division of Federal Reserve Bank Operations (202-452-3760), Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION: The Board is requesting public comment on seven proposals to amend Regulation J, 12 CFR Part 210, which governs the collection of checks and other items by Federal Reserve Banks and the handling by Reserve Banks of wire transfers of funds.

1. Reserve Bank Liability to Remote Parties

Section 210.6(a) of Regulation J provides that in collecting items a Reserve Bank acts only as the agent of its sender (i.e., the depository institution that forwards an item to a Reserve Bank for collection), and does not act as agent or subagent for any other person.

Because the liability of a collecting bank (such as a Reserve Bank) is predicated upon its status as agent, this provision has the effect of insulating a Reserve Bank from liability in collection cases from all parties except the sender. Accordingly, a third party that did not immediately precede a Reserve Bank in the collection process cannot successfully sue the Reserve Bank, even if it is able to demonstrate that it has been injured by the Reserve Bank's failure to exercise ordinary care in handling an item. This provision has been upheld by several courts. See, e.g., *Childs v. Federal Reserve Bank of Dallas*, 719 F.2d 812 (5th Cir. 1983).

Collecting banks other than Reserve Banks do not, however, have the benefit

of such a rule. Under § 4-201(a) of the Uniform Commercial Code ("U.C.C."), a collecting bank is an agent or subagent of the owner of the item. Accordingly, the collecting bank may be held liable to parties other than the immediately preceding party if its improper handling of an item causes them harm.

In view of the universality of the U.C.C. rule, the Board seeks comment on whether it would be desirable for the Federal Reserve to conform Regulation J to the rule applicable to other collecting banks. The Board also seeks comment on whether it would also be desirable to amend Regulation J to make it clear that warranties made by collecting banks and other prior parties under state law, e.g., U.C.C. 4-207(2), run to Reserve Banks as well as other collecting banks.

2. Limitation Period

a. *Action Against a Reserve Bank.* Regulation J is silent as to when a person may bring an action against a Reserve Bank for mishandling checks or other items (in subpart A) and wire transfer items or requests (in subpart B). Consequently, courts ordinarily apply the appropriate state law. This has resulted in a lack of uniform treatment among Reserve Banks, since applicable laws vary from state to state, and it is often unclear even within a state which limitation period applies. See *Bank of America N.T. & S.A. v. Security Pacific National Bank*, 23 Cal. App. 3d 638, 100 Cal. Rep. 438 (1972); *First State Bank v. Tanner*, 495 S.W.2d 267 (Tex. Civ. App. 1973).

Given the identical functions performed by Reserve Banks and their offices in collecting checks and handling wire transfers, the Board believes that it may be desirable to apply a single period of limitations to actions against Reserve Banks that arise from their collection and wire transfer activities. Accordingly, the Board seeks comment on whether to establish as a uniform federal rule a two-year limitation period for the commencement of actions against Reserve Banks for mishandling check collections and wire transfers.

b. *Action Against a Paying Bank for Failure to Give Notice of Nonpayment.* The Board recently adopted an amendment to subpart A of Regulation J requiring paying banks to provide notice to depository banks when they return unpaid large-dollar items presented by Reserve Banks. 50 FR 5734 (1985). This

amendment takes effect on October 1, 1985. In responding to the Board's request for comment on this proposal, one commenter asked what statute of limitations applied to the depository bank's claim against the paying bank for failure to comply with the notification requirement. As is the case with actions against Reserve Banks, the limitations period of the state in which the paying bank is located would ordinarily be applied. See U.C.C. 4-102(2). The Board believes, however, that a uniform rule may be appropriate; otherwise, a paying bank in one state might be in jeopardy for a longer period than a paying bank in another state even though they would be alleged to have violated a uniform requirement of a federal regulation in exactly the same way. Accordingly, the Board seeks comment on whether to amend Regulation J to establish the same two-year limitation period applicable to actions against a Reserve Bank to actions against a paying bank for failing to make the notice of nonpayment required by Regulation J.

3. Tender of Defense

Section 210.5 of Regulation J establishes a procedure that allows a Reserve Bank, when sued by a subsequent collecting or paying bank, to demand that the sender undertake defense of the action. This "tender of defense" provision simplifies forged indorsement cases by requiring the party that should have obtained a proper indorsement to come into the action and defend.¹ This provision, however, applies only when the action has been brought directly against a Reserve Bank. The Board believes that, in order to reduce litigation, it may be desirable to eliminate the requirement that an action be brought against a Reserve Bank and permit defense to be tendered by a Reserve Bank to a prior party when defense is tendered to a Reserve Bank by a subsequent party. Accordingly, the Board seeks comment on a proposed amendment that would accomplish this result.

The proposed amendment also incorporates a provision found in the uniform provisions of the Reserve Banks' operating circulars on the collection of cash items that makes it clear that if a Reserve Bank tenders defense of an action to a prior party, the

¹ A similar provision is found in U.C.C. 3-803. The U.C.C. provision differs from the Regulation J tender provision in that the U.C.C. allows the person tendered defense to require other prior parties to defend the action. The U.C.C. provision also does not clearly permit the person tendering defense to recover the amount of the judgment and expenses of litigation by charging the prior indorser's account.

Reserve Bank is not responsible for defending the action.

4. Deposit of Foreign Instruments

Section 210.2(g) defines the term "item" to include only instruments payable within a Federal Reserve District (i.e., the United States, Puerto Rico, the U.S. Virgin Islands, Guam, and American Samoa). This definition prohibits depository institutions from sending instruments drawn on payors located outside the United States to their Reserve Banks for collection. Many small institutions have indicated that this restriction imposes substantial hardships on them, because it requires them to sort their checks prior to depositing them with a Reserve Bank in order to separate out instruments payable outside a Federal Reserve District. This is particularly true with respect to instruments drawn on banks located in Canada. Consequently, they have requested that Reserve Banks collect such instruments in order to reduce the operating burden the current limitation imposes.

Board and Reserve Bank staffs are currently developing a procedure for the efficient collection of foreign instruments as a new, priced service of the Federal Reserve Banks. If this new service is adopted, Reserve Banks will probably begin by collecting instruments drawn on payors located in Canada, although the service may be extended to other countries if conditions warrant. Under the proposed service, one or more Reserve Banks would enter into arrangements with U.S. offices of Canadian banks to have the Canadian banks act as agents for presenting the instruments to the Canadian payors. Reserve Banks participating in the program would send Canadian instruments to the designated Reserve Banks for forwarding to the presentment agents. Reserve Banks accepting Canadian instruments would provide credit to the senders in accordance with a pre-established availability schedule; the sender would bear any exchange risk through an adjustment that would be made after the Reserve Bank had received final settlement from the payor. Details of this service are still being worked out. The proposed amendment, if adopted, would clear any regulatory obstacles to the implementation of this service.

Accordingly, the Board seeks comment on an amendment to Regulation J that would allow depository institutions to deposit with their Reserve Banks instruments payable in foreign countries where Reserve Banks have made arrangements

for their collection. The proposed amendment provides that the applicable foreign law will be applied with regard to the duties of a foreign payor, while Regulation J would apply to the rights and duties of parties located in the United States or its territories, dependencies, or possessions.

5. Damages for Wire Transfers

Section 210.38(b) of Regulation J provides that a Reserve Bank may be liable for damages if it fails to exercise ordinary care or act in good faith in handling a wire transfer of funds. The regulation, however, does not clearly specify that a Reserve Bank is liable only for direct damages and is not liable for consequential damages. It appears that, as a result of contractual agreements between depository institutions offering wire transfer services and their customers, the general rule is that the institutions have no liability for consequential damages in handling wire transfers. The Board seeks comment on whether it would be consistent with standard commercial practice for the Board to amend Regulation J to limit a Reserve Bank's liability to direct damages, which would include no more than the amount of the item, the cost of the transfer, and forgone interest. The Board also seeks comment on whether it should adopt such an amendment. The proposed amendment would limit a Reserve Bank's liability for mishandling wire transfer items and requests to damage that is directly and immediately attributable to the mishandling, and would make it clear that a Reserve Bank will not be liable for consequential damages.

If the Board adopts the proposed amendment, the Reserve Banks also intend to amend their operating circulars that govern their handling of automated clearing house items to provide for the same standard of liability.

6. Northern Mariana Islands

On December 26, 1981, Congress amended section 2(a) of the Federal Deposit Insurance Act, 12 U.S.C. 1813(a), to make banking institutions located in the Trust Territory of the Pacific Islands eligible for FDIC insurance. Pub. L. 97-110, section 103(a), 95 Stat. 1513. Thus, these institutions are also depository institutions within the meaning of the Monetary Control Act and, hence, eligible to receive Reserve Bank check collection and other services. See 12 U.S.C. 248a, 461(b). Within the past several months a bank located in the Northern Marianas has requested a

routing number so that collecting banks may process checks drawn on it automatically. The Board believes that an amendment defining the Twelfth District to include the Northern Marianas would conform Regulation J to the amended statute and is consistent with previous amendments defining the Twelfth District to include Guam and American Samoa, and seeks comment on such an amendment.

7. Incorporating U.C.C. Definitions

Section 210.2 of Regulation J defines several terms for purposes of subpart A. For the most part, these definitions define terms that are not found in the U.C.C. (e.g., "paying bank" and "sender") or define terms differently than the U.C.C. does (e.g., "bank"). Other terms, however, that are not defined in Regulation J, such as "good faith," "presentment," and "holder." As these terms are used in subpart A without any definition, the Board seeks comment on whether subpart A should be clarified by adopting the terminology of the U.C.C. where it is not inconsistent with the definitions specifically provided in the regulation or where the context does not require a different interpretation.

The Board does not believe that these proposed amendments will have a significant economic impact on a substantial number of small businesses or organizations.

List of Subjects in 12 CFR Part 210

Banks, Banking, Federal Reserve System.

PART 210—[AMENDED]

Pursuant to its authority under section 13 of the Federal Reserve Act, 12 U.S.C. 342, section 16 of the Federal Reserve Act, 12 U.S.C. 248(o) and 360, section 11(i) of the Federal Reserve Act, 12 U.S.C. 248(i), and other provisions of law, the Board requests comment on the proposals to amend 12 CFR Part 210, Regulation J, as set forth below:

1. By adding a new undesignated paragraph to the end of § 210.2; and by revising footnote 1 to read as follows:

§ 210.2 Definitions.

Unless the context otherwise requires, the terms not defined herein have the meanings set forth in the Uniform Commercial Code.

¹ For purposes of this subpart, the Virgin Islands and Puerto Rico are deemed to be in the Second District, and Guam, American Samoa, and the Northern Mariana Islands in the Twelfth District.

2. In § 210.3, new paragraph (e) is added to read as follows:

§ 210.3 General Provisions.

(e) *Foreign instruments.* A Reserve Bank also may receive and handle certain instruments payable outside a Federal Reserve District, as provided in its operating circulars. The handling of such instruments in a state is governed by this subpart, and the handling of such instruments outside a state is governed by the local law.

3. In § 210.5, paragraphs (a)(2), (b), and (c) are revised to read as follows:

§ 210.5 Senders Agreement; Recovery by Reserve Bank.

(a) * * *
(2) warrants to each Reserve Bank handling the item that: (i) The sender has good title to the item or is authorized to obtain payment on behalf of one who has good title (whether or not this warranty is evidenced by the sender's express guaranty of prior indorsements on the item); and (ii) to the extent prescribed by state law applicable to a Reserve Bank or subsequent collecting bank handling the item, the item has not been materially altered; but this subparagraph (a)(2) does not limit any warranty by a sender or other prior party arising under state law; and

(b) *Recovery by Reserve Bank.* If an action or proceeding is brought against (or if defense is tendered to) a Reserve Bank that has handled an item, based on:

(1) The alleged failure of the sender to have the authority to make the warranty and agreement in subparagraph (a)(1) of this section;

(2) Any action by the Reserve Bank within the scope of its authority in handling the item; or

(3) Any warranty made by the Reserve Bank under § 210.6(b) of this subpart.

The Reserve Bank may, upon entry of a final judgment or decree, recover from the sender the amount of attorney's fees and other expenses of litigation incurred, as well as any amount the Reserve Bank is required to pay because of the judgment or decree or the tender of defense, together with interest thereon.

(c) *Methods of recovery.* The Reserve Bank may recover the amount stated in paragraph (b) of this section by charging any account on its books that is maintained or used by the sender (or if the sender is another Reserve Bank, by entering a charge against the other

Reserve Bank through the Interdistrict Settlement Fund), if:

(1) The Reserve Bank made reasonable written demand on the sender to assume defense of the action or proceeding; and

(2) The sender has not made any other arrangement for payment that is acceptable to the Reserve Bank.

The Reserve Bank is not responsible for defending the action or proceeding before using this method of recovery. A Reserve Bank that has been charged through the Interdistrict Settlement Fund may recover from its sender in the manner and under the circumstances set forth in this paragraph. A Reserve Bank's failure to avail itself of the remedy provided in this paragraph does not prejudice its enforcement in any other manner of the indemnity agreement referred to in paragraph (a)(3) of this section.

4. In § 210.6, paragraph (a)(1) is revised, and new paragraph (c) is added as set forth below:

§ 210.6 Status, Warranties, and liability of Reserve Banks.

(a)(1) *Status and liability.* A Reserve Bank shall act only as agent or subagent of the owner or holder in respect of an item. This agency terminates not later than the time the Reserve Bank receives payment for the item in actually and finally collected funds and makes the proceeds available for use by the sender. A Reserve Bank shall not have or assume any liability in respect of an item or its proceeds except for the Reserve Bank's own lack of good faith or failure to exercise ordinary care and except as provided in paragraph (b) of this section.

(c) *Time for commencing action against Reserve Bank.* A claim against a Reserve Bank for lack of good faith or failure to exercise ordinary care shall be barred unless the action on the claim is commenced within two years after the claim accrues. A claim accrues on the date when a Reserve Bank's alleged failure to exercise ordinary care or to act in good faith first results in damages to the claimant.

5. In § 210.12, paragraph (c) is amended by adding a new paragraph (c)(10):

§ 210.12 Return of Cash Items.

(c) * * *
(10) A claim for failure to comply with the requirements of this paragraph is barred unless the action on the claim is

commenced within two years after the date upon which the notice was required to be received by the depository bank.

6. In § 210.38, paragraph (b) is revised to read as follows:

§ 210.38 Reserve Bank Liability.

* * * * *

(b) *Damages.* (1) A Reserve Bank is liable to its immediate transferor for a failure to credit the amount of a transfer item or request to the transferee's account caused by a Reserve Bank's

failure to exercise ordinary care or act in good faith. A Reserve Bank's liability for such a failure to credit is limited to damages that are attributable directly and immediately to the failure to credit, but does not include damages that are attributable to the consequences of the failure to credit, even if such consequences were foreseeable at the time of such failure.

(2) A claim against a Reserve Bank for failure to exercise ordinary care or to act in good faith shall be barred unless

the action on the claim is commenced within two years after the claim accrues. A claim accrues on the date a Reserve Bank's alleged failure to exercise ordinary care or to act in good faith first results in damages to the claimant.

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By order of the Board of Governors, March 22, 1985.

William W. Wiles,

Secretary of the Board.

[FR Doc. 85-7305 Filed 3-27-84; 8:45 am]