

Forged & Counterfeit Warranties

What is Rule 9?

Rule 9 is an ECCHO Rules warranty in which a Depository bank warrants to the Paying bank that (i) the signature of the purported drawer is not forged or otherwise unauthorized, and/or (ii) the related physical check is not counterfeit.

Rule 9 is ECCHO Rules Section XIX(O)

Who can Use Rule 9?

Rule 9 is only available for electronic checks exchanged under ECCHO Rules by ECCHO members who have agreed to use the Rules, and not opted out of Rule 9.

What is the Purpose of Rule 9?

Forged and counterfeit items are often identified by bank customers after the return deadlines have passed. Rule 9 allows the Paying bank to file a claim to recover from a fraudulent item after the UCC midnight return deadline. Rule 9 shifts responsibility, in some cases, from the Paying bank (as assigned in UCC 4-407 & 4-408) to the depositor when there are sufficient funds in the depositor's account. The depositor is generally in the best position to have prevented the loss. The loss remains with the Paying bank if there are insufficient funds in the depositor's account.

Why Shift Responsibility?

Checks are no longer processed as in the past:

- Financial institutions (FIs) no longer verify signatures on all checks
- Check collection is accomplished via electronic checks therefore the Paying bank never sees the paper check
- Items can be remotely deposited meaning the Depository bank often does not see the physical item

Inception of Rule 9

In the 1980s, Rule 9 was developed for paper check exchanges in a Texas clearinghouse, where it first received its name. Financial institutions have been receiving value based on the ability to make Rule 9 claims ever since.

Check Fraud is Up

Check fraud losses, along with other types of payments fraud, have trended up across the last few years. Counterfeit checks top the list of check fraud losses for banks. Today's fraud detection programs are best when fraud experts are paired with other tools like layered anti-fraud technology (e.g., behavioral rules-based systems, artificial intelligence, sophisticated signature algorithms), documented risk controls, education/training and partnerships with law enforcement. Rule 9 is another useful tool in the toolkit.

Evolution of Check Fraud Detection

In the 20th century, Paying banks compared signatures they held on file to the signature on each check. As volumes increased, they moved to comparing signatures above a certain dollar amount. In the latest version of UCC, the definition of ordinary care "does not require a bank to examine an instrument" however, the Paying bank remains liable. With electronic check exchange and remote deposit capture, physical checks are now digitized as soon as possible, often prior to deposit, and manual examination is a thing of the past.

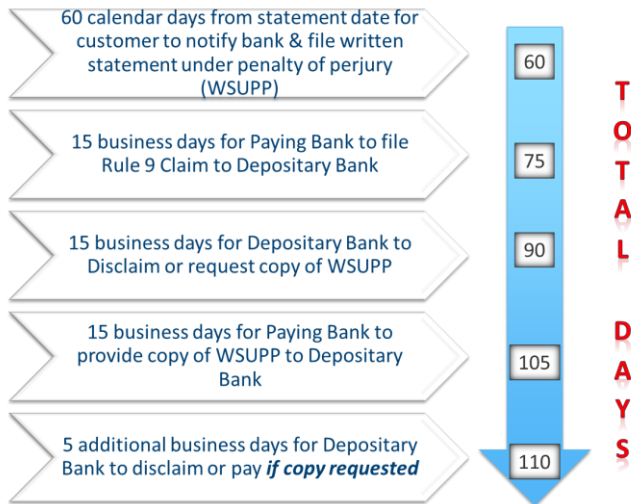
History of Forged/Counterfeit Responsibilities

The legal tenet of US check law is based on check case law from England. The assignment of responsibility for fraud to the Paying bank dates back to a legal case from 1762--Price vs. Neal. The judge in that case, Lord Mansfield, could never have imagined how far-reaching his decision would be when he ruled to assign responsibility to the entity that verifies signatures (the Paying bank). Clearly, they did not anticipate electronic checks in old England. Rule 9 varies UCC by agreement to conditionally modify responsibility for a forged/counterfeit check to better reflect 21st check collection.



Forged & Counterfeit Warranties

Rule 9 Process



Rule 9 Claims are not Returns

Although Rule 9 claims are often made via the return system, this is a breach of warranty claim and not a return--therefore not subject to expedited return deadlines. Rule 9 claims that utilize the return system occur with entry—which starts the clock for the Depository bank to disclaim a Rule 9 claim for cause.

Reasons for Rule 9 Disclaim

Conditions for the Depository bank to disclaim a Rule 9 claim include:

- *Sufficiency of funds test* - if the claim amount exceeds the available funds in the customer's account, or if the customer has closed its account
- *Not an ECCHO electronic check exchange* – item was exchanged under Fed OC3 or other agreement
- *Opted-out* - if the Depository bank has opted out of Rule 9, it is no longer a part of the process—it cannot accept or send claims
- *Failure to meet Rule 9 deadlines* (shown above); see ECCHO Rules Section XIX(O) for more information

Analyzing the Pros and Cons of Rule 9

Some financial institutions believe that the risk for counterfeit/forgery is properly placed on the Paying bank under UCC. That was certainly true prior to the advent of electronic check exchange but the massive change in processing compels the industry to examine new practices. Moving risk to the point of entry into the check system seems reasonable. In old England, banks were expected to “know the hand of their customers.” Today, it is best for banks to employ KYC policies and to introduce KYCC (know your customer's customer) policies as well.

While there has been some concern that Rule 9 results in poor customer service, in fact, Rule 9 does not govern how the customer is treated. Rule 9 is an interbank warranty. Each FI is in control of how they interact with their customers through their customer agreements. The sufficiency of funds test allows banks to disclaim Rule 9 claims when there are insufficient funds in the depositing customer's account. If there are sufficient funds, the bank pays the claim but then can choose whether to absorb the loss or charge their customer's account for the fraudulent item.

The opt-out decision is an individual FI decision that should be made by carefully weighing the risks against the benefits and under the guidance of your legal team. FIs should analyze their forged/counterfeit write-offs to understand which customers are experiencing losses and how often they occur. They can use this information as an opportunity to educate customers on fraud avoidance techniques, systems and policies.

Many banks have found Rule 9 beneficial. While Rule 9 allows the Paying bank to make a breach of warranty claim for a forged/counterfeit item to the Depository bank, in fact the rule was designed to protect Depository banks by allowing disclaim under certain conditions. It is also assumed that FIs act alternately as Depository bank and Paying bank, therefore making Rule 9 fair to all.

For More Information

Rule 9 FAQs: <https://www.eccho.org/faq>

For Rule 9 Whitepaper & Sample Forms: https://www.eccho.org/returns_adjustments_resources

Contacts

ECCHO membership: Scott Miller 406.442.4994

Rule 9: ecchoinfo@eccho.org 214.273.3200