# Remote Deposit Capture: A Legal and Transactional Overview

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*This article provides an overview of the legal and transactional issues involved with Remote Deposit Capture, a method for depositing checks without physical delivery to the depositary institution.*

Remote deposit capture ("RDC") is the process of depositing a check into a bank account without physically delivering the check to the depositary bank.[1] Currently RDC is mainly used by businesses to make deposits,[2] but it is one of the most rapidly growing methods of check processing. RDC only came into use in late 2005,[3] but as of the end of 2008, RDC was being accepted by 7,200 financial institutions, comprising two-thirds of all banks and 40 percent of financial institutions.[4] RDC was also being used by 382,000 depositors.[5] The market is expected to grow to as many as five million depositors by 2014.[6]

## HOW RDC WORKS

Under the Check 21 Act, the digital image of a check is treated as legally equivalent to a physical check.[7] Check 21 thus permits physical checks to

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be digitized and deposited electronically. This is done by creating either a digital image of the check or, for eligible items, an automated clearinghouse ("ACH") file,[8] and transmitting it via the Internet (current standard being via FTP and 128 byte encryption) to the bank, which sends an e-mail acknowledging receipt of the image. After truncation, the customer either destroys or retains the original physical checks. The interchange between the customer and the bank is often outsourced by the bank to a third party application servicer provider.[9]

When the depositary bank receives and acknowledges the image transmission, it checks for image quality, and verifies the depositor's account number.[10] The depositary bank then determines the appropriate clearing channel: ACH for eligible checks, and either image presentment via image exchange (when the depositary bank and paying bank have an image exchange agreement) or printing of substitute checks[11] (Image Replacement Documents or IRDs).[12] Next, the depositary bank assigns float to the deposit and posts the deposit to the depositor's account. Currently all banks are giving at least one day of float on RDC, but they are not required to give any.[13] Upon presentment (by whatever method), the paying bank will debit the maker's account.[14]

RDC differs from a direct deposit or an on-line deposit via the ACH system, as it requires both a physical check to have originally existed and the digitizing of the check image, rather than the extraction of account and transaction data from the check.

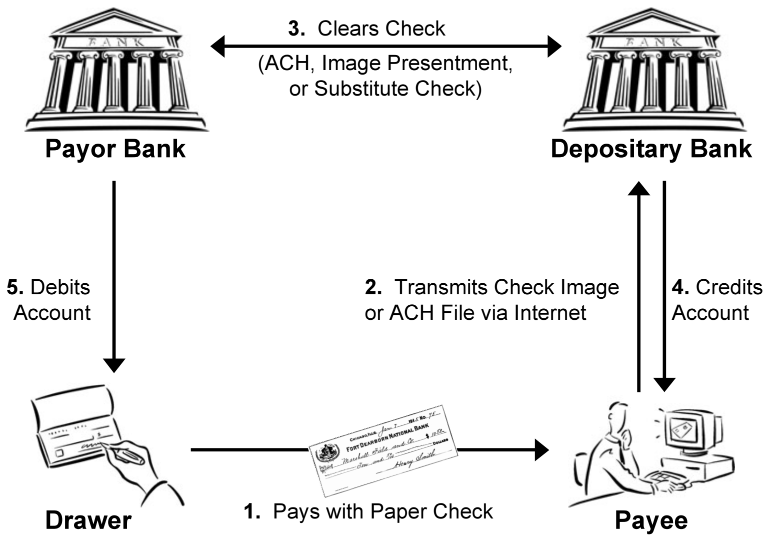
## BENEFITS AND RISKS OF RDC

### RDC Benefits to Depositors

RDC offers depositors several advantages over traditional methods of making deposits: sending an employee to the bank with the daily deposits; contracting with an armored car service or courier to deliver the deposits; or having customers directly remit checks to the bank through a lockbox operation.

For a business doing any volume of deposits, RDC may be cheaper than other depositing methods. RDC vitiates the need to physically send checks to a bank during business hours. Not only does this reduce burdens on

**Remote Deposit Capture Transaction**




employee time, paperwork, and theft risk, but it can also accelerate funds availability. Some banks offer a later cut-off time for crediting RDC deposits and accelerated funds availability schedules. Because of quicker clearing time, the RDC process also reveals bounced checks sooner.

RDC also allows businesses to consolidate their banking relationships. If a business has offices in multiple states, it might not be able to use the same bank for making physical deposits from all of its locations. Using RDC, however, all the deposits can be made at a single institution.

Likewise, RDC makes it feasible for businesses (including government units) to avoid having to use out-of-town lockboxes. For businesses currently using and planning on continuing lockbox payments, RDC offers a low-cost solution to the problem of "stranded payments" — payments erroneously sent to locations other than the lockbox, such as headquarters or local offices.[15] These payments can still be deposited without having to first reroute them to the lockbox.

Alternatively, RDC allows businesses to diversify their banking relationships more easily.[16] The cost of routing some deposits to one financial institution and some to another is greatly reduced by RDC.

## RDC Benefits to Financial Institutions

For banks in general, RDC presents four key benefits. First, it lowers their costs for check processing. According to NACHA, the cost of processing a paper check ranges from 75 cents to $3, and averages around $1.22, whereas an electronic check costs between 32 and 70 cents to process.[17] Second, RDC frees up teller time from check capture for other services.[18] Third, RDC creates a new fee-for-services product for banks. Banks generally charge merchants a monthly fee and a per transaction or per check fee for RDC.[19]

Fourth, RDC can benefit a financial institution because it creates a "sticky" relationship with the depositor. The sunk costs of customized RDC hardware and software are likely to increase RDC customer retention.

For smaller local and regional banks and credit unions, RDC can have additional benefits because of its lack of physical and geographic constraints.[20] Using RDC, smaller local and regional banks can better compete for deposits with national banks. RDC thus has the potential to reshape the deposit market from a local to a national market.

## RDC Concerns for Drawers

The increased clearing speed offered by RDC compared with traditional presentment is a boon to depositors, but means that makers face reduced float periods; theoretically a check can be cashed and cleared electronically on the same day. (Currently all banks appear to be offering at least one day of float.) Reduced float increases the chance that the check will bounce. Systemic RDC adoption would likely increase overdrafts and NSF denials, both revenue generating opportunities for financial institutions.Because the drawer of a check does not know if RDC will be used for processing the check (and there is no disclosure requirement), drawers should not presume to benefit from any float period. By allowing for float to be theoretically entirely eliminated, RDC makes checks much more like debit cards or ACH economically, albeit with a different set of public and private legal protections for banks and their customers. As payment systems' economic functionalities converge, the continued distinctions in their legal regimes is likely to receive greater attention, especially in regard to consumer protection issues.

Drawers (consumers and businesses alike) are unlikely to be aware of diminished float due to RDC, however, and may find themselves surprised and angered by the change, especially if they have relied on float for avoiding overdrafts. A prudent customer relations (and litigation avoidance) strategy for businesses that use RDC would be to provide check-paying customers with notice of the possibility of RDC and the potential elimination of float. Businesses accepting RDC may also wish to negotiate minimum float periods with their depositary institutions.

## Risks Involved with RDC

Because RDC is a check depositing method, it poses the usual fraud risks with checks, as well as the risk of errors from the scanning process and of duplicate presentment, either from fraud or by mistake.

RDC, however, poses two additional fraud issues. First, RDC makes it more difficult for banks to detect fraud because they may not be able to access the original physical check. Banks' fraud units are used to working with original checks and being able to examine watermarks and the original paper in order to detect alterations. With RDC, the original physical check may have been destroyed or, if not, will not be accessible to the bank in a timely manner. Instead, banks will have to rely solely on electronic images, where image quality limitations may pose fraud detection challenges. For example, RDC will make it extremely difficult for banks to detect photocopied checks, as the original MICR line may not be available for examination before the applicable dishonor deadline with RDC.

Second, RDC creates a unique risk of duplicate presentment and payment.[21] Because an image of the check is used for the deposit, the physical check can still be deposited. Moreover, the image can be deposited at multiple banks or multiple accounts at the same bank. This presents a risk for the check's maker of its account being duplicatively debited, for the paying bank of paying twice on the same check, and for depositary banks of breaching the Check 21 Act warranty of single payment.[22]

The Check 21 Act warranty of single payment applies only to banks, not for depositors. The depositary bank's liability for duplicate presentment, however, is generally shifted to the depositor by contract. Businesses accepting RDC may also wish to negotiate minimum float periods with their depositary institutions, as part of their own customer relations strategy.[23]

## LAW GOVERNING RDC

There is no law specifically covering RDC. Reg CC continues to set a floor for the depositor's funds availability. When an ACH file is transmitted to the bank, Reg CC's provisions for electronic payments govern.[24] When a check image is transmitted to the bank, however, Reg CC does not appear to apply, as it covers only funds availability for deposit of cash, checks (defined to include substitute checks, which must be paper reproductions of the original,[25] but not images of checks) and electronic payments (defined as ACH and wire transfers). Thus funds availability for RDC is a matter of private contract.

Check 21 merely enables the possibility of RDC, but does not govern it. Liability rules depend on whether the RDC is ultimately cleared as an ACH transaction, as an IRD or as a digital check image. If it is cleared via ACH, then Reg E and NACHA rules apply. If it is cleared as an IRD, then Check 21, Reg CC, and UCC Article 3 apply. If it is cleared as an image, then liability rules will be determined contractually, but in their absence, UCC Article 3 is likely to apply. Generally, banks accepting RDC will contract with depositors for liability rules, typically placing all liability (including actual and consequential damages) on the depositor, but there is no industry standard yet.

Remote Deposit Capture is an important step in the move away from paper payments, as it permits depositors to retain the paper check rather than physically deposit it in a bank. Combined with image presentment or ACH clearance, RDC makes it possible for financial institutions to avoid dealing with paper checks altogether. By allowing banks to avoid the physical deposits' geographic limitations on depositary relationships, RDC alters the nature of and market for competition for deposits and is a further step in the development of a truly national banking system. RDC is currently not subject to any specifically applicable regulations, but as its use expands there may be an impetus for some form of regulation or at least standardization of RDC contractual rules, perhaps through an industry association.

## NOTES

[1] RDC is also referred to as "merchant capture," "corporate capture," "image deposits," and "image cash letters," depending on the particular usage.

[2] RDC technology can easily be applied to "consumer capture." Only a small number of banks and credit unions, most notably USAA Federal Savings Bank, have engaged in large-scale consumer capture. Bob Meara, *State of Remote Deposit Capture 2008: Sprint Becomes a Marathon*, Celent Research Report, Oct. 15, 2008, at 50 – 51.

[3] *Id.* at 8.

[4] *Id.* at 4.

[5] *Id.*

[6] *Id.* at 5.

[7] 12 U.S.C. § 5001 *et seq.*

[8] The specific NACHA Standard Entry Class ("SEC") for RDC will depend on how the depositor receives the check. If the check is received by the depositor via the mail as part of a bill payment, it will be an Accounts Receivable Entry ("ARC"). If the consumer pays by check at point of sale, the check conversion occurs at the register, and the check is returned to the consumer, it will be a Point of Purchase (POP) transaction, and if the check is written at point of sale and converted in another location and not returned to the consumer it will be a Back Office Conversion ("BOC") transaction.

[9] Meara, *supra* note 2, at 16 - 17. RDC technology can also be used to capture non-check items, such as coupons and invoices. *Id.* at 18.

[10] There is not yet a standardized terminology for the different institutions in an RDC check clearance. This article uses what it hopes to be the clearest combination of potential terms.

[11] 12 U.S.C. § 5002(16).

[12] As of May 2007, less than 25 percent of RDC checks were cleared as images. Remote Deposit Capture Overview, *at* http://www.remotedepositcapture.com/overview/rdc.overview.aspx.

[13] *See infra* LAW GOVERNING RDC, for issues with Reg CC funds availability applicability.

[14] A variation on this model is when RDC services are sold to depositor clients by an independent sales organization ("ISO"). The ISO receives a commission for selling the services of a third-party processor, which aggregates deposits from multiple RDC clients of the ISO. The processor then sends the check images to a presentment bank, which clears the checks with the payor banks. After the checks have cleared, the presentment bank credits the clients' accounts at their banks (banks of first deposit) via ACH. For an illustration, *see* Meara, *supra* note 2, at 28.

[15] *Id.* at 37.

[16] Meara, *supra* note 2, at 25.

[17] NACHA—The Electronic Payments Association, at http://www.electronicpayments.org/financial/fi.check-conversion.benefits.php.

[18] Meara, *supra* note 2, at 10 - 11.

[19] Linda Punch, *Why Remote Deposit Capture Looks Super*, Digital Transactions News, April 2007.

[20] Meara, *supra* note 2, at 15.

[21] Fraudulent duplicative presentment does not yet appear to be a major problem. *See* David Breitkopf, *Remote Deposit Fraud Risk: Perception or Reality?*, Am. Banker, May 27, 2008.

[22] 12 U.S.C. § 5004(2).

[23] Meara, *supra* note 2, at 21, 39.

[24] 12 C.F.R. § 229.10(b).

[25] 12 U.S.C. § 5002(16).