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Electronic Funds Transfer System: Legal Perspectives

ELECTRONIC FUNDS TRANSFER SYSTEM: LEGAL PERSPECTIVES

By PAUL BRACE*

A. HISTORICAL BACKGROUND¹

The history of payments systems has been one of continuous evolution. Initially, trade was based upon the barter system but this soon proved to be rather cumbersome and was gradually replaced by a payments system which utilized universally accepted symbols for value — money. The important characteristic of money is not that it has value in itself but that it is recognized as representing value. Money could take the form of stones, shells or G.I. cigarettes; metal coins, as we know, eventually emerged as the most common form of money.

During the Middle Ages, goldsmiths began to play an important role in the payments system as suppliers of currency or notes. Since they had secure storage facilities, goldsmiths would accept for safekeeping coins minted by government and held by individuals. When an individual delivered coins for storage, the goldsmith would write an I.O.U. in favour of the depositor promising to return or repay on demand. Later, notes were made out in specific denominations — these were the first bank notes. Also, a practice developed whereby the depositors would write their goldsmith-bankers directing them to pay a certain amount to a named individual: this practice was the forerunner of the cheque.

In recent years, the plastic credit card has emerged as a popular method of effecting payment. It is interesting to note that when credit cards were first introduced, bankers were uncertain whether they would constitute a profitable venture. However, one of the reasons for introducing the credit card despite this uncertainty was to prepare the public for the advent of the latest stage in the evolution of the payments system, the Electronic Funds Transfer System (EFTS) which will make extensive use of the plastic card.

B. WHAT IS EFTS?

Two factors have precipitated the development of EFTS. First, the present payments system, based to a large extent on the use of the cheque, has become extremely cumbersome and costly. Each year, approximately 1.75 billion cheques are issued by consumers, corporations and government and processed by the Canadian chartered banks.² As it is processed through the

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¹ See, Hugh Hardy, *The Individual in the Payments Mechanism* (January, 1973) Canadian Chartered Accountant at 47.

² Canadian Imperial Bank of Commerce Commercial Letter, Head Office, Toronto, May/June 1974 at 2. Note that this number is growing by seven *per cent* each year.

clearing system, each cheque is handled approximately fourteen times at an average total cost of fifteen cents.³ It is unnecessary to point out that the labour component in the present system has manifested itself in high service charges to the cheque issuer. This expense, combined with the physical limitations inherent in this system have made it imperative that a more efficient means of effecting payment be found.

The second catalyst in the introduction of EFTS is the development of computer and communications technology to such a sophisticated level that it is now possible to offer a practical alternative to the present system. The computer is an information-processing device and therefore a viable substitute for the cheque since a payment by cheque is merely a method of relaying information. When a cheque is issued, no commodity of real value is exchanged; rather, the issuer simply sends a direction to the bank to transfer funds from one account to another. The computer can perform this information-relaying service much more efficiently and at less cost than the present system.

The first phase of EFTS, the Direct Funds Transfer System (DFTS), is already in operation. In DFTS, payments information is encoded on magnetic tape and processed on the bank's computer. Recurring debits and credits are the payments which are best adapted to this system. For example, an employer will encode payroll information on a magnetic tape and send it to the bank where all of the employees' accounts will be credited electronically. Debit transactions such as rent, mortgage, insurance and loan payments are currently charged against individual accounts on a regular basis without the issuance of a cheque. Although these debit transactions are not presently performed electronically, it is logical that they will be the next class of payments to be adapted to DFTS.

Another phase of EFTS which will have an even greater impact on the payments system is the eventual replacement of cash registers in retail outlets with point of sale terminals. The point of sale terminal will read a plastic card (which every consumer will receive from his bank), transmit a debit message to the consumer's bank through the communications network and, at the same time, transmit a credit message to the merchant's bank. For many consumers, there will be no need in the future for cash, cheque or Chargex.

The telephone is also destined to play an important role in the implementation of EFTS. An individual will be able to dial through to his bank from any telephone, and after obtaining clearance by providing both a card number and a confidential number, he can give instructions to make a variety of payments from the home or office without the bother of issuing and mailing a cheque. The telephone will also provide the small retailer with a less expensive alternative to the point of sale terminal, *i.e.*, consumers will be able to effect payment at the store by means of the telephone instead of the point of sale terminal.

³ *Id.*

The foregoing description of EFTS is intended only to provide the reader with a background against which to consider some of the legal questions which the implementation of this system will pose. In reality, EFTS is a much more complex concept than the rather simplified description indicates. In addition to certain unresolved technical questions and marketing problems, there is a great need for further consultation among those who share the burden of developing the system and those who will be the ultimate users of the system.

C. LEGAL ISSUES RAISED BY EFTS

Even if technology can advance the implementation of EFTS, there are a number of legal issues which must be considered before an efficient system can be operative. It must be noted that many of the legal issues raised by EFTS cannot be resolved in terms of existing statute or common law; therefore, any analysis of its legal implications is at best tentative.

1. *Invasion of privacy*

The increasing use of computers and electronic communications techniques will certainly present a greater risk of invasion of privacy than presently exists. It may become difficult to ensure the accuracy of data if a large number of tellers and retail store clerks can feed data into the system. The inevitable inaccuracies that result may impair the credit rating of the individual to whom the incorrect information relates. For example, if debits are made to an account in excess of the correct amount, and if there are not sufficient funds in the account to cover the transaction, the account will be thrown into a negative balance, resulting in the individual's being labelled as a poor credit risk through no fault of his own.

Quite apart from the possibility of human error in relaying information is the probability of human curiosity in receiving information. A large number of bank personnel will have access to confidential information on customers and this may create problems in preventing disclosure. Because of the elaborate communications network, information will be readily accessible to bank personnel in all parts of the country. More significantly, much of the information that is relayed and recorded will by its very nature shed light on the customer's lifestyle.

The use of credit cards and, in the future, 'cash cards', will enable the bank to keep tabs on the customer's travel and spending patterns. The point of sale terminal will capture information describing the transaction and transmit it to the bank for use in compiling the customer's monthly statement. (In EFTS, the monthly statement will be called a descriptive statement.) It will tell the customer not only what he spent and when, but it will also tell him what he purchased and where. Whether or not the confidentiality of the information is maintained, consumers may view the accumulation of this information as an invasion of privacy. The following passage illustrates the nature of the apprehended harm:

Whoever ran the computers could know when the individual entered the highway and when he got off; how many bottles of Scotch or Vermouth he purchased

from the liquor store; who paid the rent for the girl in apartment 4B; who went to the movies between 2 and 4 p.m. on a working day at the office; who was at Luigi's or the Four Seasons on September 15; and the hotel at which Mrs. Smith spent the rainy afternoon last Sunday.⁴

Computer fraud is also relevant to the issue of invasion of privacy. Persons with a knowledge of computer programming have been able to divert funds into their own accounts which are maintained under fictitious names; the same methods may be used to steal information which could lead to disclosure of confidential information and invasion of privacy.

The law has developed in a haphazard fashion to meet the threat of invasion of privacy. Essentially long-standing legal principles have been adapted to meet the exigencies of particular circumstances: the law has afforded protection to individuals by allowing them to institute a tort action. Two tort actions have enabled individuals to obtain redress in most cases in which injury results from the communication of information; these are the torts of defamation and negligent misrepresentation.

The law of defamation permits recovery when a false statement is made by the defendant which has caused damage to the plaintiff's reputation. To be actionable, the communication must be substantially false or misleading; truth or fair comment may provide the individual with a complete defence. The defences of absolute or qualified privilege may also be available. The defence of absolute privilege is available in certain cases where public policy and convenience dictate that one should be free from the responsibility for the publication of defamatory words. Absolute privilege attaches to statement made in the course of judicial or parliamentary proceedings and in a number of other similar situations. The defence of qualified privilege is made out where the publisher and the recipient have a mutual interest in the making and the receiving of the statement. But it should be noted that a commercial relationship such as that existing between a bank and its customer would not satisfy the requirement for the existence of a mutual interest.⁵ Another development which has enhanced the position of the individual is the refusal of the English and Canadian courts to allow the defence of qualified privilege to defendant organizations which exist for the purpose of buying and selling information.⁶ However, despite the existence of a cause of action for a victim of defamation, the remedy may be illusory in that the individual in many cases will not know that he has been defamed: when credit information is exchanged between commercial institutions, the individual is in most cases unaware of the nature of the information exchanged, or, indeed even that such an exchange has occurred.

An action for negligent misstatement may be brought when any harm is suffered by the plaintiff as a result of an erroneous statement to which the de-

⁴ A. F. Westin, *Privacy and Freedom* (New York: Atheneum, 1967) at 165.

⁵ Jeremy S. Williams, *Legal Protection of Privacy: A Study for the Privacy and Computers Task Force* (Ottawa: Department of Communications, 1972) at 19.

⁶ *Macintosh v. Dun*, [1908] A.C. 390; *London Assoc. for Protection of Trade v. Greenlands Ltd.*, [1916] 2 A.C. 15; *Cossette v. Dun* (1890), 18 S.C.R. 222; *Lemay v. Chamberlain* (1886), 10 O.R. 638.

feudant has given currency. It is a prerequisite of this cause of action that the statement be made in breach of a duty of care and that it actually cause injury. This tort has been extended to cover all types of injury resulting from the communication of false information.⁷

Nevertheless, these tort actions are not specifically designed to deal with the invasion of privacy problem although they do encompass it in a peripheral sense. The basic common law position is that invasion of privacy is not actionable *per se*. Judicial and legislative attempts have been made to protect individual privacy in two Canadian jurisdictions, British Columbia and Manitoba.⁸ The B.C. *Privacy Act* provides that one will have an action in tort where one's privacy has been invaded "wilfully and without claim of right."⁹ *The Privacy Act* of Manitoba makes similar provision but it may afford slightly broader protection than the B.C. Act: section 2(1) of the Manitoba Act provides that "a person who substantially, unreasonably and without claim of right, violates the privacy of another person, commits a tort against that other person."

The federal government recently enacted the *Protection of Privacy Act*, but it specifically aims to control interception of a private communication by means of "an electro-magnetic, acoustic or other mechanical device."¹⁰ A private communication is defined as "any oral communication or any telecommunication made under circumstances in which it is reasonable for the originator thereof to expect that it will not be intercepted by any person other than the person intended by the originator thereof to receive it."¹¹ This definition reduces the relevancy of The Act to EFTS problems since banks are obliged to prevent the disclosure of confidential information, and The Act does not give an unqualified right of action for the invasion of privacy *per se*.

Banks, credit unions and trust companies maintain records of the property and transactions of their customers. They also gather credit information which is often exchanged among themselves or sold to others. Often the customer who is the subject of the credit information is unaware of the exchange. However, it is possible that it will come to his attention and in this case there may be civil liability for negligent misrepresentation, deceit, defamation or breach of confidence.¹² When EFTS is in place and the banks are faced with the possibility of inaccurate entries and computer theft as well as the realization that many people will have access to confidential information, it will become increasingly important to ensure that adequate security precautions are taken to avoid invasion of privacy. Otherwise, liability may follow. The technical advances which are being made do not actually change the nature of the problem. In fact, they tend to increase the area of potential liability.

⁷ *Supra*, note 5 at 6.

⁸ *The Privacy Act*, S.B.C. 1968, c. 39; *The Privacy Act of Manitoba*, R.S.M. 1970, c. P-125.

⁹ *Id.*, s. 2.

¹⁰ S.C. 1973-4, c. 50, s. 2.

¹¹ *Id.*

¹² *Supra*, note 5 at 3.

It has been suggested that the consumer be given an "unqualified right to print-out."¹³ In other words, the consumer should have complete and unfettered access to the information compiled on him. This would help to ensure that inaccurate information is not disseminated to the detriment of the individual. It is also suggested that the individual should be informed of the existence of the file when information is first required and that if inquiries are made regarding the individual subsequent to this time, further notification should be given.¹⁴ This would at least give the consumer knowledge of those who have information concerning his financial situation.

2. *Misuse of card after loss or theft*

This issue is one of great concern to consumers. At present, the holder of a Chargex card is only liable for a maximum of fifty dollars of indebtedness resulting from unauthorized use. If the card holder gives notice of the loss or theft before the unauthorized user has made purchases amounting to fifty dollars, then his liability extends only to the lesser amount, *i.e.*, the dollar value of transactions made at the time notice is given. A similar contractual arrangement must be offered to consumers under EFTS to alleviate concern over potential liability.

Of course, the technological implications of unauthorized card use are as important as the legal implications. To ensure that the user of a card is authorized, identification devices might be utilized such as electronic voice recognition, thumb prints, photographic identification cards, magnetically encoded strips sealed into identification cards and special code words or numbers known only to the customer.

Certain concepts contained in the *Bills of Exchange Act*¹⁵ which do not relate to negotiability may be adapted to suit EFTS. The concepts of forgery and unauthorized signature may be adapted to deal with disputes where a card has been used without the authority of the owner. Section 49 of The Act states that a forged or unauthorized signature is "wholly inoperative, and no right to retain the bill or to give a discharge therefor or to enforce payment thereof against any party thereto can be acquired through or under that signature . . ." Under EFTS the law might impose the same burden on one accepting a card from an unauthorized user. However, since the card is probably more characteristically representative of cash than a bill of exchange, it does not seem logical to equate the remedies associated with unauthorized card use with those associated with forgery, although consumer protectionists have advocated this approach.¹⁶

3. *Incorrect entries*

In his report to the federal Law Reform Commission, Howard Eddy advocates that the consumer be given an automatic right to reverse a disputed

¹³ *Id.*, at 66.

¹⁴ *Id.*, at 67.

¹⁵ R.S.C. 1970, c. B-5.

¹⁶ H. R. Eddy, *The Canadian Payments System and the Computer: Issues for Law Reform; Study Paper* (Ottawa: L.R.C.C. 1974) at 35-36.

entry pending resolution of the dispute.¹⁷ The members of the National Automated Clearing House Association in the United States have agreed that the customer may reverse a disputed entry within 15 days of statement date or 45 days of the transaction date. There is some question whether this would be acceptable to the Canadian chartered banks. Obviously, such a right in favour of the consumer would create additional administrative work for the banks and if the entry were found to be correct, it would impose the burden of legal action on the banks to recover the funds. On the other hand, consumers fear that the impersonal computer may not be responsive to their complaints about the accuracy of entries and may refuse to use the system unless the right to reverse disputed entries is offered.

There is also the possibility that errors may be made in the preparation of magnetic tapes and in the processing from tape to tape for redistribution of payments data. Such errors would result in improper entries which the customer would expect his branch of account to rectify. The branch of account, in turn, would expect to be able to locate the source of error and shift responsibility to the party who made it. It should be possible to identify the source of error by examining the original tape and those to which data is transferred from the original tape. Would the banks be prepared to allow the consumer a right of chargeback, *i.e.*, the right to reverse disputed entries or transactions? In the long run, federal legislation may be required to deal with this problem, particularly if the banks refuse to allow the right of chargeback while at the same time insisting that the payments system can no longer continue to function without the introduction of the electronic transfer of funds.

4. *Records of electronic transactions*

Another obstacle to the implementation of an efficient EFTS is the necessity of maintaining documents of payments transactions which will be admissible as evidence in a court of law. Section 29(1) of the *Canada Evidence Act*¹⁸ states that "any entry in any book or record kept in any financial institution shall in all legal proceedings be received in evidence as *prima facie* proof of such entry and of the matters, transactions and accounts therein reported." Subsection (2) of the same section regulates the admissibility of copies of such documents.

Thus far the banks have encountered no difficulty in producing documents to be admitted as evidence. However, the records of the future will be maintained either in the form of microfilm or in a computer data bank. The *Canada Evidence Act* does make provision for the admission of a microfilm copy of a document which has been made by a financial institution.¹⁹ However, this right is premised upon two conditions: first, that the object photographed was subsequently destroyed by or in the presence of an employee, or was lost or delivered to a customer, and, secondly, that the microfilm was made for the purpose of maintaining a *permanent* record. The latter condition could cause the banks some difficulty because records are usually destroyed

¹⁷ *Id.*, at 36-37.

¹⁸ R.S.C. 1970, c. E-10.

¹⁹ *Id.*, s. 21.

after fifteen years in reliance on S. 74 of the *Bank Act*.²⁰ Section 74(2) provides that the liability of a bank shall be determined by reference only to evidence of matters that have arisen within the fifteen years preceding the commencement of the action. It would be advisable, therefore, to recommend that either the *Bank Act* or the *Canada Evidence Act* or both, be amended to clarify this matter.

In the case of a computer data bank, it is possible to retrieve the information stored but not to produce a facsimile of the original document from which the information was taken. In some cases, there will be no document at all (paperless entries). The question is what kind of computer print-out would be acceptable to a court of law as evidence of a transaction which has been recorded electronically. It does not appear to be particularly relevant whether the initial transaction was paper-based or not. In either case, the issue concerns the admissibility of some form of computer print-out. The question of acceptability is one which Parliament, with its jurisdiction over evidentiary matters involving the banks, must answer.

5. *Loss of tactical advantages inherent in other payment techniques*

Real-time payment would eliminate the ability to withhold or stop payment. The ability to countermand a cheque is based upon a time lag between delivery of the cheque and the debit to the drawer's account, whereas real-time payment effects an immediate transfer of funds. However, this need not result in the elimination of the tactical advantages which the consumer has at present. Howard Eddy, who is of the view that "a cash sale model interferes with the efficient resolution of disputes,"²¹ recommends an automatic right of chargeback which would enable the consumer to reclaim payment.²²

6. *Negotiability*

Negotiability is not a serious obstacle to the implementation of EFTS, although in a real-time system negotiability will be impossible: a debit to the customer of a merchant will be followed immediately by a credit to the merchant's account. In other words, a point of sale electronic transaction will operate as a substitute for cash, not as a substitute for a cheque or other negotiable instrument. Once the funds have been transferred to the account of the merchant, the liability of the customer to pay will be extinguished. Negotiation, which involves the assignment of the benefit of the liability of a party to a bill, is obviously not possible if the liability of the payer has been extinguished.

It is possible that negotiability could play a role in an electronic environment based on the transfer of magnetic tapes. For instance, a method might be devised whereby a payee who as a result of pre-authorization has the right to debit a payer's account could transfer this right to a third party. In this case, the concept of negotiability would be relevant. This would mean

²⁰ R.S.C. 1970, c. B-1.

²¹ *Supra*, note 16 at 53.

²² *Id.*, at 56.

that the classification of the holder of a bill as a holder in due course or otherwise would have some applicability in an electronic environment. Of course, one would no longer be the holder of a bill but the holder of a right to debit the account of another. However, the importance of negotiability must be considered in light of the fact that only ten per cent of all cheques issued are negotiated to anyone other than a bank. For this reason, and because EFTS will eventually be a real-time processing system, the elimination of negotiability cannot be considered a serious problem.

If EFTS eliminates negotiability, it is difficult to see how the *Bills of Exchange Act* could have any application. If negotiability is retained in the limited form mentioned above, The Act may have a role to play, but it would necessitate amendments: the *Bills of Exchange Act* is based on the existence of a paper document, *i.e.*, a bill, cheque or promissory note; it makes no provision for payment by plastic cards whether in conjunction with an electronic payment system or not. Nor does it provide for transfers of payments data encoded on magnetic tape. The definition of paper document would have to be expanded to deal with these new "instruments" of payment.

D. CONCLUSION

Before EFTS will operate to the satisfaction of users and financial institutions, a number of existing statutes will require amendment and new legislation may have to be enacted, particularly in the invasion of privacy area. Problems relating to the consequences of unauthorized use and the right to chargeback may be left to be resolved by contract in the private sector.

However, despite the legal barriers, EFTS represents a significant advance over the present system. Users of the system will be able to transact business more efficiently, more conveniently and at less cost than is presently possible. Because of the social benefits inherent in electronic banking, it is important that solutions be found to the problems it raises. Until they are, a successful EFTS cannot be implemented.

