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- The Rails Determine the Rules: Legal Issues to Consider in B2B Payments
- Merchant Processing, a Goldmine or a Minefield—Proceed With Caution
- Can You Trust Your Credit Model?
- Minimizing Risks and Improving Outcomes in the Supply Chain Arena



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for
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The Rails Determine the Rules: Legal Issues to Consider In B2B Payments

By: Erin F. Fonté

Abstract

There are currently two very interesting facts about business-to-business (B2B) payments in 2010. The first is that while overall issuance and usage of paper checks is decreasing dramatically, somewhere between 75% and 85% of B2B payments are still processed via paper check. The second very interesting fact is that over the past year, there has emerged a new cry and charge from Silicon Valley (and other) technology start ups who want to change the payment system as we know it and overthrow the “old thinking and old ways” of banks, the automated clearing house (ACH) system and the credit card networks, making payments a less monopolized and costly area of business (and consumer) spend.

Why should businesses be concerned about these two very interesting facts? With respect to the level of B2B payments still processed by check, companies are coming under ever-increasing pressure to shift to electronic payments in order to save costs. As economic pressures mount, companies have been exploring (and deploying) electronic invoicing, presentment and payment (“EIPP”) systems designed to reduce operating costs, accelerate receipt of cash (funds in the door), and thereby be able to increase working capital efficiency for the company. Many of these programs are also in line with company-mandated efforts to “green” the payments process by moving away from paper-based systems to electronic-based systems to save paper.

And with respect to the second fact, “payments” is the new buzzword amongst the technorati (indeed, the new Twitter-backed payments company, Square, Inc., wants to “make payments fun again”), and businesses will undoubtedly be deluged with tons of prospective vendors and new start-ups who want to help that business solve its payment problems.

Those two interesting facts mean that in order to sort through what is becoming a new “Wild West” of payment options and third-party vendors, company’s need to educate and arm themselves so they can effectively shift from their paper-based payment systems to electronic-based payment systems, while still effectively vetting the financial institutions, payment processors, and alternative payment providers that desire to move the company’s money more efficiently. The purpose of this article is to arm businesses with the key legal questions to ask (and get good, complete answers to) in order to ensure that the company is adopting an efficient and secure method of electronic payments that is easy to use, provides good customer service and responsiveness, quickly and accurately resolves payment disputes, and does not unduly introduce unforeseen fraud risk into payment operations.

This article describes the current state of EIPP, discusses why the payment and settlement issue appears to be the "last mile problem" in fully automating payments, discusses how various EIPP providers can play a role in solving the last mile issue, and provides a general overview of why it is critical for businesses to understand what payment type they will be using to fully understand their rights, responsibilities and risks in using particular EIPP services.

Current State of EIPP

For years there has been talk about paperless B2B invoicing and payment transactions. The promise of automated procurement and accounts payable is so enticing that many of the largest companies have invested in fairly expensive electronic data interchange ("EDI") systems that directly connect very large buyers and their banks to their very large suppliers and their banks.

For companies that are unable or unwilling to make costly capital investments in an EDI solution, EIPP software and services offers an alternative solution that promises to be cost-effective, highly functional and secure.

EIPP solutions have been available for many years now, and today there are over 150 EIPP vendors in the marketplace. Adoption of EIPP has accelerated over the last several years, with the market growing at a 26% annual rate since 2004. (Forrester Research, "Predictions 2009: ePurchasing Market," March 2009.) Some businesses are still studying EIPP, some are dipping their toes into the EIPP pool, and still others have jumped right in. The question now is how well is EIPP actually doing in streamlining accounts payable and the purchase-to-payment cycle?

EIPP promises several feature-rich benefits, including:

- Online creation of purchase orders (POs) and invoices
- Optical scanning of paper invoices
- Automatic matching of invoices with POs and remittance info for quick error resolution
- Automated payment approval workflow
- Sophisticated accounts payable business rules for automating release of payment

The truly puzzling question, however, is why so many businesses are still not adopting EIPP systems? "Despite being expensive, slow and error-prone, human beings still handle [between 75% and 85%] of all business-to-business invoices." (The Forrester Wave, AP-EIPP, Q2, 2008, Duncan Jones). The unfortunate reality in today's world of accounts payable is that, excluding the largest companies, between 75% and 85% of all B2B payments are still made with paper checks stuffed into envelopes and sent through the mail. (Forrester Research, "The Forrester Wave: AP-EIPP, Q2 2008," June 2008.)

And even if your company has adopted EIPP, the entire process still may not be fully automated. If your company is using EIPP right now, it is entirely possible that the actual payment part is not truly a part of your EIPP service, and is still, in fact, a separate component of the payable process handled internally at your company or by your check-writing service. Indeed, many industry analysts and EIPP vendors themselves do not consider the transfer of funds as part of EIPP. Consequently, what should be a fully automated process for invoice presentment, payment

and settlement is still largely handled manually, and at great systemic costs. The key to overcoming this barrier has to do with the second “P” in EIPP: payment.

Payment: How Funds Are Typically Transferred Today

Your company can invest in streamlining and automating your payments workflow, but the foundation of the entire payments automation issue lies in what happens after you, the buyer, “release” the payment. (For purposes of this article, “buyer” is the company remitting payment to a vendor, supplier, employee, etc., and “vendor” is the company or individual receiving payment. This article is useful for vendors as well because it highlights many of the issues vendors will have to address when negotiating with a buyer over payment processing and settlement, or perhaps when a vendor is evaluating payment services.)

The following description shows what typically happens in today’s EIPP environment:

- Step 1: Buyer receives the invoice
- Step 2: Invoice validation and correction (if needed) occurs
- Step 3: Approval and release of payment
- Step 4: Buyer/Buyer’s third party contractor prints checks and remittance information
- Step 5: Checks and remittance information placed into envelopes and sent via regular mail
- Step 6: Vendor/Vendor’s third party contractor receives check/remittance information at physical lockbox location and converts checks to check images through remote deposit capture or converts check to ACH transactions, and enters remittance information into Vendor’s accounting system
- Step 7: Payment transaction settled and funds deposited in Vendor’s account

For an “automated” process, it still utilizes manual labor at many points along the way, which undermines the goals of automation and can lead to human errors and more expense. But there are reasons why the current system works in this manner. First, because buyers, vendors and their respective banks are not integrated into a common transaction settlement system (at least in the same way very large companies are with comprehensive EDI solutions), buyers and vendors cannot automatically transfer funds and remittance information between each other. They can initiate ACH transfers using payment information they provide to each other, like bank account numbers, routing information or payment card numbers, but the process of initiating and settling the payment essentially remains a manual one.

The other main reason why businesses are not automating B2B payments at a more rapid rate is due to regulatory compliance issues (both with laws and with the rules of various private payment system networks). If the vendor’s and buyer’s respective financial systems are directly connected, each party is immediately under certain legal and private network obligations regarding storing and securing each other’s financial information, like checking account numbers and credit card information.

The steps necessary to meet all of the legal and private payment network security obligations can be costly and expensive, so employing a payment processing and settlement system that is semi-

manual avoids the need to store the other party's financial information thus eliminating the expense of, for example, becoming compliant with the Payment Card Industry Data Security Standards for credit card information when the business would not otherwise have to comply with such security standards. However, certain third-party service providers are currently attempting to create products that bring the "payment" component into EIPP and further automate the B2B payment process.

Payment Processing Component: Can EIPP Get Closer To True Automation?

Many third-party payment processors and similar service provider companies offering EIPP services believe the way to make EIPP more efficient is to bring the actual payment and settlement of the transactions fully into the EIPP process. This solution would entail bringing transaction settlement into the EIPP services in a way that is simple and does not require either the buyer or the vendor to take on any of the compliance burdens discussed above.

If the transaction settlement piece itself were automated, then several significant steps from the description above would be eliminated, and the process would be as follows:

- Step 1: Buyer receives the invoice
- Step 2: Invoice validation and correction (if needed) occurs
- Step 3: Approval and release of payment
- Step 4: Processing and settlement of payment by FI or third-party payment processor
- Step 5: Payment transaction settled and funds deposited in Vendor's account

So what is currently so complicated about the processing and settlement component of electronic transactions? To understand this issue (particularly from a legal perspective, as explored later in this article) companies must understand that as it stands today, and despite what third-party service providers or tech startups say about how they are revolutionizing the payments space, there are five and only five ways that money can be transferred and settled from one entity or person to another:

- Cash (and in reality, closed loop, store-issued gift cards and gift certificates are really cash except for the portability factor)
- Paper Check (including cashier's check, money order and travelers' cheque)
- Payment Cards (including network branded credit, debit card or stored value cards; if network branded, then the transaction is routed over credit card network "rails")
- ACH Transactions (of any type, including paper checks converted to ACH and decoupled debit cards)
- Wire (instantaneous transfer of money via FedWire or other similar wire transfer network)

That's it. Every payment transaction that is processed – be it through JPMorgan Chase or Bank of America, FirstData or Chase Paymentech, PayPal or Square, Inc., OboPay or TwitPay – every transaction moves along either one, or a combination of two or more, of the five payment “rails” described above. To make an analogy, I live in Austin, Texas, and in order for me to drive to, say, Los Angeles, California, I can take any type of vehicle I want – basic sedan, fancy sports car, gas/electric hybrid, and can even let someone else do the driving by taking the bus or a limousine or car service. But, sooner or later, if I want to make any sort of decent time on the drive at all, I am going to be on Interstate 10 for a lot of my journey.

To move money from one person or entity to another, the payment networks (or payment “rails” for the purposes of this article) described above must be used for the purpose of settling the transactions. And while integrating payment processing into the EIPP solution seems straightforward and simple enough, it is, in practice, much more complicated than that. But how that step can be accomplished really has to do with what type of entity is performing the transaction settlement. Currently, there are generally two types of entities that can settle B2B payment transactions, with a quickly emerging third group: (1) banks/financial institutions; and (2) payment processors; (3) alternative payment providers.

Banks/Financial Institutions

In this type of settlement, the EIPP is brought to the banks. A few large commercial banks extended the services they offer business customers by, in most cases, acquiring EIPP vendors and incorporating their own transaction settlement services into the EIPP offering. The banks/FIs have the networks to settle B2B transactions on a large scale, and they are already in compliance with the laws, regulations, and private payment network rules. Furthermore, they are sponsored into and are already a part of the private networks, such as NACHA and the various payment card networks (Visa, MasterCard, American Express, Discover).

Typically banks/Fis require customers who are buyers using their EIPP and transaction settlement services to also use their other business banking services. For instance, if you use a business credit card or corporate purchase card, you may be required to use a card issued by that bank. You may be required to maintain one or more business accounts at that bank. And some banks require that you do all of your business banking exclusively through them in order to use their EIPP services. An advantage to the bank/FI model is enhancing your banking relationship to include EIPP, allowing you to avoid managing new vendors and could provide tighter controls for lines of credit and cash positions. However, potential drawbacks of these systems are that you may lose flexibility in managing your banking relationships and financial products. Your switching costs may also increase in the event you wish to change financial services providers.

Payment Processors (e.g., FirstData, Chase Paymentech, etc.)

The alternative approach to the bank/FI model is to bring transaction settlement to EIPP. Some EIPP third-party service providers are establishing relationships with payment processors. This enables the EIPP service provider to extend transaction settlement services as part of its EIPP offering. Like large banks, payment processors themselves are well-positioned to process and settle large volumes of transactions. They typically are already part of the payment card networks because they process payment card transactions for merchants accepting the cards, and

they typically maintain an enormous network of banking relationships because they interact with such banks during card and other transaction settlement processes.

The advantages to this type of EIPP vendor are that your company and your vendors are not tied to any one bank/FI, and your company retains flexibility to use whatever financial services work best for your business. However, because you have introduced a third party into the transaction flow, your company will need to make sure that the agreement with the third party covers many of the same issues that your agreement with your bank/FI would cover in terms of applicable laws and rules by payment channel, dispute resolution procedures, etc.

Alternative Payment Providers

I will take a moment to discuss alternative payment providers and platforms because there are many industry analysts who believe that the future of payments belongs to innovators using software platforms to develop new services that can be quickly brought to market. David S. Evans, an economist, veteran payments observer, and keynote speaker at the Federal Reserve Bank of Chicago's annual payments conference on May 20, 2010, cited PayPal Inc., the new Square, Inc., and a Denver-based developer, IP Commerce, Inc., as leaders in what he called a "revolutionary transformation of electronic payments that some day will be built upon no more than five to 10 software platforms that will give rise to countless applications for consumer and business users."

"There is going to be a race," Evans said. "PayPal is first out of the gate and has made significant progress, but there are going to be other players." Evans was referring to the PayPal X platform that the eBay Inc. subsidiary introduced late in November 2009, a platform that enables third-party software developers to build new applications based on a foundation of PayPal code. In just six months, developers have produced approximately 25,000 applications, according to Evans.

IP Commerce, Inc. has constructed a software platform that builds upon its myriad connections with payment processors. And Square, Inc., while less than six months old, has significant potential with its platform built upon Apple Inc.'s iPad and iPhone/iPod touch operating systems and Google Inc.'s Android operating system for mobile devices. (Square, Inc., has also been getting lots of press because of the involvement of Jack Dorsey, co-founder of Twitter.) "We're already seeing lots of entry by developers ... entrepreneurs who are coming up with creative ways to have software based on these systems," Evans said. "It's almost certain to lead to a massive amount of innovation over the next decade."

Payments innovators are finding that changing longstanding business models is no cakewalk. Jack Dorsey, co-founder of Twitter and chief executive of San Francisco-based Square, Inc., reports in a letter under the headline "Taking Time" on Square, Inc.'s website that developing a new payment alternative has been "surprisingly difficult." Square, Inc., announced its existence in December, and has the following as its stated goal on its website: "Square intends to bring immediacy, transparency, and approachability to the financial world. We want to enable all people to accept payments instantly, with access to all the information they need, in a way that feels amazing and engaging. When you think about it, paying someone is just another form of communication, an exchange of value that deserves to have the same design and product considerations that every social service prides itself on maintaining." From a payments lawyer's

perspective, yes, there is a social component to making a payment. But tendering a payment is also the way in which you extinguish a legal debt owed to another, and, therefore, it is not merely process or engineering, but rather contains legal substance and significance. A company can make payments fun, but will they be there to answer the phone when you have a dispute or security breach issue to resolve ASAP?

So, the area of alternative payments providers is an interesting one to watch, but these providers should be fully vetted by any company seeking to use their services in B2B transactions. For example, PayPal Inc. has had a lot of success in enabling person-to-person transactions, but, at the end of the day, PayPal Inc. is really just standing in as the merchant of record for credit card transactions (those that move along the credit card rails), and is a third-party originator (or something similar) for ACH transactions (moving money between people's bank accounts via ACH). But one of the biggest complaints with PayPal is the dispute resolution procedures. Because PayPal is the merchant of record, it falls to PayPal to respond to a chargeback situation where a person making payment (buyer) disputes a payment to a merchant. Whereas a merchant acquiring bank may take a more "hands on" approach in providing customer service and aiding the merchant in fighting a chargeback, many complaints against PayPal are that the automated nature of the system makes it extremely difficult for merchants to fight chargeback's.

Many of these alternative payment providers started in order to fill a niche. PayPal (and to a certain extent Amazon Payments) are working to address person-to-person transactions. Square Inc. is initially focusing on allowing small and solo businesses to process card transactions without having to enter into complex merchant processing agreements. Another company called FaceCash is trying to create a type of e-wallet function where the user loads value into their FaceCash account via ACH transfers from their bank accounts.

At the end of the day, if your company is looking at the next big startup for B2B processing (I am sure there are start ups right now working furiously to fill this niche), the main business question you have to ask is one about the rails. Getting past all of the sales pitches and hype, a good company will tell you how the B2B process is transacted, all the steps involved, and what payment network "rails" the transaction travels over. And every payment transaction must, at the end of the day, travel over one or more of the five "rails" discussed above. This is a critical question because in order to fully understand the product or service your company is obtaining, you must understand the rails involved, because the rails determine the risk, legal rights and responsibilities, and, ultimately, many other elements of your B2B EIPP process.

Legal Issues in B2B Payments

At its most basic definition, a "payment" is a transfer of money or wealth or value from one party to another. In the B2B context, that transfer is carried out in order to extinguish a commercial debt. For many, many years now, B2B payments have been carried out under a set of laws that has been fairly contained and evolving over many, many years. The laws governing a commercial transaction settled via paper check are fairly straightforward and typically involve state sales laws, contracts between the company and its financial institution, and Uniform Commercial Code ("UCC") Articles 3 and 4. Well-established laws, such as UCC Articles 3 and 4, also govern the entire settlement process regarding that paper check. This area of the law is well-established, with lots of case law rulings addressing instances of check kiting, fraudulent

signatures, fraudulent indorsements – just about everything you can imagine that has or can go wrong with a paper check transaction has been covered.

But when a company decides to move from the realm of paper check law where physical items are mailed, the company has entered a broader realm of “payments law,” and this is an area of the law that is in a state of change and flux. From a broader perspective, there really is no unified body of “payments law” in the U.S. Separate rule structures exist for each payment type; as we payments lawyers like to say, “the rails determines the rules.” And still different rules apply whether the payment transaction involves a consumer or is strictly commercial.

The body of “payments law,” if there really is one, runs the gambit from public laws (federal and state statutes, rules and regulations), to private sector rules (NACHA/ACH Rules, ECCHO Check Clearing Rules, Payment Card Association Rules, to private contract (deposit agreements and treasury management agreements between customers and banks)). In addition, existing and emerging payment products now use existing payment products in new payment channels, such as credit/debit/ACH transactions over Internet and telephone, or remote deposit capture (check image capture) for Check 21 substitute checks or electronic conversion to ACH transactions. While there are multiple efforts underway to establish a more comprehensive and uniform system of “payments law” in the U.S., for the present we are stuck with a complicated system where rights and responsibilities vary by payment type or rail.

Checks

Paper checks are now generally governed by UCC Articles 3 and 4, Federal Reserve Board Regulation CC (expedited funds availability, hold periods and return rules), Check 21 Act and Regulation CC provisions governing substitute checks (including remote deposit capture). These provisions set forth the warranties that go along with presentment of these instruments, and establish the necessary customer-to-bank and bank-to-bank notifications and deadlines for situations like fraudulent checks, fraudulent indorsement, encoding error (amount deposited varies from amount on the check). A company must know it is paying by paper check to know what its associated rights and responsibilities are regarding payment, settlement, funds availability and how to handle instances of forgery or fraud.

ACH

ACH transactions (including credits and debits to/from accounts via the ACH network) are generally governed by UCC Article 4A regarding electronic funds transfers. However, UCC 4A contains a huge exception allowing variation by agreement from the default terms of UCC 4A, and variation from many of the default terms are contained in the almost 600 page set of NACHA operating rules and regulations. And, whether your company is aware of it or not, when you enter into a bank treasury management services agreement, or other agreement, in order to initiate ACH transactions, you are agreeing that you have received and you will abide by all applicable NACHA Rules.

Even if an EIPP service claims to have, for example, a dispute resolution mechanism, if the payment moves over the ACH rails, the parties to that payment will still have separate rights and obligations under NACHA Rules, including a whole host of ways to dispute an ACH transaction through financial institutions, who are actually the members of the ACH network providing

services to their customers. (If an ACH transaction involves a consumer account, then the federal Electronic Funds Transfer Act (EFTA) and corresponding Federal Reserve Board Regulation E can also come into play.) ACH transactions generally have a two-day period for final settlement from origination, and, therefore, companies must carefully monitor their ACH transactions for erroneous, unauthorized or fraudulent transactions. There are lots of requirements that individual banks or processors impose with regard to origination of ACH transactions, and ACH transactions are often subject to credit underwriting, reserve account and other risk-mitigation requirements that a customer using the services must meet.

It is also important to note that a major legal issue that is not addressed or governed by the NACHA rules is the allocation of liability between a customer and bank or processor regarding who bears the loss of an unauthorized ACH transfer. Over the past two years, the instances of corporate account takeover fraud – where a fraudster steals commercial online banking or payment processing and instigates a man-in-the-browser or man-in-the-middle attack – have grown exponentially. There are many pending cases where customers and banks are arguing with each other over who bears the loss in such a fraud situation where the bank followed its commercially reasonable security procedures, but the customer was hacked for the online banking credentials. This issue of corporate account takeover is also affecting wires initiated online, and depending on a company's daily wire or ACH limit, can range up into the millions of dollars. These types of attacks are growing more and more sophisticated, and have in many instances been tied back to organized crime rings in Eastern Europe, Asia, and Africa.

Payment Cards

Payment cards, whether they be credit cards (including corporate credit cards), debit cards or branded stored value cards, are governed by the rules of the credit card networks (Visa, American Express, MasterCard, Discover). The networks are governed by a complex nexus of agreement and private contracts among card issuers, merchant acquirers, payment processors, merchants, and cardholders. No matter what stage or role in the payment card transaction process, there are rules that govern actions, including processing and settlement, fraud prevention, and chargeback and dispute resolution. And there is also an added layer of consumer/customer protection, such as Federal Reserve Regulation Z (Truth in Lending) for credit cards; Federal Reserve Board Regulation E provisions for payroll cards (and don't forget state wage/labor laws); and Regulation E-like agreements for many debit cards issued by FIs.

What is interesting about payment card settlement is that while the individual accepting payment for goods or services via payment card receives money within 24 hours, the individual making payment can dispute the validity of a transaction for a much longer period of time, typically a period of thirty days from the date of transaction at a minimum. If a chargeback of this nature is upheld by the issuing bank and card network, the recipient of the funds can find those funds subject to offset because the transaction is declared invalid.

Wires

Wire transactions are the most efficient and most high risk, of the electronic funds transfers. Wire transfers are generally governed by UCC Article 4A, rules of the applicable wire network (FedWire, the Clearing House Interbank Payments System ("CHIPS"), and the Society for Worldwide Interbank Financial Telecommunication ("SWIFT")). Banks will also have detailed

requirements and contractual agreements regarding the initiation and settlement of wires. Banks and other wire originators will also often require dual authorization of wires where a one company employee originates the wire, and a second employee authorizes it. Many banks also use callbacks and various other security procedures to ensure the wire is authorized.

Wires are often used to transfer funds because the transfer is made and settled within mere hours, as opposed to two days with ACH transfers. And when the transaction is settled, it is pretty much definitively settled barring extraordinary circumstances or a customer catching an erroneous or fraudulent transaction in very close proximity in time to when it is made. Because wires are speedy and almost always definitive when settled, they are efficient for businesses, but require great care and security on the front end. Also, online initiated wires (along with ACH transactions) have seen a sharp increase in the past several years in terms of fraudulent initiation, for the same reason as ACH transactions.

Conclusion

There is great appeal and potential for companies to implement EIPP to achieve cost savings, maximize dollars in the door in a timely manner, and better control the company's working capital. And there is the added benefit of "greening" a company's payment process. However, as this article has attempted to illustrate, companies need to understand how any service provider they retain – be they a bank/FI, payment processor or alternative payment provider – can explain the rails over which the B2B payments will move, how the company's legal rights and responsibilities will vary depending on what rails are used, and how the vendor will or won't help the company monitor for fraud and then attempt to recover fraudulently transferred funds.

A company should conduct extensive due diligence for any EIPP service provider, and ask the following questions at a minimum:

- How long has the EIPP service provider been in existence?
- Does the EIPP service provider partner with other banks/Fis or payment providers, and if so, who?
- What do the terms of service or agreement with the EIPP service provider actually say regarding what the EIPP service provider promises to do in terms of customer support, company employee training, service levels and standards of performance, etc.?
- What rules must your company follow and what additional agreements are you bound by?
- What additional bank accounts or reserve accounts must your company open to use the EIPP provider's services, and must you put a certain dollar amount aside in a reserve account set aside strictly for disputed and charged back payments?
- What security procedures and technologies are used, how often are they updated, and what is your company's responsibilities for implementing them?

- How will your company be protected in terms of disputed and fraudulent payments, and what assistance will you receive from the EIPP service provider in investigating and resolving such events?
- Has the company, or any affiliate or independent contractor that will touch or process your money in any way, ever been investigated or convicted by federal, state or local law enforcement personnel for deceptive acts or processing unauthorized payments?

Knowing the payment rails, and knowing the payment players, will help your organization choose an effective EIPP service provider to meet your needs.

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