



CHECK 21: WILL IT REDUCE CHECK FRAUD AS WELL AS PROCESSING COSTS?

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On October 28, 2003, President Bush signed the landmark Check Clearing for the 21st Century Act, H.R. 1474 (commonly referred to as "Check 21") into law. Check 21 represents perhaps the only time that the Federal Reserve has proposed new legislation to Congress. Each professional group impacted by the Act actively supported its passage. Commentators have remarked that it represents the most significant change to check processing since the adoption of the magnetic ink character recognition line.

The stated purpose of the Act is: (1) to facilitate check truncation by authorizing substitute checks; (2) to foster innovation in the check collection system without mandating receipt of checks in electronic form; and (3) to improve the overall efficiency of the Nation's payment systems. The Act has an effective date of October 28, 2004.

Currently, institutions are prevented from readily utilizing new technology in check payments due to various legal constraints. The main legal barrier to the conversion of an original paper check into an electronic record is the current requirement to obtain agreements to convert the check from all interested parties. Banks must be able to identify to each other which checks can be reduced to an electronic image (in other words, which can be "truncated") and which cannot. Under Check 21, institutions may unilaterally decide to truncate the original check and send, in lieu of the original, a substitute check to those still requiring something in tangible form without the need for agree-

ments. As a result, the best features of checks (i.e., their security and negotiability) are retained, while the elimination of their worst features (i.e., labor and capital intensive collection processes) is encouraged.

The Act

The main provision of the Act is the creation of a new negotiable paper instrument called a "substitute check." Although the Act does not require that banks create a substitute check, it does validate their creation. Once created, substitute checks must be accepted by all parties as the legal equivalent of the original check. Substitute checks are then subject to the same laws (e.g., Uniform Commercial Code, Regulation CC, etc.) as the original check.

A substitute check is suitable for automated processing and contains an image of the front and back of the original check. For a substitute check to be the legal equivalent of the original it must accurately represent all of the information from the original check, including all endorsements, and contain the following legend: "This is a legal copy of your check. You can use it the same way you would use the original check." The Act adopts the term "reconverting bank" to describe the bank which creates a substitute check or if a substitute check is created by a person other than a bank, the first bank that transfers or presents such substitute check.

A reconverting bank and each bank that subsequently transfers, presents or returns a substitute check and receives consideration for such transfer, presentment or return indemnifies any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser, to the extent of any loss incurred by any recipient of a substitute check if that loss occurred due to receipt of a substitute check instead of an original check. The amount of the indemnity is dependent on whether there is also a breach of warranty.

A bank that transfers, presents, or returns a substitute check and receives consideration for the check warrants to

the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser that (1) the substitute check meets all the requirements of legal equivalence and (2) no party will be asked to make payment on a check that has already been paid.¹

In the event of a breach of warranty, the amount of the indemnity will include consequential damages; otherwise, the amount of the indemnity is limited to the amount of the substitute check and interest and expenses. The principles of comparative negligence present in the UCC are also present in Check 21. If an indemnifiable loss results in whole or in part from the negligence or failure to act in good faith of an indemnified party, the indemnification obligation is reduced in proportion to the amount of such negligence or bad faith.

The Act also provides an expedited recredit process for consumers who assert in good faith that the bank improperly charged the consumer's account for a substitute check that was provided to the consumer or that there was a breach of warranty claim and the production of the original check or a better copy of the original check is necessary to determine the validity of the claim. The expedited recredit procedure only applies to consumers and only in situations where the consumer receives a substitute check.

As a general matter, such a recredit claim by a consumer shall be made before the end of the 40 day period beginning on the later of the date the financial institution delivers the account statement which contains information concerning the transaction or the date the substitute check is made available to the consumer. The 40 day period can be extended for extenuating circumstances. The bank then generally has 10 business days to research the claim and provide at least a partial credit to its customer, with the balance recredited no later than the 45th

1. Since only banks make the warranties set forth in the Act, but customers themselves can make and deposit substitute checks, banks may need to alter their deposit agreements to protect themselves against unknown deposits of a substitute check.

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calendar day following the business day on which the claim is submitted. As safeguards Banks may withhold availability in situations like those provided in Regulation CC, including for the prevention of fraud losses. There is also an expedited recredit process for banks that receive a recredit claim from a consumer.

An action to enforce a claim under Check 21 may be brought within 1-year of the date the injured party first learns or should have learned of the facts and circumstances giving rise to the cause of action. Generally, unless a person gives notice of a claim to the indemnifying or warranting bank within 30 days after the person has reason to know of the claim and the identity of the indemnifying or warranting bank, such bank is discharged from liability under the Act to the extent of any loss caused by the delay in giving notice of the claim.

The Act does not address all the issues which it creates, leaving those to agreements between the parties. For example, since Check 21 covers the creation of the substitute check, banks will need other agreements (whether Federal Reserve operating circulars or clearing house rules) respecting the exchange of electronic images. In addition, a bank that creates a substitute check from an image created by another bank would want an agreement to shift liability under Check 21 to the bank sending the images.

Implementing the Act

A key aspect of Check 21 is that no bank is required to participate in the creation of substitute checks. No bank, therefore, will be obliged to purchase large, expensive systems, although market pressures may ultimately dictate otherwise. However, every bank will experience some level of change. In addition to customer service, training and education implications, there are a few required activities for all banks to perform in connection with the implementation of Check 21.

Check 21 requires that banks provide consumer accountholders with a brief notice about substitute checks that describes how a substitute check is the legal equivalent of an original check and the consumer recredit rights when a consumer believes in good faith that a substitute check was not properly charged to the account of the consumer. The notice is required to be delivered to existing cus-

tomers as of October 28, 2004 who receive original checks or substitute checks no later than the first regularly scheduled communication with the consumer thereafter. For new customers, the bank needs to provide the notice at the time the account is opened. The Board of Governors of the Federal Reserve System will publish before July 28, 2004 model forms and clauses that a bank may use to satisfy the foregoing notice requirements. Such notice may likely be included in an updated customer account agreement.

Banks must also develop expedited recredit procedures which are similar to the Regulation E error resolution processes banks currently perform. As a technical change in operations, banks that receive a substitute check and need to return that check as a qualified return must use a "5" rather than the "2" currently used for a qualified return indicator.

Opportunities

The main benefit of Check 21 is the faster collection and return of checks without unnecessary transportation and processing costs. Banks can utilize technology to transmit images closer to the receiving bank where substitute checks can be printed. Currently, a bank may spend 50 cents or more to clear a return item through the Federal Reserve.² If a substitute check were printed closer to the recipient, the item could be cleared less expensively without the Federal Reserve.

Items could be sorted electronically prior to printing substitute checks for return processing. As a result, the sorting of a large volume of checks in order to find a relatively small number of return checks would be eliminated.

Even though the number of checks written in this country is slowly declining, people still write 40 billion checks per year.³ As the volume declines, the price to process an item is expected to increase. McKinsey estimates that truncating the process of paying checks and returning originals to the appropriate account holder could save \$2 billion to \$3 billion of the estimated annual cost - \$8 billion - of processing checks.⁴ The potential for savings is staggering.

Impact on Check Fraud

Although the potential for significant cost savings in the clearing and return check processes is clear, the beneficial impact

of Check 21 upon check fraud is less certain. Accelerating the rate of clearing checks between banks could possibly reduce overdraft losses and facilitate earlier identification of fraud activity. Quicker return of NSF and fraudulent checks between banks may also result in reduced losses. Reduced float and faster clearing times may limit opportunities for check kiting.

On the other hand, accelerating the speed of clearing checks is no guarantee that fraud will be detected earlier since most fraud is not detected until the consumer reviews a bank statement. The expedited recrediting process of Check 21 may actually present an additional opportunity for someone intent on committing fraud. Substitute checks may not show forgeries and alterations as clearly as the original, causing banks to refuse to reimburse and increasing the number of warranty claim disputes. Moreover, substitute checks will not include some of the traditional security feature printing of the original check. Counterfeits and forgeries may in fact increase until financial institutions deploy automated signature and check stock validation systems. Banks will also need systems to prevent duplicate posting of items.

Conclusion

It is impossible to predict the full effects of Check 21, but some of the effects are reasonably clear. Check fraud will likely remain a unique problem for institutions, but, over time, best practices will be developed with an increased reliance on technology to help minimize the fraud. Check processing will evolve more quickly through the utilization of new technology. As a result, the check payments system will be vastly improved. Banks will be able to compete better against non-banks for the payments franchise. Image exchanges may ultimately replace an archaic system completely. Opportunity for those vendors of imaging and storage technology will be created. Significant savings may in the end be passed on to consumers of bank services.

2. *Imminent Imaging*, Costanzo, www.bai.org/bankingstrategies/2004-jan-feb/imminent/, January 20, 2004.

3. *Can banks grow beyond M&A?*, Coyne, Mendonca and Wilson. *The McKinsey Quarterly*, 2004 Number 1.

4. *Id.*