

Check "21" Truncation

- Some Check Basics
- Special Types of Checks
- Check Processing and Collection
- Limiting Risks from Checks
- The Future of Checks

In the United States, Electronic Check Presentment (ECP) is increasing in the retail payment system and the United States is still writing more than 15 times the number of checks of most European countries. Approximately 50 billion checks are written in the United States each year. Typically each night after a check has been deposited at a bank's branch or ATM, the bank transports the check to a central operations center. The check is then usually sent to one or more intermediaries such as a Federal Reserve Bank or a clearinghouse for collection before it is ultimately delivered for payment to the bank on which it is drawn. At each step, the check must be physically processed and then shipped to its destination by air and/or ground transportation.

These obstacles have hindered system-wide check settlement efficiencies. Consequently, the Federal Reserve has embarked on a wide range of initiatives to streamline check-processing operations nationally. In February 2003, the Federal Reserve announced a restructuring plan to eliminate 13 regional check-processing centers in some locations and increase infrastructure in others. Additionally, the Federal Reserve proposed the Check Truncation Act (CTA) to remove certain legal impediments for implementing a nationwide Electronic Check Presentment (ECP) program. The Act accomplishes this by creating a new type of check document called a "substitute check" that can be created from an electronic check image and that would be the legal equivalent of the original check. A legally equivalent substitute check would (1) contain an image that accurately represents all of the information on the front and back of the original check as of the time the original check was truncated, (2) contain a MICR line that would permit the substitute check to be processed on standard check-sorting equipment, (3) conform to industry standards for substitute checks, and (4) bear a legend that indicates that it is the legal equivalent of the original check.

Is there a difference between the Check Clearing for the 21st Century Act (Check 21) and the Check Truncation Act (CTA)? In essence, both regulations are equivalent; CTA was a regulation developed by the Federal Reserve and forwarded onto Congress for adoption after a provisional period by the Federal Reserve. Congress renamed CTA to Check 21 and made additional changes specifically to areas of consumer protection such as recrediting provisions for unauthorized charges, lost ECP checks, and timing guidelines for dispute resolution.

Check truncation refers to any of a number of arrangements in which the original paper checks are removed from the collection or return process before reaching either paying or depository banks. Under the Act, certain electronic information about truncated checks could be used to create substitute checks, which could be presented to paying banks. Returned checks can also be truncated and processed electronically before they reach the depository banks and their customers. This paper is intended to outline some of the key provisions of the Act and its impact upon the banking industry. For specific details about the Act, you will need to refer to the Act for guidance.

Substitute Checks:

The "substitute checks" subsection permits a person to send a substitute check without the agreement of the recipient if a bank provided the requisite warranties. As a result, a non-bank customer that creates a substitute check would need its bank's agreement before it could deposit that substitute check with the bank for collection. The customer's bank in this case would be deemed the "reconverting bank" under the Act and would make the warranties and indemnities. The customer could, however, deposit a substitute check without its bank's agreement such as in the case of the redeposit of a returned substitute check, if that substitute check was created by or on behalf of another bank and was transferred such that the other bank had already made the warranties with respect to that substitute check. A paper reproduction of a check that does not meet the Act requirements for a substitute check cannot be sent to a recipient for forward collection or return without the agreement of that recipient.

Legal Equivalence:

The "legal equivalence" subsection establishes the requirements that a substitute check must meet to constitute the legal equivalent of the original check. If these conditions are met, any party may use the substitute check for all of the same purposes as it would use the original check, such as negotiating it or using the canceled substitute check as proof of payment.

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A substitute check, as defined by the Act, must contain an image of the front and back of the original check, must bear a MICR line containing all information required under generally applicable industry standards for substitute checks, must conform to generally applicable industry standards for substitute checks, such as paper stock, dimension, MICR line indicators, and must be suitable for automated processing. A substitute check is the legal equivalent of the original check if, in addition to meeting the requirements of the definition of substitute check, it accurately represents all of the information on the front and back of the original check as of the time the original check was truncated and includes the following language: "This is a legal copy of your check. You can use it the same way you would use the original check." A substitute check that does not bear the aforementioned language may still be machine processed and would still carry all of the Act's warranties and indemnities for substitute checks if it was used for forward collection or return and a bank that received consideration for the check, even though it would not be the legal equivalent of the original check.

Endorsements:

The "endorsement" subsection of the Act requires the reconverting bank to ensure that the substitute check bears all endorsements applied by parties that previously handled the check, whether the check was handled in paper or electronic form. The lack of endorsements does not affect the legal equivalence of a substitute check. Because a substitute check under the Act would be subject to existing law as if it were the original check, UCC and/or Regulation CC endorsement requirements would apply to substitute checks.

Identification of Reconverting Bank:

The "identification of reconverting bank" subsection of the Act requires that a reconverting bank be clearly identified as such on the substitute check in conformance with generally applicable industry standards. A reconverting bank must ensure that any previous reconverting bank identifications are preserved.

Applicable Law:

The "applicable Law" subsection of the Act provides that a substitute check is the legal equivalent of the original check and is subject to all other applicable Federal or State laws as if it were the original check, to the extent such law is not inconsistent with the Act. A paying bank may dishonor a substitute check, for example, if it suspects forgery to the same

extent it could dishonor an original paper check under the current rules. Correspondingly, a paying bank that wrongfully dishonors a substitute check is subject to the wrongful dishonor provision of UCC to the same extent as if it had wrongfully dishonored an original paper check. As another example, a returned substitute check would be subject to Regulation CC requirements for including a reason for return.

Substitute Check Warranties:

The check warranties under the Act apply to any bank that transfers, presents, or returns a substitute check, and receives consideration for it, warrants that the substitute check meets the requirements for legal equivalence and that payment will not be requested for a check that has already been paid. These warranties are made to the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser. Once a substitute check is created, these warranties flow through to subsequent parties regardless of whether the substitute check remains in substitute check form, is converted into electronic form, or is reconverted from an electronic image back into another substitute check. Furthermore, because a substitute check that is transferred for consideration is warranted to be the legal equivalent of the original check and thereby subject to existing law as the original check, all UCC warranties applicable to the original check flow through to the recipients of the substitute check.

If a substitute check is converted to electronic form and subsequently reconverted again into a second substitute check, then the second reconverting bank and all subsequent banks warrant the legal equivalence of the second substitute check but not of the first substitute check. Thus, a subsequent party would have a claim on a reconverting bank only if the substitute check created by that bank did not meet the legal equivalence requirements. A reconverting bank would not be liable under this warranty if the legal equivalence defect were the fault of a subsequent bank that handled the check either electronically or as another substitute check.

No Double Debit Warranty:

The "no double debit warranty" subsection of the Act provides additional protections to consumers who do not have truncation agreements with their banks in cases in which a double debit to the consumer's account results from a substitute check. In such cases, if a substitute check is properly paid and the original check from which the substitute check was created is subsequently also paid in violation of the "no double debit warranty", the consumer holding the account may claim an expedited recredit under the Act and may enforce a warranty claim against the reconverting bank. If the order of presentment is reversed, such that an original check is properly paid and a substitute check created from the original check is later also paid,

the consumer holding the account may enforce an expedited recredit claim as well as a warranty claim for breach of the "no double debit warranty".

A reconverting bank may protect itself from losses caused by a bank from which it accepts checks electronically by including in its electronic exchange agreement with that bank provisions specifying that bank's warranties to the reconverting bank.

Additionally, a bank that accepts for transfer or presentment a substitute check created by its customer may protect itself by limiting which customers may create substitute checks and by entering into agreements specifying the liabilities of those customers that it permits to create substitute checks.

Treasury Check Warranties:

This subsection of the Act provides warranties relating to the truncation of Treasury checks. This permits the truncation of Treasury checks but requires that the originals of those checks be sent to a Federal Reserve Bank for safekeeping. This subsection applies only to Treasury checks and to checks drawn on accounts maintained by the Treasury at a commercial bank.

Indemnity:

This subsection of the Act provides an indemnity for a loss incurred by the recipient of a substitute check, if the loss is due to the receipt of the substitute check rather than the original check. If the loss would have occurred even if the original check had been transferred or presented instead of the substitute check, the party incurring the loss would not have an indemnity claim, because that party is no worse off as a result of having received the substitute check.

The indemnity originates with the reconverting bank and, like the warranties subsection, the indemnity runs with the check. Each bank that subsequently handles a substitute check in electronic and/or paper form and receives consideration for it provides the indemnity. The indemnity is provided to all parties in the check collection process and return stream, including the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser.

An indemnity claim could arise when a bank in the check collection chain has breached a warranty. For example, if there is a breach of the "no double debit warranty" due to the creation of two substitute checks from the same original check, a drawer's account could become overdrawn, with resulting losses related not only to the particular payment in question but also to other payments. In this case, the indemnity would apply because the loss would not have occurred had the original check been presented for payment because the original could only have been presented once. An additional example would be if there is a breach of the "legal

equivalence" warranty because the image on the substitute check is inaccurate, a drawer attempting to collect payment may be unable to do so and may incur a loss. In this case the indemnity would apply because the loss would not have occurred had the original check been presented.

An indemnity claim could arise even if there is no warranty breach. For example, if a customer claims that the drawer's signature has been forged, a paying bank may not be able to determine the validity of the claim by looking at the substitute check, even if it is an accurate image of the original check. The original check may be necessary for handwriting analysis. If the paying bank credited the customer's account for the amount of the check, it would have an indemnity claim. Correspondingly, if the paying bank did not credit the customer's account, the customer would have an indemnity claim. As another example, if a check security feature such as a watermark were lost when a check was truncated, resulting in a loss to the paying bank that would not have occurred if the check security feature had been retained, the indemnity would apply.

If there is a breach of a warranty, the amount of the indemnity shall be the amount of any loss including costs and reasonable attorney's fees and/or other expenses of representation proximately caused by the warranty breach if that loss would not have occurred had the original check been transferred or presented. In the absence of a breach of a warranty, the amount of the indemnity shall be the amount of any loss, up to the amount of the substitute check plus interest and expenses including costs and/or reasonable fees and/or other expenses, if that loss would not have occurred had the original check been transferred or presented. Any indemnified party may bring a claim in the aforementioned check stream process.

Comparative Negligence:

The "comparative negligence" subsection of the Act reduces a party's indemnification in proportion to the amount of that party's negligence and/or failure to act in good faith that contributed to the loss. Let's suppose a substitute check is converted into electronic form and later reconverted into a second substitute check. Further, suppose that the second substitute check created by the second reconverting bank is illegible, making the second reconverting bank liable under the Act's indemnity. If the second reconverting bank attempts to make an indemnity claim against the first reconverting bank, the amount it could recover would be reduced by the amount attributable to its own negligence.

Under "comparative negligence" rules, the amount of a consumer's loss that may be recovered may be reduced if the consumer fails to comply with duties imposed by other applicable law. If an indemnifying bank produces the original check, it is liable only for losses covered by the indemnity that have been incurred up to the time that the original check is provided to the indemnified party.

An indemnifying bank that produces the original check under the Act is entitled to a return of any funds already paid under the indemnity that are in excess of the losses incurred up to the time of production. The production of the original check does not absolve the indemnifying bank, however it does from liability for breach of warranty under the Act.

For example, suppose a reconvert bank creates an illegible substitute check from a legible original check, presents that illegible substitute check to the paying bank, and receives payment. Suppose that the drawer later claims to the paying bank that the check is not properly payable because of forgery and that production of the original check is necessary to determine the validity of the claim. If a consumer received the substitute check in a statement, the paying bank recredits the consumer's account under the Act and makes an indemnity claim under this section against the reconvert bank. If the consumer did not receive the substitute check in a statement, the consumer could still assert a claim that the item was not properly payable because a substitute check under the Act would be subject to existing law as if it were the original check. The paying bank, in turn, may make an indemnity claim against the reconvert bank. If the reconvert bank cannot produce the original check, then it must indemnify the paying bank. If the reconvert bank cannot provide to the paying bank the original check, and the parties cannot agree on liability, they can turn to the courts to determine liability. If in this example, the reconvert bank produces the original check, then it is entitled to a refund of any amount already paid that is in excess of the losses incurred up to the time of production of the original check. If the original check establishes that the charge to the consumer's account was in fact not authorized, then the paying bank may have additional warranty claims against prior banks under the Act, which may offset the amount that must be refunded because of the production of the original check.

Subrogation of Rights:
The "subrogation of rights" subsection of the Act provides that each indemnifying bank is subrogated to the rights of any indemnified party to the extent of the indemnity. This subsection also requires each indemnified party to comply with all reasonable requests for assistance from the indemnifying bank in connection with any warranty claim the indemnifying bank brings against a warrantor.

Expedited Recredit Procedures for Consumers:
The Check 21 permits a consumer in certain cases to obtain expedited recredit for the amount of a substitute check that is improperly charged to the consumer's account. Not only do the expedited recredit provisions apply only to consumers, but they also apply only in cases in which a consumer suffers a loss because a substitute check was charged to the consumer's account and when production of the original check is necessary to determine the validity of the charge.

The expedited recredit provisions of the Act are further limited to those cases in which substitute checks are provided to the consumer. The expedited recredit provisions would not apply to consumers who do not receive their paid checks, that is when they have agreed with their banks to have their checks truncated. Although consumers who agree to have their checks truncated would not be eligible for expedited recredit, they could nevertheless make warranty and indemnity claims under the Act.

Consumers may make a claim for expedited recredit from their own bank in addition to a separate claim against any other bank that provided a warranty and/or indemnity. For example, a consumer could assert a claim for expedited recredit when the bank charges the consumer's account for a substitute check that appears to bear the consumer's authorized signature but that the consumer asserts is a forgery. In this case, examination of the original check may be necessary to determine the authenticity of the signature. On the other hand, if the authenticity of the signature can be determined from the substitute check, such as when the signature is obviously not the signature of the consumer, the original check would probably not be necessary in order to determine the validity of the consumer's claim. In that case, the consumer could not make a claim for expedited recredit under the Act, because the consumer and the bank would be in the same position as they would have been had the original check been presented; that is, the consumer can show that the signature is unauthorized based on the substitute check that was presented. While the bank in this case is obligated under UCC to recredit the consumer's account for the unauthorized charge, the expedited recredit procedures of the Act would not apply.

Claims for expedited recredit must be made within sixty calendar days of the relevant statement and/or substitute check being made available to the consumer, whichever is later, subject to extension for extenuating circumstances. If a consumer fails to make a timely claim for expedited recredit, the consumer would still be able to make an indemnity claim within the period provided under the Act's Statute of limitations subsection.

To make a claim, consumers must provide to the bank holding the consumer's account a description of why the substitute check was not properly chargeable to the account or the nature of the warranty claim, a statement declaring the loss, an estimate of the amount of the loss, the reason that production of the original check is necessary to determine the validity of the charge and/or warranty claim, and sufficient additional information that is necessary for the bank to investigate the claim. The bank may, at its discretion, require the consumer to put the consumer's claim in writing.

When a consumer makes a claim for expedited recredit, the bank must either produce the original check and show that the substitute check was properly payable, or must recredit the consumer's

account for the amount of the claim up to the amount of the substitute check or \$2,500, whichever is less.

The bank must take either of these actions no later than the business day following the banking day on which the consumer makes the claim. The bank must recredit to the consumer's account the remainder of the claim, up to the amount of the check plus interest, no later than the business day following the banking day that the bank determines the consumer's claim is valid, but no later than twenty business days after the banking day on which the consumer makes the claim.

One of the potential problems caused by the use of a substitute check is the probability of a double debit caused by the presentment of the original check and a substitute check, this event could significantly affect a consumer's account balance if that check were a large-dollar check, such as a mortgage payment. In these circumstances, a consumer may need expedited recredit so that other payments from their account would not be affected. On the other hand, banks desire protection against fraudulent claims and the possibility that a consumer would withdraw and abscond with the proceeds of an expedited recredit before the bank is able to determine that the expedited recredit claim is not valid. Claims for expedited recredit are limited to the amount of the check plus interest. Expenses and other damages are not subject to expedited recredit but may be recovered through other provisions of the Act when appropriate.

Banks must make recredited funds available for withdrawal by the start of the next business day after the business day that the bank is required to recredit the consumer's account. A bank that receives a recredit claim from a consumer by the bank's cutoff hour on the first banking day must produce the original check or recredit the account on the second business day, and must make funds available on the third business day, except in cases where a bank may delay availability. Banks may delay the availability of the recredit, under certain circumstances, until the twentieth business day after the consumer makes the claim. The circumstances under which delayed availability is permitted are (1) new accounts, (2) accounts that are regularly overdrawn, and (3) situations in which the bank has reasonable cause to believe that the claim is fraudulent. Under emergency conditions, a bank may delay availability for a reasonable period of time, provided that the bank exercises such diligence as the circumstances may require.

Banks may reverse any recredit provided under Act if it determines that the substitute check was properly charged to the consumer's account. The Act provides that upon any such reversal, the bank must provide to the consumer the original check and must notify the consumer of the date and amount of the reversal.

Moreover, the bank must honor, for five business days after the notice and without overdraft charges, checks and other payments to third parties that would have been paid if the recredit had not been reversed, and must notify the consumer that the bank will honor such payments. At this time, no specific form or wording is required for the said notices.

Most likely there will be cases in which consumers substitute check claims can be resolved if the bank provides a better copy of the substitute check in question. For example, the consumer may have received a substitute check containing a blurry image of the check. In this case, the bank may be able to provide a copy of the substitute check with a sufficiently clear image of the check that is sufficient to determine the validity of the charge to the account or the warranty claim. The consumer's claim in this case would no longer meet the requirements of the Act. A bank would therefore be permitted to reverse the recredit to the consumer's account since the claim turned out not to be eligible for expedited recredit in the first instance.

Expedited Recredit Procedures for Banks:
Banks are entitled to be expedited recredit for a claim against a previous indemnifying bank if the following four conditions are met. First, the claimant bank must have received a claim for expedited recredit from a consumer. Second, the claimant bank must have suffered a resulting loss and/or must be obligated to recredit a consumer's account under section six (Expedited Recredit) of the Act. Third, production of the original check must be necessary to determine the validity of the charge to the consumer's account or the warranty claim. Fourth, the bank must have submitted the claim to the indemnifying bank within 120 calendar days after the date of the transaction that gave rise to the claim.

For example, in the case of a double debit in which first a substitute check and then the original check are presented and debited, and a consumer makes a claim for expedited recredit from the claimant bank, the transaction that gave rise to the claimant bank's claim would be the presentment and debiting of the original check, which was the second of the two checks that were presented. The provision of the Act only applies to the expedited recredit. Indemnifying banks continue to provide indemnities until the expiration of the statute of limitations within section nine (Measure of Damages) of the Act. Nevertheless, to make a claim against a previous indemnifying bank, a bank must provide a description explaining why the substitute check was not properly chargeable to the consumer's account or explaining the nature of the warranty claim along with a statement estimating the amount of the loss incurred by the bank. The bank must also provide a statement that the original check is necessary to determine the validity of the charge or the warranty claim and sufficient information for the indemnifying bank to identify the substitute check and investigate the claim.

If the consumer's claim against its bank is not in writing, an indemnifying bank may not require the consumer's bank to obtain such a writing, but may request a copy of the consumer's written claim if a written claim exists. The amount of the claim subject to expedited recredit under this section is limited to the amount of the loss up to the amount of the check plus interest. The amount of the claim subject to expedited recredit does not include expenses or other damages but expenses and other damages may be recovered under the indemnity provisions of the Act under certain circumstances.

Within ten business days of receipt of an indemnity claim from a claimant bank, an indemnifying bank must either provide to the claimant bank the original check or recredit the claimant bank for the amount of the claim, up to the amount of the substitute check plus interest. If the indemnifying bank produces the original check, it has the same rights to the return of recredited funds as provided in section five (Indemnity) of the Act.

Statute of Limitations & Notice of Claim:

This subsection of the Act provides that actions to enforce any claim under the Act may be brought before the appropriate court and must be filed within one year after the cause of action accrues. The statute of limitations period under the Act is consistent with Regulation CC statute of limitations.

Effect on Other Law:

This subsection of the Act provides that the Check 21 Act supersede any provision of Federal and/or state law that is inconsistent with the Act.

Truncation of Treasury Checks:

This subsection of the Act applies only to Treasury checks, and does not apply to checks drawn on accounts maintained by the Treasury at a commercial bank. Banks may truncate Treasury checks, however banks must send the originals of those checks to a Federal Reserve Bank for safekeeping and must send them in a manner that reasonably ensures that the original checks will not be mistakenly handled.

Effective Date:

Various provisions of Check 21 will become effective on varying dates, the general effective date will be October 28th, 2004; conversely the Secretary of the Treasury may extend the Act's effective date with respect to Treasury checks only. The Treasury Department has indicated that it will publish a regulation extending the effective date for Act with respect to Treasury checks, if needed, as soon as it can specify a date certain.

