



CHECK 21 ACT

President Bush signed the Check 21 Act on October 28, 2003, with an effective date of one year later. The Act encourages check truncation and is intended to make the payments system more efficient. The Act gave the Federal Reserve Board the authority to write implementing regulations, which were released July 26, 2004.



Basically, the Act allows any financial institution in the check-clearing process to truncate a check, turn it into an electronic image, and process it electronically. Many large banks already exchange image copies with each other by agreement. Under the Act, an agreement is still necessary to exchange image copies with another bank, but any bank in the check-clearing chain can choose to truncate an item and convert it into an electronic image. The electronic image must be capable of being reconverted into a paper version of the electronic image, called a substitute check. The Act doesn't require banks to truncate, nor does it require banks to accept an electronic image. A substitute check must be provided to banks that do not accept electronic images.

A. Substitute Checks

The Act defines a substitute check as a paper reproduction of the original check that:

- 1) contains an image of the front and back of the original check;
- 2) bears a MICR line containing all the information from the MICR line of the original check;
- 3) conforms with the general industry standards for paper stock and size; and
- 4) is suitable for automated processing in the same manner as the original check.

A substitute check is legally equivalent to the original check if it:

- 1) Accurately represents the information on the front and back of the check at the time the original check was truncated; and
- 2) Bears the legend "This is a legal copy of your check. You can use it the same way you would use the original check."

A financial institution that reconverts the electronic image into a substitute check must ensure that all the endorsements applied by the parties that previously handled the check appear on the substitute check, whether those endorsements were in electronic form, on the original check, or on the substitute check. The reconvertng bank must also identify itself as the reconvertng bank on the substitute check.

B. Warranties

The Act introduces new warranties in addition to those contained in the Uniform Commercial Code. For example, a bank that receives payment for a substitute check warrants that the check is the legal equivalent of the original and that no bank will be asked to pay a check that has already been paid. If this warranty is breached, the breaching party may be liable for the loss caused by the breach. This includes the amount of the check, interest and expenses, and any other loss caused by the breach.

C. Indemnity

Any bank that creates a substitute check agrees to indemnify all subsequent persons who receive the substitute check and incur a loss because the check was not the original. In addition, any bank that receives payment for transfer of either an electronic or paper version of that check indemnifies all subsequent persons who receive the substitute check and incur a loss because the check was not the original. Damages are limited to the amount of the check plus interest and expenses, including costs and reasonable attorney's fees.

If an indemnifying bank is able to produce the original check or a copy of the original check (either an image or a substitute check) that accurately represents the information on the front and the back of the original check at the time of truncation, or is otherwise sufficient to determine whether a claim is valid, the indemnifying bank will be liable only for losses that are incurred up until the original check or copy is provided to the indemnified party. The Act requires an indemnified party to comply with all reasonable requests for assistance from the indemnifying bank.

D. Expedited Recredit for Consumers

The Act contains expedited recredit rules similar to those in Regulation E. The rules apply to *consumer* accounts when consumers assert that their bank either improperly charged their account with a substitute check or when consumers have a warranty claim regarding a substitute check, most likely that the substitute check is not the legal equivalent of the original. Consumers must show that they experienced a loss and that the production of the original or a better copy of the original is necessary to determine the validity of the claim. A consumer has 40 days to make a claim for expedited credit. The 40-day period runs from the date the bank sends the monthly statement to the consumer or the date the consumer receives the substitute check, whichever is later. However, the bank must extend the 40-day period for a reasonable amount of time if the consumer wasn't able to submit the claim in a timely fashion due to extenuating circumstances such as extended travel or illness. The bank may require the consumer's claim to be made in writing, but may allow the customer to make a claim electronically if the customer has agreed to communicate with the bank in that manner.

A bank must recredit a consumer's account if the consumer submits a claim regarding a substitute check if:

- 1) the bank did not provide the original check or a legal copy to the consumer; and
- 2) the bank cannot prove that the substitute check was properly charged against the account.

The bank must recredit a consumer's account within one day of determining that the consumer's claim is valid. If that determination is not made within 10 business days of the consumer's claim, the bank must recredit the amount charged or \$2,500, whichever is less. Any remaining amount must be recredited within 45 calendar days.

The recredit may be delayed up to 45 days on claims made on certain accounts:

- 1) New accounts where the claim is made during the first 30 days after account opening;
- 2) Accounts with repeated overdrafts, if on six or more business days in the six months prior to the claim, the balance on the account was negative or would have been negative if checks had been paid, or if on two or more business days during those six months, the balance was negative or would have been negative for \$5,000 or more if checks had been paid; and
- 3) When the bank reasonably believes the claim is fraudulent.

If a bank delays the availability of or reverses a recredit, it must promptly notify the customer. Notice must be given no later than the day after the bank makes its determination. In addition, no overdraft fee may be imposed on the delayed amount in the five days following the date that notice of delay is sent to the customer. If a bank determines that a consumer claim is invalid, it must send a notice on the day after that determination is made.

E. Expedited Recredit for Banks

The Act authorizes a bank to make a claim against an indemnifying bank for an expedited recredit if the claimant bank's customer has made a claim for recredit. The claimant bank must have suffered a loss and production of the original check or a better copy of the check must be necessary to determine the validity of the claim. The claim must be made within 120 days of the transaction and the indemnifying bank has 10 business days to produce the original check or a better copy of the original check. The indemnifying bank must also recredit the amount to the claimant bank or provide information as to why it does not have to provide a recredit.

F. Statute of Limitations

Any action to enforce a claim under the Act must be brought within one year of the date the claimant learned, or should have learned, of the facts and circumstances giving rise to the cause of action.

G. Consumer Awareness

The Act requires banks to provide customers that receive original checks or substitute checks with a brief notice for the first three years that the Act is in effect. The notice must describe how a substitute check is the legal equivalent of an original check for all purposes if the check accurately represents the information on the front and the back of the check at the time of truncation and bears the legend: "This is a legal copy of your check. You can use it in the same way you would use the original check." The notice must also describe the consumer expedited recredit rights. The Federal Reserve Board of Governors published model forms that banks may use.

The notice must be distributed to existing customers who receive original or substitute checks on the first regularly scheduled communication with the customer following the effective date of the Act. For most customers, that will be the first account statement sent after October 28, 2004. For new account holders, the notice must be given when the account is opened. Notice must also be given whenever a customer requests a copy of a check and receives a substitute check. The notices may be sent by mail or by any other method through which the customer has agreed to receive account information.

H. Effect on Customers

The Act will have two major effects on consumers. First, the bank cannot guarantee that the customer's original checks will be returned. The bank has no control over what happens to the check while in the payment system. This is especially significant for customers who are currently required to get their original checks back. Second, electronic checks will move much more rapidly through the payment system. Customers who currently rely on the float may be unpleasantly surprised by overdraft notices.

I. Conclusion

The Check 21 Act marks a big change in the clearing system. Some banks will benefit from the increased speed in clearing and the lower clearing system costs. However, the cost of producing a substitute check will likely be more expensive than processing an original check. Another benefit is that the clearing system will be less vulnerable to air and ground travel problems. On the other hand, some banks aren't interested in processing checks electronically and are now being dragged into the 21st Century, whether they like it or not. They've got new laws to learn and potential customer dissatisfaction to deal with while their customers get used to substitute copies and quick clearing. Another potential downside to the Check 21 Act is its impact on check fraud. Hand reviewing large items may not be as effective with only images to review.

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