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### INTRODUCTION TO CHECK 21

1. *A Background.* Consider that for the last century and the beginning of this one, banks had to daily exchange mountains of paper checks, a very inefficient system. In the last few decades banks had experimented with a process called “check truncation” (or sometimes “check retention”) in which the depository bank simply keeps the deposited check and forwards only a description of it through the bank collection process. Specific provision is made for electronic presentment and warranties connected with same; see §§4-110 and 4-209(b).<sup>1</sup> In such a system, the customer never gets the check back, although it is reflected on the bank statement. In the 1990s the bank statement rule, §4-406, was amended to require banks to send certain information back to the customer and to give the customer the right to demand a legible copy of the check for seven years after the statement was sent out.

The idea of creating an “image” of the check and sending it through bank channels instead of the original paper check had been urged for over a decade, but it was expensive to get such a system up and running and there was a lot of resistance to the suggestion. However, the September 11, 2001, attacks gave new life to this idea. Planes were grounded for five or more days that September and many checks could not move at all from bank to bank, resulting in chaos. Check imaging began to look much more attractive.

Congress passed the “Check Clearing for the 21st Century Act” or the “Check 21 Act,” effective October 28, 2004.<sup>2</sup> The Federal Reserve has created amendments to Regulations CC and J to implement the Act., and the bulk of these new regulations are found in Subpart D to Regulation CC.

2. *Creating the Image and the Substitute Check.* Under the statute banks have the option (not duty) to create an image of the original check and pass it on if the receiving bank agrees to that; Reg. CC §229.2(ddd).. A bank creating such an image is called a “truncating bank” in Reg. CC §229.2(ddd).

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<sup>1</sup> Federal Reserve Regulation CC has a similar encoding warranty provision in §229.34(c)(3).

<sup>2</sup> The text of the statute is at <http://www.bankersonline.com/check21/check21act.pdf>.

After truncation the imaged check is passed along as a computer file until someone (a later bank, the bank's customer, or whoever) refuses to take the imaged version and insists on getting paper. In that case the bank (now named a "*reconverting* bank"<sup>3</sup>) will print out a paper version of the check. The paper version is called a "substitute check." To understand the definition of a "substitute check" in the Regulation, you should know what a "MICR line"(pronounced "my-ker") is. The initials stand for "magnetic character ink recognition" and refer to the line at the bottom of all checks with the strange printing, identifying the routing information so the check can be sent to the payor bank and charged against the correct account. The depository bank will also encode the amount of the check to the MICR line, below the drawer's signature (and our laws have long had warranties that this encoding is correct<sup>4</sup>). Now read the definition of "substitute check" in Reg. CC §229.2(zz).<sup>5</sup> If the paper reproduction of the image does not meet these standards it will not technically qualify as a "substitute check," with important consequences as we shall see.

The reconverting bank must also add to the substituted checks all the indorsements that would have been placed on the original check had it traveled the same route as the image. Regulation CC §229.51(b) creates a duty in the reconverting check to ensure that the substitute check:

- (1) Bears all indorsements applied by parties that previously handled the check in any form (including the original check, a substitute check, or another paper or electronic representation of such original check or substitute check) for forward collection or return;
- (2) Identifies the reconverting bank in a manner that preserves any previous reconverting bank identifications, in accordance with generally applicable industry standards for substitute checks and appendix D of this part; and
- (3) Identifies the bank that truncated the original check in accordance with generally applicable industry standards for substitute checks and appendix D of this part.

3. *Legal Equivalence.* *No one can refuse to take the substitute check*, which is legally the same (for all purposes, including criminal prosecution), as the original. Customers cannot insist on getting the original back. If the parties agree to imaging without a paper copy being created, the image also has the same legal effect as the original. These rules will greatly speed up check collection, though there are some downsides to loss of the original (no fingerprints, for example, which can be important in criminal prosecutions). Section 4(b) of the statute provides:

- A substitute check shall be the legal equivalent of the original check for all purposes, including any provision of any Federal or State law, and for all persons if the substitute check—
- (1) 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
  - (2) bears the legend: "This is a legal copy of your check. You can use it the same

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<sup>3</sup> See Regulation CC §229.2(yy).

<sup>4</sup> UCC § 4-209(a); Reg. CC §229.34(c)(3).

<sup>5</sup> In the statute see §3(16).

way you would use the original check.”<sup>6</sup>

#### PROBLEM 1

Portia Moot paid her state income taxes in full with a check, and was considerably annoyed when the State sent her a letter informing her that the taxes were still due and she would be assessed penalties. When she protested, the State demanded to see the check she had allegedly sent in. Portia had received that check only as an image returned as part of her monthly bank statement, but she contacted her bank and the bank printed out a copy of the check and sent it to her. She mailed this copy to the State, but received back a letter informing her that it was State policy to only accept the original cancelled check as proof of payment, so they refused to consider what was clearly a mere copy. Now what should Ms. Moot do?

4. *Warranty Liability*. Parties passing on the substitute check make both transfer and presentment warranties that everything is on the up and up. Section 5 of the statute states the warranties made by reconverting banks that create the substitute check and transfer it to others:

A bank that transfers, presents, or returns a substitute check and receives consideration for the check warrants, as a matter of law, to the transferee, any subsequent collecting or returning bank, the depository bank, the drawee, the drawer, the payee, the depositor, and any endorser (regardless of whether the warrantee receives the substitute check or another paper or electronic form of the substitute check or original check) that—

(1) the substitute check meets all the requirements for legal equivalence under section 4(b); and

(2) no depository bank, drawee, drawer, or endorser will receive presentment or return of the substitute check, the original check, or a copy or other paper or electronic version of the substitute check or original check such that the bank, drawee, drawer, or endorser will be asked to make a payment based on a check that the bank, drawee, drawer, or endorser has already paid.

#### PROBLEM 2

When the check was truncated by the depository bank and turned into an electronic image, the image was blurry. When the reconverting bank printed out the substitute check the account number was incorrectly listed as starting with an “8” when the original started with a “3.” As a consequence the wrong account was debited for the amount of this check, causing other checks to bounce. The customer complained and the payor bank recredited the account, and calls you, the bank’s attorney. Now what? See Reg. CC §229.52.

The answer is that the account holder could sue for breach of the above warranty of legal equivalence. Liability would flow back to the reconverting bank. That bank could not use the above warranty to pass the loss back to the truncating bank because that bank did not transfer a “substitute check” (a piece of paper). However, the Federal Reserve has created similar warranties for the transfer of electronic images in Regulation J §210.5(a)(3) and (4), and these warranties would operate in the same fashion. Moreover the wise attorney will make sure there is a contractual agreement in place between banks transferring and accepting images that they correctly reflect the terms of the original check, and this contractual agreement

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<sup>6</sup> See the similar language in Reg. CC §229.51,

would also create liability in the truncating bank.

5. *Indemnity Liability.* In addition to this warranty liability, section 6 of the statute creates *indemnity* liability against banks transferring either the image or the substitute check if doing so causes *damages that could have been prevented by use of the original check*; in the reg see §229.53. In the above Problem, the truncating bank would have to respond to an indemnity claim because of its blurry image of the original check; if the original had been transferred, the right amount would have been debited from the correct account. It is unclear what this indemnity liability will mean in many situations, though the Official Commentary to Regulation CC gives this example:

A drawer received a substitute check that met all the legal equivalence requirements and that was only charged once to the drawer's account, but the drawer believed that the underlying original check was a forgery. If the drawer suffered a loss because it could not prove the forgery based on the substitute check, for example because proving the forgery required analysis of pen pressure that could be determined only from the original check, the drawer would have an indemnity claim. However, the drawer would not have a substitute check warranty claim because the substitute check was the legal equivalent of the original and no person was asked to pay the substitute check more than once. In that case, the amount of the drawer's indemnity would be limited to the amount of the substitute check, plus interest and expenses, although the drawer could attempt to recover additional losses, if any, under other law.<sup>7</sup>

As a practical matter this means that the original check must be preserved so that it can be found in the event of trouble and produced to help resolve the difficulty. All claims must be made within 120 days after the transaction that gives rise to the claim—see Regulation CC §299.55(b)(1)—so that is the relevant period for preserving the original check. Lawsuits under Check 21 must be brought within one year after the transaction,<sup>8</sup> and the prudent bank may wish to hold the original checks until that statute of limitations has passed.

6. *Expedited Recredit For Consumer.* Section 7 of the Act allows *consumers* (but not *non-consumer* customers) to get an expedited recredit to their account in certain circumstances when the consumer disputes the validity of the charge to the account. Section 7(a) of the statute provides:

(a) Recredit Claims---

(1) In General.—A consumer may make a claim for expedited recredit from the bank that holds the account of the consumer with respect to a substitute check, if the consumer asserts in good faith that—

(A) the bank charged the consumer's account for a substitute check that was provided to the consumer;

(B) either—

(i) the check was not properly charged to the consumer's account; **or**

(ii) the consumer has a warranty claim with respect to such substitute check;

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<sup>7</sup> This is the Official Commentary to Regulation CC §229.53(b).

<sup>8</sup> Regulation CC §229.56(c).

(C) the consumer suffered a resulting loss; **and**

(D) the production of the original check or a better copy of the original check is necessary to determine the validity of any claim described in subparagraph (B). . . .<sup>9</sup>

Suppose, for example, that the consumer cannot read the substitute check because the image is not clear. In that case, the consumer must report the problem within 40 days, and may demand an immediate recredit. The bank may investigate for ten business days, or if it recredits the account while it investigates, for 45 calendar days. Section 7(a)(2) contains these time limits, which are copied from the Electronic Fund Transfer Act (the federal debit card statute we will discuss in Chapter 13):

(2) Timing of Recredit.—

(A) In General—The bank shall recredit the consumer’s account for the amount described in paragraph (1) no later than the end of the business day following the business day on which the bank determines the consumer’s claim is valid.

(B) Recredit Pending Investigation.—If the bank has not yet determined that the consumer’s claim is valid before the end of the 10th business day after the business day on which the consumer submitted the claim, the bank shall recredit the consumer’s account for—

(i) the lesser of the amount of the substitute check that was charged against the consumer account, or \$2,500, together with interest if the account is an interest-bearing account, no later than the end of such 10th business day; and

(ii) the remaining amount of the substitute check that was charged against the consumer account, if any, together with interest if the account is an interest bearing account, not later than the 45th calendar day following the business day on which the consumer submits the claim.

Section 7(d) of the statute has “Safeguard Exceptions” (copied almost word for word from the same safeguard exceptions to funds availability in Regulation CC, discussed later in this Chapter), describing situations where the bank need not recredit the account in accordance with the usual time limits.

7. *Expedited Recredit For Banks.* A bank that is forced to recredit a consumer’s account may seek indemnity from the bank that presented the check to it. The indemnity rules are discussed above, and the procedure for an expedited recredit is given details in Regulation CC §229.55. It contains a requirement that all claims be made within 120 days of the original transaction giving rise to the claim, and must describe the reasons for the recredit clearly. If the claiming bank includes a copy of any substitute check as part of its claim it must take reasonable steps to make sure that copy will not get into circulation and be mistaken for the legal equivalent of the original check. Within ten business days of the recredit claim, the indemnifying bank must recredit the amount of the check, return the original check, or provide information as to why it will not do so.

8. *Lawsuits and Miscellaneous Provisions.* Section 10 allows a civil action for violations of the statute with an award of actual damages (up to the amount of the check), plus

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<sup>9</sup> Regulation CC §229.54 expands upon the statutory language.

costs and attorneys fees. Notice of claims must be given within 30 days after a claimant discovers the grounds for the claim or the amount of any recovery is reduced by the amount that such prompt notice would have provided; Regulation CC §229.56(d). Suit may be brought in either federal or state courts, and there is a one year statute of limitations. The rules of Check 21 may not be varied by agreement, except for the expedited recredit provisions between banks in §229.55.