

CONTRACTOR ALERT

Contractor Alert is a joint publication by this Contractor and the Law Offices of Richard M. Sissman, Esquire, located at 1485 Chain Bridge Road, Suite 105, McLean, VA 22101. This newsletter is designed to give general information on the matters covered. Space limitation prevents exhaustive treatment or analysis of this topic. This newsletter is not intended to substitute for advice on specific legal problems. If you are interested in receiving a complimentary issue or to be placed on our mailing list, contact Richard M. Sissman, Esquire. We welcome and appreciate your suggestions for future article topics.

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INTRODUCTION TO CHECK 21

Banking and Payment Laws

This article is excerpted from the forthcoming 2004 Supplement to NCLC's Consumer Banking and Payments Law, and was written by Mark Budnitz, professor at Georgia State University College of Law. That volume details the new technological developments and law changes that revolutionize the way money is taken out of consumer bank accounts, including electronic check conversions, internet banking, electronic re-presentment of bounced checks, telechecks, account aggregations, electronic benefit transfers, direct deposit of federal benefits, bank set off of bank fees, and much more.

New federal legislation represents a death knell to the process of banks returning original checks to consumers with their monthly statements or even when there is a problem with a particular check. Instead, if consumers want to inspect checks for forgeries or alterations or to present a canceled check as proof of payment, they usually will have to be content with a new payment instrument created by Check 21, called a "substitute check."

The Check Clearing for the 21st Century Act, popularly known as Check 21, was enacted in October of 2003, with an effective date of October 28, 2004.¹ The Act allows banks to dispense with original paper checks and instead transmit electronic images of the check through the check clearing process. If a consumer or bank anywhere along the chain insists on receiving the original paper check, the Act allows use instead of a substitute check (such as a laser printout of an electronic image).

The main goal of Check 21 is to avoid the necessity of original paper checks being physically transported

all over the country and instead to facilitate the electronic transfer of an image or other information about a check. The Federal Reserve and the banking industry sought to decrease the dependence on a system relying on transport of physical paper checks, that they view as slow, costly, and inefficient.

For consumers, the major disadvantages of the new Check 21 system are two-fold: first, it will become more difficult to spot and prove forgeries and check alterations (consumers may not have access to the original paper and ink, showing pressure points and other important clues) and, second, the speed of electronic transfers will decrease the "float" that enables consumers to keep their money in their account for a number of days until the check they have written clears. Check 21 does provide consumers certain remedies whenever use of a substitute check instead of an original check causes a monetary loss to the consumer.

Check 21 is not effective until October 28, 2004, so it is too early to tell how banks will respond to the Act. This discussion uses the Public Law section numbering for the Check 21 Act, but the Act is reprinted at Appendix I, infra, with both Public Law section numbering and anticipated United States Code numbering. The FRB has proposed regulations interpreting the Act. Because these proposals are the only current interpretations of Check 21, this section will refer to them. But keep in mind that these are proposed regulations and the final regulations may differ.

The Basic Statutory Scheme

Check 21 is not comprehensive legislation regulating the check collection process, nor does it require check truncation, defined as removing the original paper check from the check collection process. Check 21 encourages voluntary agreements among banks to accept electronic versions of checks in the check collection and clearing process. Under such agreements, each bank will agree to accept images in lieu of the original paper check. An agreement may be bilateral (between two banks) or multilateral (between more than two banks). An agreement may be pursuant to a clearinghouse's rules. A financial institution may contract with an image exchange service to process check images. Check 21 makes these voluntary agreements between banks practical because it provides an easy alternative for a bank when a party in the check clearing process refuses to accept an electronic version of the check. Instead of locating the physical check and forwarding it to the party demanding the physical check, Check 21 allows the bank to provide a "substitute check," which is defined as, among other things, a paper reproduction of the original check that contains an image of the front and back of the original check. Thus an image of the original check can be stored electronically, transferred electronically, and then printed out whenever a party so demands. By providing a practical alternative when a paper check is demanded, banks can now feel secure forwarding, not the physical check, but the electronic information. The entity removing the original check might be a payee or other transferee. For example, a large retailer might truncate checks. Or it might be a collecting bank, including the depository bank. A financial institution, for example, might truncate the check at a branch or even at an ATM. For purposes of simplification, Check 21 will be discussed here only in terms of a bank removing the original check. When the original check is removed, only electronic information concerning a check will be transferred to the subsequent transferees in the collection process until the information reaches a party that does not agree to accept the check in electronic form. Check 21 does not directly regulate electronic check imaging

or the transfer of images except to say that, if a check is truncated and an entity to whom the check is to be transferred (the "recipient") has agreed not to demand that the transferor send an original check or a "substitute check," the transferor can send "information relating to the original check (including data taken from the MICR line of the original check or an electronic image of the original check), whether with or without subsequent delivery of the original paper check." If the drawer or any bank downstream in the collection process from the entity that truncated the check does not agree to truncation, Check 21 is triggered and specifies that the party who has not agreed is entitled only to a "substitute check," and not the original check. Since the bank producing the substitute check typically does not have ready access to the original check, in effect, the Act "authorizes the creation of the substitute check from images of the front and back of the original paper check." When a bank removes the original check from the process, it can send electronic images of the check to the payor bank (called the paying bank in the Act) or to another collecting bank that has agreed to accept the image. If the payor bank or other collecting bank has not agreed to accept the image, the bank may not send it an electronic image. Instead, it must send either the original or a "substitute check." In Check 21 parlance, the bank that creates the substitute check is a "reconverting bank." Check 21 remedies apply solely to losses as a result of the use of a substitute check. The Act provides a consumer right to an immediate recredit and a right to sue for certain damages but provides no additional relief when the loss is unrelated to the use of a substitute check. Check 21 differs from truncation as defined under the UCC, a process which many banks, and particularly credit unions, already are utilizing. The UCC requires that a bank include with the bank statement either the checks paid or the check numbers, amounts and dates of payment. Upon a consumer's request, the bank must provide either the original canceled check or a legible copy of the check. For more on check truncation, see NCLC's Consumer Banking and Payments §§1.2.3.7 (2d. ed. 2002 and Supp.).