

The Journey of a Check

Peter J. Mucklestone*

I. CHECK 21

The Check Clearing for the 21st Century Act (“Check 21”) is a federal law that is designed to enable banks to handle more checks electronically, which should make check processing faster and more efficient. It was signed into law on October 28, 2003.

On July 26, 2004, the Federal Reserve Board (the “Board”) released final amendments to Regulation CC (a new Subpart D was added) and its commentary to implement Check 21 which became effective on October 28, 2004. Check 21 and Subpart D supersede any provision of federal or state law, including the Uniform Commercial Code, that is inconsistent but only to the extent of the inconsistency.

II. THE CHECK COLLECTION PROCESS

A. BEFORE CHECK 21

Historically, the check collection process was entirely paper based. An original paper check was physically moved from the bank where the check was deposited to the bank that paid it. This transportation was time consuming, cumbersome and costly.

Example:

A client draws a check on Eastern Washington Savings Bank, a one office community bank in Walla Walla, Washington, and mails it to a law firm in New York City in payment of legal fees. The law firm receives the check three days later, endorses it on the back and deposits it into the firm’s trust account at the Midtown Branch of Global Bank. Global Bank commences collection of the check.

Day 1, Global Bank grants the law firm provisional credit for the amount of the check in the trust account, and either allows immediate withdrawal or places a day hold on the uncollected funds. At the close of business, the check together with all other checks deposited at the Midtown Branch that day is transported to Global Bank’s operations center in New Jersey. There, a bank employee encodes the amount of the check thereon and processes it through a reader-sorter machine, which reads the “MICR line” (or *Magnetic ink character recognition line*) of the check, stamps the depository bank endorsement on the back and sorts it by routing number, which identifies the drawee bank by location.

Day 2, an armored car delivers the check to the Federal Reserve Bank of New York (the “New York Fed”) in lower Manhattan. That evening, the check is

* Partner, Seattle office of Davis Wright Tremaine LLP.

processed together with all other checks that the New York Fed receives from banks in the New York region. The check is sorted with all other checks drawn on banks in the 12th Federal Reserve District, which includes the nine western states—Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington—plus American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. Global Bank's account at the New York Fed is credited in the amount of the check.

Day 3, an armored car delivers the check, together with all other checks destined for the 12th Federal Reserve District to Teterboro Airport in New Jersey, where it is loaded onto an aircraft bound for Oakland, California. After arrival in Oakland, the check is delivered to the Federal Reserve Bank of San Francisco (the "San Francisco Fed") by armored car, where the check is processed and sorted for delivery to the Seattle Branch of the San Francisco Fed the next day. The San Francisco Fed credits the New York Fed in the amount of the check.

Day 4, an armored car delivers the check, together with all other checks destined for the Seattle Branch of the San Francisco Fed back to Oakland, where it is loaded onto a flight to Boeing Field in Seattle and then delivered to the Seattle Branch for processing.

Day 5, Regional Bank, the correspondent bank for Eastern Washington Savings Bank, receives the check from the Seattle Fed at the morning exchange of the Seattle Clearing House. Regional Bank credits the San Francisco Fed in the amount of the check. Regional Bank sorts the check with all of its own checks and the checks of its correspondents, which are destined for Southeastern Washington.

Day 6, the check is delivered back to Boeing Field, loaded onto a Piper Twin Comanche and flown across the Cascade Mountains in icing conditions to Pasco, Washington, from where an armored car drives 60 miles to Eastern Washington Savings Bank in Walla Walla.

Day 7, Eastern Washington Savings Bank processes the check. If it elects to pay the check, it debits the account of the client and credits the account of its correspondent, Regional Bank. If there are insufficient funds in the client's account, the Bank returns the check unpaid the next day and the collection process is reversed.

More recently segments of the check collection process have been automated but unless the drawee bank agreed to accept electronic presentment, a bank had to present the original paper check for payment. Because of the large number of banks and the unwillingness of some drawee banks to receive checks electronically, it was difficult, if not impossible, for a bank to obtain electronic presentment agreements with all other banks. As a result, banks that wanted to engage in electronic check exchange on a widespread basis could not do so.

Check 21 allows banks to capture a picture of the front and back of the check along with the associated payment information and transmit this informa-

tion electronically. If a drawee bank or its customer requires a paper check, the bank can use the electronic picture and payment information to create a paper “substitute check.” The law does not require banks to accept checks in electronic form but they must accept a substitute check.

B. AFTER CHECK 21

With Check 21, Banks are encouraged to truncate checks. The word “*truncate*” means to remove an original check from the check collection process and send to a recipient, in lieu of such original check, a substitute check or, by agreement, 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 the subsequent delivery of the original check. With truncation, most of the time the original check will be destroyed.

A “*substitute check*” is a paper reproduction of an original check that: contains an image of the front and back of the original check; bears a MICR line that contains all the information appearing on the MICR line of the original check at the time that the original check was issued and any additional information that was encoded on the original check’s MICR line before an image of the original check was captured; conforms in paper stock, dimension, etc.; and is suitable for automated processing in the same manner as the original check. A substitute check might be created several times in the check collection process.

A substitute check is the legal equivalent of an original check for all persons and all purposes, including any provision of federal or state law, if the substitute check 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 bears the legend, “This is a legal copy of your check. You can use it the same way you would use the original check.”

While it will be a bank that will usually create a substitute check, a bank might enter into an agreement with its customer/depositor for the remote deposit of checks electronically through the internet or by data transmission.

In some cases, the original check used to create a substitute check could be forged or otherwise fraudulent. A substitute check created from a fraudulent original check would have the same status under Regulation CC and the U.C.C. as the original fraudulent check. For example, a substitute check of a fraudulent original check would not be properly payable under U.C.C. 4–401 and would be subject to the transfer and presentment warranties in U.C.C. 4–207 and 4–208.

Examples:

A depositor enters into a remote deposit agreement with Bank A, which is the depository bank, whereby the depositor will copy the front and back of its checks and send the images to Bank A via the internet allowing Bank A to process the checks electronically. The customer destroys the original checks.

Bank B captures the image of an original check, indorses it electronically and, by agreement, transmits to Bank C an electronic image of the check accom-

panied by the electronic endorsement. Bank C then creates a substitute check to send to Bank D. The back of the substitute check created by Bank C must contain a representation of the endorsement previously applied electronically by Bank B and Bank C's own endorsement.

Bank D presents a substitute check that meets the legal equivalence requirements to a drawee bank. The drawee bank cannot refuse presentment of the substitute check on the basis that it is a substitute check, because the substitute check is the legal equivalent of the original check.

A depositor's account agreement with a bank provides that the depositor is entitled to receive original cancelled checks back with his or her periodic account statement. The drawee bank may honor this agreement by providing original checks, substitute checks, or a combination thereof.

C. LIABILITY AND CONSUMER PROTECTION

1. Warranties. A Bank that transfers, presents, or returns a substitute check warrants that:

- (a) the substitute check meets the requirements for legal equivalence; and,
- (b) no depository bank, drawee, drawer, or endorser will receive presentment or return of, or otherwise be charged for, the substitute check, the original check, or a paper or electronic representation of the substitute check or original check such that that person will be asked to make a payment based on a check that it already has paid.

A bank makes these warranties to the bank that transfers, presents, or returns the substitute check or a paper or electronic representation of such substitute check and to any subsequent recipient, which could include a collecting or returning bank, the depository bank, the drawer, the drawee, the payee, the depositor, and any endorser. These parties receive the warranties regardless of whether they received the substitute check or a paper or electronic representation of a substitute check.

2. Indemnity. A bank that transfers, presents, or returns a substitute check or a paper or electronic representation of a substitute check for which it receives consideration shall indemnify the recipient and any subsequent recipient (including a collecting or returning bank, the depository bank, the drawer, the drawee, the payee, the depositor, and any endorser) for any loss incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check instead of the original check.

3. Liability. Any person that breaches a warranty or fails to comply with any requirement of Subpart D with respect to any other person shall be liable to that person for an amount equal to the sum of the amount of the loss suffered by the person as a result of the breach or failure, up to the amount of the substitute check; and (ii) interest and expenses (including costs and reasonable attorney's fees and other expenses of representation) related to the substitute check.

4. Recredit Rights for Consumers. Check 21 provides an error resolution

procedure and recredit rights that allows a consumer to claim a refund when the consumer receives a substitute check from a bank and the consumer thinks there is an error because of the substitute check. A “*consumer*” is defined as a natural person.

For example, the consumer may think that he or she were charged twice for the same check.

To use the special refund procedure for substitute checks, the consumer should contact the depository bank no later than 40 days from the date the bank provided the substitute check or from the date of the statement that shows the problem. In general, the consumer must: describe why the charge is incorrect; describe why the original check or a better version of the substitute check is needed; estimate how much money was lost because of the substitute check; provide a copy of the substitute check, or give the bank information that will help it identify the substitute check and investigate the claim.

If the bank finds that the claim is valid, the consumer should receive a refund by the next business day after the bank’s finding. Unless the bank finds that the claim is not valid, the consumer should receive up to \$2,500 (plus interest if the account earns interest), of the refund within 10 business days after the bank receives the claim. The customer should receive the rest of the refund (plus interest if the account earns interest) no later than 45 days after the bank receives the claim. If the bank finds that the claim is not valid, it will send a notice explaining why.

The bank may reverse the refund (including any interest on the refund) if it can show that the substitute check did not cause an error in the account.

Example:

A client receives a substitute check for which his or her account was charged and believes that the original check from which the substitute was derived was a forgery. The forgery was good enough that analysis of the original check is necessary to verify whether the signature is that of the client. Under these circumstances, the client, if acting in good faith, could assert that the charge was improper, that he or she therefore had incurred a loss in the amount of the check (plus foregone interest if the account was an interest-bearing account), and that he or she needed the original check to determine the validity of the forgery claim.

By contrast, if the signature on the substitute check obviously was forged (for example, if the forger signed a name other than that of the account holder) and there was no other defect with the substitute check, the consumer would not need the original check or a sufficient copy to determine the fact of the forgery and thus would not be able to make an expedited recredit claim.

III. ELECTRONIC ALTERNATIVES TO CHECKS

A. Fedwire. Used for most domestic wire transfers, the Fedwire funds transfer system, is owned and operated by the Federal Reserve Banks, and is a real-time settlement system that enables participants to make final payments in central bank money.

B. ACH Transactions – Electronic Check Conversion. The Automated Clearing House or “ACH” also operates through the Federal Reserve Banks but it is not a real-time settlement system. Transactions are processed on a batch basis and settled overnight.

The ACH provides a number of ways to convert checks to electronic transactions. Information from the *MICR* line of the check is used to make a one-time electronic payment. The check itself is not the method of payment and it will be destroyed.

An ARC or *account receivable* entry allows a business that receives checks in payment for goods or services to notify its customer in its invoice that information from the check will be used to make an electronic payment from the customer’s account.

A POP or *point of purchase* entry allows a retailer to make a disclosure at the time of sale that that information from the check will be used to make an electronic payment from the customer’s account. If a customer objects, the customer must provide another means of payment.

A RCK or *returned check* entry allows a payee who has received a dishonored check to use the information from the check to make an electronic payment from the customer’s account.

Example:

A law firm’s form of invoice provides a notice that tells the client that when a check is mailed, information from that check will be used to make an electronic payment from the client’s account. If the client then sends a check, the client has agreed to electronic check conversion. The law firm will process the transaction through the Automated Clearing House as an ARC Entry. Under ACH Rules, the check must be destroyed within 14 days and there is no requirement for the client’s bank to provide the check to the client with the account statement because the transaction was processed as an electronic fund transfer, not as a check transaction.

C. Credit Cards and Debit Cards. The distinction between credit cards and debit cards is based on whether the account accessed is a line of credit in the case of a credit card, or a deposit account, in the case of a debit card. A card bearing the VISA or MasterCard logo may, therefore, be a debit card or a credit card.

The VISA and MasterCard networks are made up of banks that may assume the role as an issuer or an acquirer. An issuer issues the card to the cardholder and establishes the line of credit or holds the deposit account. The issuer, therefore, assumes the credit risk of the cardholder within the network. An acquirer has the relationship with the merchant that accepts the card and assumes the credit risk of the merchant within the network. The rules of the VISA and MasterCard networks favor the cardholder, and “chargebacks” for disputed transactions may occur for as long as six months after the transaction.

The American Express credit card is an example of a network where the issuer and acquirer are the same. American Express establishes the line of credit, issues the card and acquires the transaction from the merchant.

D. PayPal. PayPal operates a non-bank payment system and is licensed under state money transmitter laws. Customers open accounts on the PayPal system by visiting the PayPal website and entering the required personal information in an online application form and choosing a password. Deposits and withdrawals flow through third-party financial institutions or by check or money order. Funds deposited to accounts are actually held for the benefit of customers in a general account in the name of PayPal at a financial institution. All transactions within the PayPal system are simply notional payments between accounts maintained in the PayPal client account database.