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# The Check 21 Act: As the Paper Trail Goes Cold, Will Banking Become a Riskier Business for Banks, Bank Customers, or Crime Insurers?

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## ***I. Introduction***

On October 28, 2004, the Check Clearing for the 21<sup>st</sup> Century Act<sup>1</sup> took effect and with our system of paper checks gave further ground to electronic communications and imaging. Check 21 is intended to make the country's present payment system more efficient and safer, while saving the banking industry billions of dollars in processing costs by reducing the dependency and use of paper checks.<sup>2</sup> The new federal law has been acclaimed as the broadest transformation in banking law in more than thirty years.<sup>3</sup> While Check 21's potential rewards may be clear, some critics caution that there are risks,<sup>4</sup> and the extent of those risks may only become evident over time.

This article summarizes the new check clearing law and considers the potential effect certain of its provisions may ultimately have for fidelity bond insurers. The first section of this article highlights the design and key features of the Check 21 Act. The second section examines potential consequences of the Act, including the rights and liabilities of banks and their customers. The third section discusses potential implications under coverage provisions of the standard form Financial Institutions Bond.<sup>5</sup>

## ***II. The Who, What, When, Where, and Why of Check 21***

The Check 21 Act embodies a Congressional response to demands from the Federal Reserve Board and banking industry leaders for increased efficiency in the

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<sup>1</sup> Check Clearing for the 21<sup>st</sup> Century Act § 20, 12 U.S.C. §§ 5001 (2004) [hereinafter Act, Check 21, or Check 21 Act].

<sup>2</sup> *Consumers Union: 'Check 21' Law Benefits Banks But Will Mean More Bounced Checks, Fees for Consumers*, U.S. NEWSWIRE, Aug. 24, 2004, at <http://www.usnewswire.com>.

<sup>3</sup> *How Will Your Account Holders Learn About Check 21?; Clarke American's Communications Solution for Financial Institutions Focuses on Relationship Building*, PR NEWSWIRE, Sept. 7, 2004, at <http://www.prnewswire.com> [hereinafter *Clarke American's Communications Solution*].

<sup>4</sup> *Id.*

<sup>5</sup> Financial Institution Bond, Standard Form No. 24 (Jan. 1986), reprinted in STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (Surety Ass'n of Am. 1995) [hereinafter Financial Institution Bond].

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processing of paper checks.<sup>6</sup> The essence of the Act is check truncation, the practice of immobilizing the original paper check at a financial institution and then condensing it to an electronic image file that may be electronically transferred through the check collection chain and, if needed, later printed.<sup>7</sup> While a few financial institutions employ some means of electronic presentment, many do not, choosing instead to rely on the physical transportation and presentment of paper checks for processing or payment.

Under the current system, more than 42.5 billion checks are exchanged each year in a process that has its roots in the eighteenth century.<sup>8</sup> The physical transportation of paper checks slows the banking industry's processing of checks and the posting and clearing of funds at a significant expense. Over time, reliance on the physical presentment of a check has become untenable, and the industry has slowly turned to alternatives offered by electronic payment processes.<sup>9</sup>

The evolution of the banking system from paper to electronic presentment was hastened by the events of September 11, 2001. In September 2001, the federal government grounded all air traffic for four days, during which time nearly \$23 billion worth of checks stood still after funds had been credited to the depositor but not yet debited from the payor.<sup>10</sup>

Check 21 seeks an orderly transition to a paperless system by encouraging truncation and electronic check presentment by banks, while preserving some of the physical characteristics of the present system. The new check processing law operates to eliminate or reduce physical check transports while accommodating those banks that still prefer paper checks.<sup>11</sup> This is achieved through a core provision of the new law allowing banks or other qualified persons to create a new negotiable instrument called a "substitute check" from an original paper check or the electronic image of an original paper check.<sup>12</sup> There is no mandate that a banking institution be required to create substitute checks, only that it must accept substitute checks as the legal equivalent of a paper check.<sup>13</sup>

#### **A. THE NEW CORE PRESENTMENT AND COLLECTION MECHANICS UNDER CHECK 21**

Under the Check 21 Act, any bank may truncate, or reduce to an electronic image, an original paper check.<sup>14</sup> The electronic truncated image then may be electronically

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<sup>6</sup> Archie B. Kelly, *The Future of the Check; How Check 21 and Emerging Technologies Will Change our Payments System; Check 21*, GOV'T FIN. REV. 29 (Aug. 1, 2004) [hereinafter *The Future of the Check*]. See also *Check 21 Resource Document* (Mar. 2004), at <http://www.nacha.org/OtherResources/default.htm>.

<sup>7</sup> 12 U.S.C. § 5001(b).

<sup>8</sup> H.R. REP. NO. 108-132, at 11 (2003).

<sup>9</sup> S. REP. NO. 108-79, at 2-3 (2003).

<sup>10</sup> *The Future of the Check*, *supra* note 6.

<sup>11</sup> H.R. REP. NO. 108-132, *supra* note 8, at 11; see also S. REP. NO. 108-79, *supra* note 9, at 2.

<sup>12</sup> 12 U.S.C. §§ 5002(16), 5003(b) (2004).

<sup>13</sup> *Id.* § 5003 (a), (b).

<sup>14</sup> *Id.* § 5002(18).

transmitted to each subsequent bank in the collection chain.<sup>15</sup> From that point forward in the check's processing, the image can be converted to a substitute check, which eventually will reach the drawee bank for payment. The Check 21 Act defines the term "substitute check" and sets forth the rules concerning how they must be accepted and how liability will be addressed.<sup>16</sup> Importantly, the bank that creates the substitute check has significant potential liability under the Act.<sup>17</sup>

The Check 21 Act does not deal with images from the time the image is created until the time a substitute check is created. The law provides neither legal status nor value to an image of a check. Contracts between banks regarding the exchanging of images are a significant and necessary part of the process of electronic processing of check images. The risks of exchanging check images will be better defined when contracts are in place between banks. The Act provides that any bank that still utilizes a paper check for processing does not need to accept an electronic image but may require the sender to deliver a paper substitute check.<sup>18</sup> The bank that creates the substitute check is the bank that provides the warranties and indemnity.<sup>19</sup> The substitute check is a printed piece of paper bearing the original check's front and back image and becomes a negotiable instrument complete with its own set of warranties and claim procedures.<sup>20</sup>

Over time, this process is expected to accelerate check processing more than ever. To illustrate, when a consumer writes a check at a grocery store, that check theoretically could clear the consumer's bank account in a matter of hours; whereas previously it may have taken days for that same check to clear.<sup>21</sup> Because the drawee bank can return the check up until midnight of the day after it first receives the check,<sup>22</sup> however, the speed of final payment likely will not be significantly increased.

## B. THE SUBSTITUTE CHECK

### 1. Definition

Check 21 defines a "substitute check" as follows:

A paper reproduction of the original check that –

- (A) contains an image of the front and back of the check;
- (B) bears a MICR line of the original check, except as provided under generally applicable industry standards for

<sup>15</sup> *Id.* § 5003.

<sup>16</sup> *Id.* §§ 5002(16), 5003-5007, 5009.

<sup>17</sup> *Id.* §§ 5004-5007.

<sup>18</sup> H.R. REP. NO. 108-132, *supra* note 8, at 10.

<sup>19</sup> 12 U.S.C. §§ 5004-5005.

<sup>20</sup> H.R. REP. NO. 108-132, *supra* note 8, at 10-11.

<sup>21</sup> *Questions and Answers About the Check Clearing for the 21<sup>st</sup> Century Act, "Check 21,"* CONSUMERS UNION, July 27, 2004, available at <http://www.consumersunion.org/finance/ckclear1002.htm> [hereinafter *Questions and Answers*].

<sup>22</sup> U.C.C. § 4-302 (2002).

substitute checks to facilitate the processing of substitute checks;

(C) conforms, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks; and

(D) is suitable for automated processing in the same manner as the original check.<sup>23</sup>

A substitute check is a piece of paper, just like the original check, which is created from an electronic image of the original check. It can be processed in the same manner as a paper check, and, perhaps its most important characteristic, it is a negotiable instrument.<sup>24</sup>

Parties to banking transactions, including banks, processors, paying or depositing customers, and the Federal Reserve, cannot refuse to accept a substitute check.<sup>25</sup> However, as noted above, there is no requirement that any person or institution must create a substitute check in lieu of a paper check, nor any requirement that any party must accept any electronic check image.

## **2. Characteristics of the Substitute Check**

The substitute check has three primary features, which are collectively designed to encourage its use and clear the traffic jams associated with paper checks. First, the substitute check is the “legal equivalent” of a paper check.<sup>26</sup> Second, the substitute check has two warranties.<sup>27</sup> And third, the substitute check has a built-in indemnity system to address losses associated with its use.<sup>28</sup>

### **a. Legal Equivalence**

#### **(i) Requirements**

A substitute check will provide the legal equivalence of an original paper check when the substitute check meets two requirements. First, the paper reproduction of the original check or its electronic image must be an exact, scaled image of the front and back of the original paper check.<sup>29</sup> Second, the substitute check must also precisely bear the following legend: “This is a legal copy of your check. You can use it the same way you would use the original check.”<sup>30</sup> This means, among other things, that substitute checks can be used as proof of payment with the same weight as original checks, such as in court disputes with creditors or debtors and in matters involving the IRS.

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<sup>23</sup> 12 U.S.C. § 5002(16); *see also* 12 C.F.R. § 229.2(11)(aaa) (2004).

<sup>24</sup> *Id.* §§ 5002(16), 5003(a), (b).

<sup>25</sup> *Id.* § 5003(a).

<sup>26</sup> *Id.* § 5003(b).

<sup>27</sup> *Id.* § 5004.

<sup>28</sup> *Id.* § 5005.

<sup>29</sup> *Id.* § 5003(b)(1).

<sup>30</sup> *Id.* § 5003(b)(2) (2004).

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**(ii) Endorsements**

The creator of a substitute check is charged with ensuring that all endorsements on the paper check, by all who previously handled or endorsed the item, appear legibly on the substitute check.<sup>31</sup> The regulations, therefore, require that all endorsements on the substitute check be printed in black ink in accordance with industry technical guidelines.<sup>32</sup>

**b. Warranties**

**(i) Two Warranties Created**

The first bank that creates a substitute check, or the first bank to process a customer-created substitute check, is called the “reconverting bank.”<sup>33</sup> Under the Check 21 Act, the reconverting bank makes two separate warranties concerning the substitute check.<sup>34</sup> First, the reconverting bank warrants that the substitute check meets all of the requirements for legal equivalence.<sup>35</sup> Second, the reconverting bank warrants that no one to whom the substitute check is subsequently presented or transferred will be asked to pay the check more than once.<sup>36</sup> The two warranties apply even to a subsequent electronic image of a substitute check.<sup>37</sup>

**(ii) Additional Considerations**

The reconverting bank makes the above warranties to all subsequent banks and other parties.<sup>38</sup> While entities other than banks, such as corporations, can create a substitute check, they would not be the warrantor under the Act as they are not the first bank to transmit or present the check.

Banks can allocate liability for the two warranties with entities creating or depositing substitute checks for presentment or payment by, for instance, amending the terms and conditions of the customer’s deposit agreement.<sup>39</sup>

**(iii) Damages for Breach of Warranty**

When a bank breaches either of the warranties of the substitute check, a customer or another bank can recover damages, but only for the actual amount lost, which sometimes may be less than the amount of the check.<sup>40</sup> In any event, the customer or bank can never recover more than the amount of the check, plus interest and those costs

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<sup>31</sup> *Id.* § 5003(c).

<sup>32</sup> 12 C.F.R. § 229.51(b)(2).

<sup>33</sup> 12 U.S.C. § 5002(15); *see also* 12 C.F.R. § 229.2(zz).

<sup>34</sup> *Id.* § 5004.

<sup>35</sup> *Id.* § 5004(1).

<sup>36</sup> *Id.* § 5004(2).

<sup>37</sup> *Id.* § 5004.

<sup>38</sup> *Id.*

<sup>39</sup> H.R. REP. NO. 108-132, *supra* note 8, at 17.

<sup>40</sup> 12 U.S.C. § 5009(a).

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associated with the loss, such as attorneys' fees, bank fees for returned checks, and merchant fees for returned checks.<sup>41</sup> In addition, the amount of damages is automatically offset by any re-credits that the customer or bank has received from another bank, and a comparative negligence analysis applies to breach of warranty claims.<sup>42</sup>

Potential losses may not result from a breach of either of the two warranties. For example, in the case of a forged or altered original paper check, neither warranty will be breached if the substitute check meets the legal equivalence standard and the non-repetitive payment standard. Even though no warranty has been breached, if the customer or bank has suffered a loss as a result of the substitute check, the customer or bank can still seek to get its money back from the offending bank under the new law's indemnity provision.<sup>43</sup>

### **c. Indemnity**

#### **(i) Scope of Indemnity**

The Check 21 Act also gives banks and their customers a system of down-the-line indemnity for any losses suffered as a result of use of a substitute check. The reconverting bank—the first bank to create or present a substitute check—will indemnify subsequent banks for losses associated with the use or presentment of substitute checks.<sup>44</sup> The indemnity runs to “the transferee, any subsequent collecting or returning bank, the depositary bank, the drawee, the drawer, the payee, the depositor and any endorser.”<sup>45</sup>

Check 21 limits the scope of the indemnity to payment of loss only if “that loss occurred due to the receipt of a substitute check instead of the original check.”<sup>46</sup> This fact-based standard will, no doubt, be the basis of litigation down the Check 21 road because it leaves open to interpretation whether the loss was suffered due to use of a substitute check or the original check.

#### **(ii) Amount of Indemnity**

The amount of the indemnity includes any amount proximately caused by a breach of warranty and includes costs and attorney's fees.<sup>47</sup> In the case of losses that do not result from a breach of warranty, the Act provides that the indemnity will replace any amount of loss, up to the amount of the check, and interests and costs.<sup>48</sup> With respect to fraudulent checks, the scope of the indemnity applies only where the “loss occurred due to the receipt of a substitute check instead of the original check,”<sup>49</sup> such as only if the

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.* § 5009(a)(2), (c).

<sup>43</sup> *Id.* § 5005.

<sup>44</sup> *Id.* § 5005(a).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* § 5005(a).

<sup>47</sup> *Id.* § 5005(b)(1).

<sup>48</sup> *Id.* § 5005(b)(2).

<sup>49</sup> *Id.* § 5005(a).



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original check would have alerted someone to the fraud and the substitute check took away that opportunity.

**(iii) Contributory Negligence Considered**

The Check 21 Act also features a counter-balance to the indemnity. The negligence or failure to act of the indemnitee will reduce the indemnity amount by the portion of that contributory negligence.<sup>50</sup> The Act does not, however, limit the recourse available to the indemnitee under the state laws.<sup>51</sup>

**(iv) Subrogation of Rights**

The Check 21 Act does give the reconverting bank, and therefore its insurer, recourse for an indemnity payment of a loss associated with the use or presentment of a substitute check. Under the law, the indemnifying bank is subrogated to the rights of the indemnitee, including the right to pursue breach of warranty claims where appropriate.<sup>52</sup> This subsection further provides that the indemnitee has an affirmative duty to reasonably cooperate with the subrogation efforts of the indemnifying bank.<sup>53</sup>

**(v) Additional Considerations**

The statute of limitations for an indemnity claim is one year from the date the cause of action accrues.<sup>54</sup> Accrual is defined as the date at which the consumer knew or should have known of a breach of warranty.<sup>55</sup> In the case of a consumer indemnity-claimant, the date of accrual will generally be one year from the date a bank statement is issued.

Further, a “notice of claim” period applies. This means that a notice of claim based on warranty or indemnity claims to an indemnifying and warranting bank must be given within thirty days after the person has reason to know of the claim and when that person learns the identity of the warranting or indemnifying bank.<sup>56</sup> A timely expedited consumer re-credit claim, discussed in more detail below, constitutes timely notice of a claim.<sup>57</sup>

Finally, federal courts will have jurisdiction over claims filed as a result of the use, presentment, or payment of substitute checks.<sup>58</sup> Even a breach of warranty claim

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<sup>50</sup> *Id.* § 5005(c)(1).

<sup>51</sup> *Id.* § 5005(c)(2).

<sup>52</sup> *Id.* § 5005(e)(1), (2).

<sup>53</sup> *Id.* § 5005(e)(3).

<sup>54</sup> *Id.* § 5010(a)(1).

<sup>55</sup> *Id.* § 5010(a)(2).

<sup>56</sup> *Id.* § 5010(b).

<sup>57</sup> *Id.* § 5010(c).

<sup>58</sup> *Id.* § 5010(a)(1).

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will come under federal question jurisdiction because federal law has created the cause of action.<sup>59</sup>

### C. EXPEDITED RE-CREDITS

Check 21 establishes an expedited “re-credit” claim procedure that provides refunds to an account for faulty substitute check transactions.

#### 1. Consumer Re-Credits

The new law requires a consumer seeking an expedited re-credit to assert, in good faith, the following:

- (a) the bank charged the customer’s account for a substitute check;
- (b) the charge was improper or the consumer has a warranty claim;
- (c) the consumer suffered a loss; and
- (d) the original check, or a better copy of the original check is necessary to establish the breach of warranty or improper payment.<sup>60</sup>

A consumer must make the expedited re-credit claim generally within forty days of receiving its bank statement or a copy of the substitute check.<sup>61</sup> An extension of the forty-day claim period is available for extenuating circumstances.<sup>62</sup>

Once the consumer makes the expedited re-credit claim, the bank must re-credit the account if the customer shows the factors above. In order to deny the re-credit claim, the bank must provide an accurate copy of the original check at the time it was truncated and must demonstrate that the substitute check was properly charged to the account.<sup>63</sup> This process shifts the burden of proof to the banking institution once the consumer has shown the four factors above.

After the claim is made, the bank may, and should, immediately investigate the claim. However, Check 21’s expedited re-credit scheme sets forth that, if the bank cannot complete its investigation within ten business days, it must re-credit the consumer’s account for the amount of the check up to \$2,500.<sup>64</sup> After forty-five days, any amount above \$2,500 must be re-credited.<sup>65</sup> The bank can later reverse the consumer

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<sup>59</sup> 28 U.S.C. § 1331 (2003).

<sup>60</sup> 12 U.S.C. § 5006(a)(1).

<sup>61</sup> *Id.* § 5006(a)(2).

<sup>62</sup> *Id.* § 5006(a)(3).

<sup>63</sup> *Id.* § 5006(c)(1).

<sup>64</sup> *Id.* § 5006(c)(2)(B)(i).

<sup>65</sup> *Id.* § 5006(c)(2)(B)(ii).

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re-credit, on notice to the consumer, after determining that the original charge to the account was proper.<sup>66</sup>

## 2. Bank Re-Credits

Banking institutions may make expedited re-credit claims of their own. Banks that re-credit customer accounts can, in turn, seek re-credit from other appropriate presenting banks within 120 days of paying the customer re-credit.<sup>67</sup> Within ten business days of the bank's re-credit claim, the presenting bank must produce the original paper check or an appropriate copy and re-credit the paying bank or notify the paying bank as to why the presenting bank is not obligated to pay.<sup>68</sup> If the paying bank later reverses the consumer re-credit, it must immediately notify the presenting bank from which it sought re-credit.<sup>69</sup>

This multi-step process, although cumbersome in its details, ensures that any bank that pays for a loss associated with a substitute check can seek recovery of the funds from the previous bank. This recovery process, however, only goes back to the bank that created the substitute check. To go back further, to the bank that transmitted the image to the bank that created the substitute check, will depend upon the contract between the banks.

### *III. The Check is in the E-Mail—Some Practical Applications of Check 21*

Discussed below are certain of the anticipated practical implications of Check 21 for banks and their customers.

#### **A. WHAT HAPPENS TO THE ORIGINAL PAPER CHECK?**

The Check 21 Act does not require a bank to retain or store an original paper check that has been truncated for forward processing. Under current law, banks that truncate are required to return the original check to its maker, store the original, or destroy the original while maintaining a legible copy, usually for seven years.<sup>70</sup> In its consideration of Check 21, the Federal Reserve Board specifically declined to impose any requirements on banks to retain the original of a truncated check but instead commented that the decision to retain or destroy the original will be a business decision.<sup>71</sup> The Federal Reserve Board stated in the preamble to its final rule that “Banks and other persons that destroy checks may take fraud risks into account when deciding whether to destroy a truncated check. For example, some banks may choose to keep original checks above a certain dollar amount due to the potentially greater risks associated with those

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<sup>66</sup> *Id.* § 5006(e).

<sup>67</sup> *Id.* § 5007(a).

<sup>68</sup> *Id.* § 5007(c)(1).

<sup>69</sup> *Id.* § 5007(c)(3).

<sup>70</sup> 69 Fed. Reg. 47289, 47292 (Aug. 4, 2004) (Final Rule preamble).

<sup>71</sup> *Id.*

items.”<sup>72</sup> Thus, while banks have no duty to retain original checks, they must keep in mind the potential requirement to produce the original or a legible copy later.

At least one consumer group believes the absence of a requirement to retain the original paper check will hinder the ability of bank customers to enforce their rights under Check 21 and other laws.<sup>73</sup> Yet with document retention and storage apparently still to be individually determined by each bank,<sup>74</sup> the actual effect of Check 21’s truncation allowances on the need for original paper checks to make out claims is impossible to measure. It is currently unknown how many banks that currently truncate store the original paper checks and how many such banks destroy the original.

Problems that may flow from decreased retention of and access to original paper checks could make check truncation a less desirable change, but ultimately the benefits will likely outweigh the risks in this regard and the industry will develop a way to preserve or replicate the physical evidence sometimes necessary to establish claims.

#### **B. WHAT OVERALL EFFECT IS CHECK 21 EXPECTED TO PRODUCE ON CHECK FRAUD AND CHECK FORGERIES?**

Check fraud in the United States is a \$10 billion problem each year.<sup>75</sup> There is some debate as to whether or how Check 21 will reduce this problem.

On the one hand, some observers acknowledge that Check 21, with its faster processing of checks and quicker debiting of accounts, will reduce current check fraud trends because it will help speed along the detection of fraudulent checks by account-holders.<sup>76</sup> Some have suggested that consumers who write checks will either go on-line to check their accounts or otherwise notice unauthorized debits from their accounts faster than before Check 21.<sup>77</sup> The consumer may then notify the bank of the fraudulent check perhaps the same day the check was written, rather than days later, a difference in time that many believe will cut off the time-cushion opportunity for check fraudsters.<sup>78</sup> It is also speculated that, by collapsing the length of a check’s float, the Act will reduce the possibility of check kiting.<sup>79</sup>

On the other hand, loss of certain security features in the check-imaging process and other potential printing and employee dishonesty problems may actually increase the risk for fraud under Check 21. For instance, watermarks or microprints on paper checks may make it more difficult to detect a fraudulent check. The Federal Reserve Board requirements that images be no better than 240 dpi and black and white with no

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<sup>72</sup> *Id.*

<sup>73</sup> *Questions and Answers, supra* note 21.

<sup>74</sup> Walt Young, *Check 21—A New Age for Check Processing*, KIRCHMAN REGULATORY SERVICE, Dec. 2003.

<sup>75</sup> *Using Check 21 to Help Manage Systemic and Payment Risk*, ITEM PROCESSING REPORT, Apr. 8, 2004 [hereinafter *Using Check 21*].

<sup>76</sup> *Id.*; see also H.R. REP. NO. 108-79, *supra* note 8, at 11.

<sup>77</sup> H.R. REP. NO. 108-79, *supra* note 8, at 11.

<sup>78</sup> *Id.*

<sup>79</sup> *Using Check 21, supra* note 75.

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grayscale<sup>80</sup> will make the file size manageable but will result in many poor quality substitute checks, which may make it more difficult for a customer to promptly detect alterations and other problems with checks.

Embezzlement losses may increase. For example, a back-room bank employee may be able to compromise the image of a check, perhaps by manipulating the check's image on the computer, so that when it is printed into substitute check form, its funds can be diverted.

The technology industry, however, might help alleviate most of these concerns. Banks can implement an array of security features in the back-room printing arena, and the banking industry's technology partners may come up with ways to image watermarks or create new microprints on check images.<sup>81</sup> That said, the banking industry generally acknowledges that check truncation will ultimately mean more private information posted electronically. Some speculated this will in turn cause an increase in fraudulent activities related to checks, at least at first.<sup>82</sup> Hackers may obtain such information and then be able to exploit the information.<sup>83</sup>

### C. CAN A SUBSTITUTE CHECK BE FORGED OR ALTERED?

A substitute check will be produced by creating a printed image of the original paper check or its electronic image, and it stands to reason that fraudsters may compromise the imaging process. This could happen in one of two ways. First, as noted above, dishonest bank employees creating a substitute check in the back-room of their branch office could conceivably change or alter the image of the original paper check so that, when the substitute check is printed, the funds can be diverted. Second, because the Act allows for depositing substitute checks without an agreement with the depositing bank,<sup>84</sup> persons can create a substitute check on their own. One example of this could be where large companies, which do not wish to go to the expense of transporting physical checks, can truncate the original customer checks themselves and then electronically transmit the images of those checks to their banks, which may or may not print the images into substitute checks. The company-initiated check truncation can be accomplished regardless of whether the company's bank has previously agreed to accept truncated checks. Thus, under this second situation, there exists the potential that, despite a bank's efforts to control the imaging process, an unscrupulous corporate employee could compromise the process.

Under the Act, the individual or corporate depositor makes no warranties as to the substitute check because they are not the "reconverting bank."<sup>85</sup> While only large companies might take on this expense of converting their paper checks to substitute

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<sup>80</sup> 69 Fed. Reg. at 47298.

<sup>81</sup> *Id.*

<sup>82</sup> David Wells, *The Future is Clear for Cheques: IMAGING*, FIN. TIMES (LONDON), Sept. 15, 2004, at 15.

<sup>83</sup> *Id.*

<sup>84</sup> 12 U.S.C. § 5003(a).

<sup>85</sup> *Id.* § 5004.

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checks, check fraudsters could seek to exploit the provision of the law that puts the onus of the warranties on the bank by compromising the imaging process and creating fraudulent substitute checks, even though they make no warranties on the instrument.

Thus, it appears that a substitute check can conceivably be forged or altered at some point in the processing. With these possibilities in mind, banks should take special precautions to implement fraud detection and prevention measures, including security procedures for back-room imaging and printing. Banks should have carefully worded depository agreements and perform credit checks and other additional scrutiny before allowing individuals, small companies, or even large companies to deposit an image of any check.

#### **D. IF A SUBSTITUTE CHECK IS STOLEN, CAN IT BE NEGOTIATED OR TRANSFERRED?**

A substitute check is a negotiable instrument,<sup>86</sup> and thus a stolen substitute check might be fraudulently negotiated or transferred, just as an original paper check. Moreover, because substitute checks do not change the warranties made and remedies available under the U.C.C., as discussed below, banks may still have certain defenses available when they make payment on a fraudulent substitute check, including the defense of “good-faith acceptance.”<sup>87</sup>

#### **E. DOES THE ACT CHANGE THE WARRANTY ORDER OF THE U.C.C.?**

Check 21 is not intended to override any other loss-recovery systems currently in place but is only designed to address the specific circumstance of a loss from a substitute check that would not have occurred but for the creation and presentment of a substitute check.<sup>88</sup>

A substitute check will have the same properties as an original paper check under the U.C.C.<sup>89</sup> Therefore, a substitute check of a fraudulent original paper check will be considered not properly payable under the Uniform Commercial Code and subject to transfer and presentment warranties.<sup>90</sup> Nothing in Check 21 will change the legal weight of the check when it is truncated or processed into a substitute check. The substitute check will thus leave the consumer in the same position as with the original paper check, and it will leave banks in the same position under other applicable law.

#### **F. HOW DOES THE ACT’S INDEMNITY PROVISION OPERATE?**

For purposes of claims made against banks under the indemnity portion of the Act, fraudulent or altered check claims will necessarily depend on whether the outcome would have differed had the original check been available instead of the substitute

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<sup>86</sup> *Id.* §§ 5002(16), 5003(a), (b).

<sup>87</sup> *See, e.g.,* Shearson Lehman Bros., Inc. v. Wasatch Bank, 788 F. Supp. 1184, 1192 (D. Utah 1992); *see also* Matco Tools Corp. v. Pontiac State Bank, 614 F. Supp. 1059, 1065 (E.D. Mich. 1985).

<sup>88</sup> H.R. REP. NO. 108-132, *supra* note 8, at 12.

<sup>89</sup> 12 U.S.C. § 5003(e).

<sup>90</sup> H.R. REP. NO. 108-132, *supra* note 8, at 12.

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check.<sup>91</sup> For instance, where the check amount was too small to have triggered internal alerts to verify the check, then the fact that it was presented by substitute check makes no difference, and the indemnity is not available. In other words, even if the bank had processed the original paper check, the fraud would not have been discovered. By contrast, if a security feature present on the original paper check does not survive the imaging process to the creation of a substitute check, and the bank normally checks for the security feature, and the security feature or mark would have raised an alert as to the fraudulent nature of the check, then any losses suffered on payment of the fraudulent check would not have occurred if the original paper check had been presented, and the indemnity applies. Put another way, the indemnity applies in the latter circumstance because if the original check had been processed, the original check's security features, such as watermarks and microprints, would have exposed the check as fraudulent. Note that, under the former situation where the indemnity does not apply, the bank or account-holder may still pursue other recourse for the fraudulent check, and losses to banks and their insurers under current coverage may apply.

#### **G. CHECK 21 MAY INCREASE THE NUMBER OF ATMS IN REMOTE LOCATIONS**

In enacting Check 21, Congress recognized that one reason banks have not placed their own ATM machines in remote locations is that someone from the bank must physically retrieve the checks deposited at the ATM on a frequent basis.<sup>92</sup> Under Check 21, and using new technology, a bank may be inclined to place ATMs in more locations. The ATMs may be equipped to scan deposited checks and electronically transfer the image from remote and rural locations to the main bank premises.<sup>93</sup>

#### **H. WHAT WILL CHECK 21 DO TO INVESTIGATIONS OF CHECK FRAUD?**

Critics of the new law say that it will hinder fraud investigations and make catching fraudsters more difficult. Because banks are no longer required to maintain original paper checks, obtaining the documents for certain forensic analyses, *e.g.*, pen pressure testing, may no longer be a viable means of investigating certain civil and criminal forgery claims.<sup>94</sup> In fact, federal law enforcement felt left out of the Check 21 legislative process and now complains that the law takes away a vital tool in preventing fraud, thereby raising the risk of fraud when Check 21 goes into effect.<sup>95</sup>

The Federal Reserve Board, charged with promulgating the federal regulations to implement the Act, says that its research shows that an original check is only rarely needed for forensic analysis in the first place.<sup>96</sup>

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<sup>91</sup> 12 U.S.C. § 5005(a).

<sup>92</sup> H.R. REP. NO. 108-132, *supra* note 8, at 11.

<sup>93</sup> *Id.*

<sup>94</sup> *Questions and Answers*, *supra* note 21.

<sup>95</sup> Will Wade, *Check 21's Unexamined Side Effect?* THE AM. BANKER, Apr. 27, 2004, at 1.

<sup>96</sup> 69 Fed. Reg. at 47292 n.13.

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#### ***IV. Does Check 21 Affect Some of the Risks Under Financial Institution Bonds or Commercial Crime Policies?***

Only experience will demonstrate how the trend to going “paperless” and the enactment of Check 21 will affect claims and coverage under standard Financial Institution Bond and Commercial Crime Policies. The insurance industry already has reacted by adding a rider that can be used to redefine “original” to include “substitute checks.”<sup>97</sup> Certain questions, however, may be anticipated for claims presented under standard coverage forms for forgery or alteration<sup>98</sup> and employee dishonesty.<sup>99</sup> This section identifies some of these potential implications.

##### **A. IS A SUBSTITUTE CHECK A “NEGOTIABLE INSTRUMENT”?**

Although the Check 21 Act does not explicitly refer to a substitute check as a negotiable instrument, Congress intended it to be one and thus endowed the substitute check with all the properties of a negotiable instrument.<sup>100</sup> It is not clear, however, that a substitute check is a negotiable instrument for purposes of the bond. The 1986 Standard Form Financial Institution Bond, for example, defines a Negotiable Instrument as a “writing signed by its maker with an unconditional promise to pay a sum certain.”<sup>101</sup> Thus, the treatment of a substitute check may be different under the Act than under defined policy terms.

If the policy definition at issue requires a “writing signed by the maker,” the substitute check may not qualify. The process by which a substitute check is created—where the original check is scanned into electronic form and the printout of that electronic form equals the substitute check—does not allow for any signatures by the writing’s maker, and thus a substitute check may not qualify under the bond definition as a Negotiable Instrument. One possible argument, however, might be that, when printed into substitute check form, the signature has gone from an electronic image of the truncated original to “a mechanically reproduced facsimile signature” on the substitute check, which may be deemed to be its own original negotiable instrument under the Act. This, in turn, may be recognized as part of a Negotiable Instrument under standard

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<sup>97</sup> Financial Institution Bond, *supra* note 5, Substitute Check Rider.

<sup>98</sup> Forgery or Alteration coverage under Insuring Agreement (D) of the current Financial Institution Bond provides potential coverage for “Loss resulting directly from Forgery or alteration of, on or in any Negotiable Instrument.” Financial Institution Bond, *supra* note 5, at Insuring Agreement (D).

A typical Commercial Crime Policy provides potential coverage for “[f]orgery or alteration of, on or in” instruments defined as “checks, drafts, promissory notes, or similar written promises, orders or directions to pay a sum certain in ‘money.’” COMMERCIAL CRIME POLICY, FORGERY OR ALTERATION COVERAGE (Insurance Services Office, Inc. 1984), *reprinted in* STANDARD FORMS OF THE SURETY ASS’N OF AMERICA [hereinafter Commercial Crime Policy].

<sup>99</sup> The Financial Institution Bond and the Commercial Crime Policy’s Employee Dishonesty Coverage section provide similar coverage for direct losses arising from dishonest or fraudulent acts of an employee committed with the manifest intent to cause the loss and to gain a financial benefit. Financial Institution Bond, Insuring Agreements, at (A); Commercial Crime Policy, Employee Dishonesty Coverage.

<sup>100</sup> 12 U.S.C. §§ 5002(16), 5003(a), (b) (2004); *see also* H.R. REP. NO. 108-132, *supra* note 8, at 10.

<sup>101</sup> *Id.*, Conditions and Limitations, Section 1(o).



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wording providing that “a mechanically reproduced facsimile signature is treated the same as a handwritten signature.”<sup>102</sup>

Where a policy does not define the term “negotiable instrument” or the policy definition has incorporated a reference to substitute checks, then coverage may be analyzed in the same manner as it now is for standard paper checks. An October 2004 “Substitute Check Rider” for the Financial Institution Bond defines “original” to include, “for the purpose of Insuring Agreement (D) only, a ‘substitute check’ as defined in the Check Clearing for the 21<sup>st</sup> Century Act.”<sup>103</sup> With the addition of this rider, there is little doubt that a substitute check is intended to be covered under Insuring Agreement (D) for forgery or alteration of a Negotiable Instrument.

**B. IF A SUBSTITUTE CHECK QUALIFIES AS A COVERED INSTRUMENT,  
CAN IT BE “FORGED OR ALTERED”?**

The Financial Institution Bond defines “forgery” as “the signing of the name of another person or organization with intent to deceive; it does not mean a signature which consists in whole or in part of one’s own name signed with or without authority, in any capacity for any purposes.”<sup>104</sup> As a practical matter, once a check is truncated, successful forgery or alteration in the traditional sense of signing another’s name or altering a physical check is far less likely. The forgery or alteration to the original check before it was converted to an image and then printed as a substitute check, however, will still likely be covered in the same manner that forged or altered checks have been covered in the past. Insurance companies may also become involved in disputes over which bank has liability for a forged or altered check. Currently, if a thief steals an original check and physically alters it, the depository bank usually has breach of warranty liabilities.<sup>105</sup> However, if that thief steals a check, scans it, alters the image, and prints out a counterfeit check, the drawee bank will have liability if it does not catch the forged check and return it by the midnight deadline. When the deposited fraudulent check is converted to an image and reprinted as a substitute check, it can become impossible to determine if the check was an original check that was altered or is instead a scanned and printed forged counterfeit check. Because it cannot be determined, the reconverting bank would have liability, and, depending upon the contracts in place, it may be able to pass such liability to the first truncating bank.

**C. POTENTIAL IMPACT ON EMPLOYEE DISHONESTY LOSSES**

As with current check-processing procedures, bank employees may seek to compromise the system that evolves to satisfy Check 21 provisions and cause the institution and its carrier a loss. According to a newsletter of one small-town, Midwestern bank, the new law will limit the potential for employee crimes because fewer hands will have access to the original paper document—the source of the demand for

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<sup>102</sup> *Id.*, Insuring Agreements, at (D).

<sup>103</sup> *Id.*, Substitute Check Rider.

<sup>104</sup> *Id.*, Conditions and Limitations, at Section 1(i).

<sup>105</sup> U.C.C. §§ 4-207, 4-208, 4-401 (2002).

payment.<sup>106</sup> But at least one leader in the check-processing industry believes that, without implementation of security features in the printing of substitute checks, employee dishonesty will abound.<sup>107</sup>

The potential coverage for such losses will vary from case to case, but one easily can imagine a situation where a dishonest employee intentionally manipulates information somewhere in the process of converting the paper check to a substitute check and diverts the funds for his or her own benefit. The resulting loss could, depending on the circumstances, be covered under a fidelity bond. Therefore, understanding that check truncation might be risky business in the event of unchecked employee transgressions, both banks and their insurers should know just where they stand and who is going to ultimately pick up the tab.

#### **D. FORGERY COVERAGE FOR LOSSES WHERE IMAGING FAILS**

One of the chief concerns about Check 21 centers on the process that banks will use in creating and presenting substitute checks. Banking industry and consumer groups alike are concerned that certain security features currently present on paper checks will not survive the imaging process to transform them into substitute checks.<sup>108</sup> This concern has spawned a technology race to produce imaging programs to preserve the original check's security features or provide new security features in the creation of substitute checks.<sup>109</sup>

No doubt the banking industry, which worked so hard to achieve the Check 21 truncation process, influences its technology partners to be able to implement Check 21 as soon and as safely as possible. As to the risk that fraudulent checks go unnoticed because of the transformation into a substitute check, the industry will regulate itself and find ways to reduce the risk. That said, insurers can be certain that bond claims will result from failures to detect fraud by using substitute checks.

#### **V. Conclusion**

As with any unknown, it is difficult to predict the effect Check 21 will have on fidelity bond claims. Insurers certainly cannot ignore the fact that banks across the country process checks in a manner wholly different from when the current bond forms were created. Banks must likewise determine whether Check 21 losses are contemplated by their policies or whether clarifying riders or endorsements are needed.

If the Check 21 Act is successful, a check eventually will be received by the first branch of a bank, which then will scan the item and convert it to an image to be transmitted to the drawee bank for payment. The customer will receive only an image in

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<sup>106</sup> Lake City Bank, *Check 21 Act: The Future of Check Clearing and How it Affects Your Checking Account* (2004), at <http://www.lakecitybank.com/PDF/IntranetBrochure.pdf>.

<sup>107</sup> Miles Busby, *A Post-Check 21 Security Issue: How to Print Substitute Checks*, THE AMERICAN BANKER, Aug. 13, 2004, at 10.

<sup>108</sup> *The Future of the Check*, *supra* note 6, at 2.

<sup>109</sup> *Document Security Systems, Inc. Announces New Electronic Check 21 Protection Technology for the Banking Industry*, PR NEWSWIRE, at <http://prnewswire.com>, Sept. 8, 2004.

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his or her bank statement and no substitute check will ever be printed. Under such a scenario, Check 21 would not apply because no substitute check was ever actually used. Because no current law gives any value to an image nor any right to a bank to charge a customer's account for an image, however, carefully constructed account agreements and inter-bank agreements will be needed, as will possible changes in the law before such full imaging of checks can safely occur. How risk under the Financial Institution Bond will be affected by such contracts and agreements is currently unknown.

**APPENDIX**

1. The Federal Reserve Board:  
<http://www.federalreserve.gov/paymentsystems/truncation/default.htm>
2. BAI (financial services industry professional organization):  
<http://www.bai.org/check21/>
3. *Check 21 Resource Document* (produced by consortium of financial services industry professional organizations):  
<http://www.aba.com/NR/rdonlyres/CBDC1A5C-43E3-43CC-B733-BE417C638618/35072/ResourceDocument.pdf>
4. American Bankers Association:  
<http://www.aba.com/About+ABA/CheckTruncationAct.htm>