

COMMENTARY

A Report Card on Check 21

By Darrell Payne, Esq.

The Check 21 Act, 12 U.S.C. § 5001, is designed to encourage expanded use of "substitute" checks. It was expressly intended to foster innovation in the check collection system and improve the efficiency of U.S. banks' payment systems.¹

Now, more than two-and-a-half years after the law's October 2004 effective date, the jury is still out on whether it has led to any measurable improvement. The Federal Reserve Board's recent report to Congress reveals only marginal improvement in check-clearing turnaround time and shows a rapid increase in the use of electronics to collect and present checks for payment since March 2006.²

The Check 21 Act promotes the use of truncated or substitute checks as a way to facilitate the expanded use of electronics in check collection and returns. Under the new system, a bank can process check payments electronically without physically conveying the original paper check to the paying bank. Even if the paying bank does not accept electronic checks, it now must accept a "substitute check" (a paper reproduction of the original check), containing the essential information the bank needs to process the check.³ The law effectively makes a substitute check the legal equivalent of the original paper check.⁴

This allows banks to make electronic copies or digital images of the original check and avoid the expense and delay associated with physically delivering checks to other banks through the federal reserve system. The statute also provides protection in the form of warranties and indemnification from the bank providing the substitute check, for any loss concerning receipt of the substitute check in lieu of the original check, including attorney fees and costs.⁵

The law provides for expedited re-credit procedures for consumers and banks for any substitute checks that are not properly charged to an account.⁶ If notice of a claim

is not given within 30 days of learning of a possible claim, the indemnifying bank will be protected from further liability resulting from the delay. Otherwise, the statute proves a one-year limitations period for any claim.⁷

Check 21 required the board to report to Congress within 30 months of the law's enactment, with much of the report based on data from a March 2006 survey.⁸ At that time, 93 percent of all processed checks still involved paper checks. Banks were using substitute checks only 3 percent of the time.

Over the past year, however, the movement toward check truncation has gained momentum. In January the use of substitute checks had tripled from the rate of usage in March 2006, and the use of electronic imaging increased fivefold. In February about 30 percent of checks returned by federal reserve banks to depository banks were in substitute check form, up from about 10 percent in March 2006. This data suggests rapid improvement in the coming years.

Check 21, however, has not meaningfully improved the efficiency of check collection since March 2006. In 1995 the average check clearance time was 3.9 business days. In the survey, the average check clearance time was minimally reduced to 3.7 business days. The board determined that there was insufficient improvement to warrant reducing the maximum allowable holds for any category of checks, pursuant to the Expedited Funds Availability Act.⁹

Although 90 percent of banks were releasing funds more quickly than required under the EFAA, less than two-thirds were receiving returned checks faster than the maximum allowable hold time. Thus, the system has not reached the congressionally mandated threshold time that would mandate a reduction in hold time. However, if banks continue the recent trend of adopting imaging systems to use Check 21 authority, this could soon change.

The survey did find some benefits for consumers. Increased efficiency has allowed the federal reserve to consolidate its check processing centers from 45 in 2003 to 22 this year, with four more set to close by 2008. The consolidation has resulted in more checks being subject to the two-day local-check hold instead of a five-day non-local-check hold. Thus, some consumers are benefiting from faster check availability, whereas a few years ago a check

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might have been considered non-local before the consolidation of check-processing centers.

There is a concern about increasing monetary losses associated with bad checks as the overall use of checks decreases. However, the board could not determine whether these losses represent a one-time increase or a trend. The bulk of monetary losses was concentrated with large commercial banks, but small and medium-sized banks experienced significant increases in check losses from 2004 to 2005. Ultimately, the board concluded that because the adoption of Check 21 was so limited in 2005, any increase in check losses was probably not due to adoption of the statute.

The report noted few consumer complaints concerning Check 21. Of the complaints received between January 2003 and December 2006, less than 1 percent (31 total) were related to Check 21. It is unclear, however, if this low number is due simply to a lack of consumer awareness about the statute.

The report notes that Check 21 may be an important catalyst for potential long-term improvements in the nation's check-collection system. However, because of limited utilization of the technology necessary to take better advantage of Check 21's substitute-check authority, the board did not recommend any changes to maximum hold periods and safeguards exceptions under EFAA.

There is a sentiment in the industry that Check 21 will make little difference in banks' day-to-day operations. One commentator recently concluded that Check 21, by retaining the vestiges of the current system for physically presenting checks (substitute or original), effectively has delayed the inevitable conversion to a truly efficient, electronic-based system for processing payments and transfers.¹⁰ In contrast to the declining number of check transactions, there has been a steady increase in the use of credit cards, debit cards, automated clearinghouse transactions, electronic benefit transfers and other emerging technologies for "e-money."

Some describe Check 21 as a middle ground between a processing system using only image exchange and the old all-paper processing system.¹¹ Part of the problem in implementing imaging software is the capital cost of the software on small banks. Another cause of delay is the fervent merger activity of large commercial banks, which delayed in software integration.

Fraud also may become a big problem. The authorization of substitute checks may render ineffective the original check's fraud-detection devices, such as signature ink, watermarks and micro-type.

Some critics say the statute opens the door to new fraud. They say creating a fake check image, which now has some legal authority under the law, may be easier than creating a fake paper check. Because the law allows for imaging but does not require retention of the original check, most consumers will not be able to obtain the original document, with its built-in security features. Consumers ultimately will end up paying for the fraud.¹²

Check 21's support of digital imaging technology may be spearheading continued evolution in standardizing industry practices. This ultimately may affect the standard by which banks are judged in determining their comparative fault for alleged negligence with regard to the failure to examine checks.¹³ Can a bank negligently fail to detect fraud if its practice is not to examine checks? Given recent case law, it appears that consumers most often will be deemed the negligent party, allowing the bank to avoid compensating the victims of consumer fraud. Because banks' negligence is now judged based on standard industry practices, a bank should be confident in its ability to beat negligence cases, so long as it follows the practices of other similarly situated institutions.¹⁴

The movement toward truncation and away from check examination should decrease check fraud liability. Because of Check 21, banks probably will adopt an industry-wide practice of not physically examining checks. Thus, it will become increasingly unlikely for banks to be found negligent.

In theory, this should lead to reduced fraud liability for banks — which they should in turn pass on to the consumer in the form of reduced fees or other forms of savings.¹⁵

Conclusion

Although the recent trend reflects greater adoption of the benefits of Check 21, other developments and innovations in the banking field ultimately may render the statute less relevant. Banks may gain greater efficiencies through investment in other forms of e-transfer, while awaiting more definitive data on the benefits of using substitute checks.

Notes

¹ 12 U.S.C. § 5001(b). The Check 21 Act is also called the Check Clearing for the 21st Century Act of 2003.

² Report to Congress on the Check Clearing for the 21st Century Act of 2003, Board of Governors of the Federal Reserve System, April 2007 ("Report to Congress"), p. 11.

³ 12 U.S.C. § 5003 (a).

⁴ 12 U.S.C. § 5003 (b). The requirements for a substitute check are found at 12 U.S.C. § 5002 (16).

⁵ 12 U.S.C. §§ 5004, 5005 (a), (b), (c).

⁶ 12 U.S.C. §§ 5006, 5007.

⁷ 12 U.S.C. § 5010.

⁸ 12 U.S.C. § 5015.

⁹ 12 U.S.C. §§ 4001-4010. The EFAA-established maximum time that banks can hold deposited funds while waiting for the deposited check to clear. Generally, funds must be made available on local checks within two business days, and funds from non-local checks must be made available within five days. The EFAA regulations are codified at 12 C.F.R. part 229 (Regulation CC).

¹⁰ Carl Felsenfeld, Genci Bilali, *The Check Clearing for the 21st Century Act – A Wrong Turn in the Road to Improvement of the U.S. Payments System*, 85 *NEB. L. REV.* 52 (2006).

¹¹ *Id.*

¹² See Cliff G. Anderson, *Eliminating the Paper: The Truncation of Paper Checks*, 6 *J. HIGH TECH. L.* 280 (2006).

¹³ Barkley Clark and Barbara Clark, *Clarks' Guide to Electronic Check Collection*, Chapter 3 (2006)

¹⁴ *Id.*

¹⁵ *Id.*
