Check Fraud and CHECK 21's Indemnity Provision

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Check Clearing for the 21st Century Act, aka “Check 21” was passed unanimously by the House of Representatives and the Senate in October 2003. It was signed by President George W. Bush on October 28, 2003 and became effective October 28, 2004.

While Check 21 does not mandate that any check be imaged and truncated, all checks except checks drawn on foreign banks[1] are eligible to be truncated into images and reconverted [2] into substitute checks.

The Indemnity provision gives financial institutions, especially smaller banks and credit unions, a powerful defensive strategy against losses that result directly from a big bank (the bank of first deposit - BOFD) sending the digital image of a counterfeit check to the smaller bank or credit union instead of the original paper counterfeit check. The indemnity provision extends the period for a paying bank to return a counterfeit check from 24 hours (the Fed's "midnight deadline") to one year from the date the injured party first learns of the loss, conditional upon the security features in its customer's original paper check and the dollar amount of the paying bank's internal "Sight Review" threshold.

INDEMNITY PROVISION

The Final Rule states a bank “that transfers, presents, or returns a substitute check…shall indemnify the recipient and any subsequent recipient…for any loss incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check[3] instead of the original check.”[4]

The Fed gives this example:

“A paying bank makes payment based on a substitute check that was derived from a fraudulent original cashier’s check. The amount and other characteristics of the original cashier’s check are such that, had the original check been presented instead, the paying bank would have inspected the original check for security features and likely would have detected the fraud and returned the original check before its midnight deadline. The security features that the bank would have inspected were security features that did not survive the imaging process.[5] Under these circumstances, the paying bank could assert an indemnity claim against the bank that presented the substitute check.

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1 Federal Reserve Board’s Final Rule issued July 26, 2004. See Pages 81-82 AAA.229.2(aaa).3 Substitute Check.

2 ibid. Page 11, Footnote 15. “Reconverting” is the statutory term and reflects the fact that the original check is converted to electronic form and then later reconverted back to a paper substitute check.

3 Today, banks send digital images, called an "X9" file, not paper substitute checks.

4 Federal Reserve Board’s Final Rule, Page 58, Substitute Check Indemnity

5 Security features that do not survive the image conversion process (from paper to X9 digital image) include a true watermark, ultraviolet light-sensitive fibers, heat-sensitive ink, e.g. Signature Paper.

"By contrast with the previous example, the indemnity would not apply if the characteristics of the presented substitute check were such that the bank's security policies and procedures would not have detected the fraud even if the original had been presented. <u>For example, if the dollar value of the check was below the threshold amount the bank has established for examining inclearing check images, the bank likely would not have caught the error and accordingly would have suffered a loss even if it had received the original check</u>."[6]

The Final Rule is clear that a "…claim shall be brought within one year of the date on which the person's cause of action accrues. …a cause of action accrues as of the date on which the injured person first learns, or by which such person reasonably should have learned, of the facts and circumstances giving rise to the cause of action, including the identity of the warranting or indemnifying bank against which the action is brought." [7]

Note that the one-year timeframe <u>begins</u> when the injured party learns or should have learned of the loss, <u>not</u> when the loss actually occurred.

INDEMNITY CLAIMS

In an indemnity claim, a financial institution (the paying bank) that received a digital image or substitute check of a counterfeit check claims it has incurred a loss attributable to receiving a digital image in place of the original check. The paying bank would bring such claim against the reconverting bank, i.e., the bank that created and/or passed along the digital image or substitute check. Typically, in turn, reconverting banks have agreements in place with the upstream banks from which they receive electronic check files, such that they can recover from these banks, i.e., a reconverting bank typically has agreements in place such that it can recover from the original truncating bank.[8] And, as mentioned in the previous paragraph, truncating banks typically have agreements in place with their remote-capture depositors such that they can recover from those depositors.

If a loss results from a truncated item drawn on an account that uses original checks with security features that do not survive imaging, AND if the dollar amount of the item was sufficiently high that the paying bank would have examined the original paper check for those security features when it was presented for payment, the party that truncated the check may face an indemnity claim.

On the other hand, if the original paper check did not contain security features that would not survive the image conversion process, OR if the dollar amount of the counterfeit check is so low that the paying bank would not have examined the check when it was presented for payment, the paying bank has no grounds for an indemnity claim.

Note: Signature Paper was created to take advantage of Check 21's Indemnity provision. Designed by Frank Abagnale and SAFEChecks in 2022, Signature Paper <u>cannot be chemically washed without leaving a permanent stain</u>.

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[6] Federal Reserve Board's Final Rule, pages 99-100, Substitute Check Indemnity

[7] ibid. Page 67(c) Jurisdiction.

[8] For example, Regulation J functions as this agreement for the Reserve Banks when the Reserve Banks act as reconverting bank. If (1) a bank – the truncating bank – deposits checks electronically with the Reserve Banks, (2) the Reserve Banks create a substitute check for presentment to the paying bank, and (3) the paying bank that receives the substitute check brings a Check 21 claim against the Reserve Banks, Regulation J enables the Reserve Banks to recover on that Check 21 claim from the truncating bank.