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**MEMORANDUM**

October 17, 2003

To Our Clients and Friends

Re: Passage of the Check Clearing for the 21<sup>st</sup> Century Act

Congress has passed the Check Clearing for the 21<sup>st</sup> Century Act (the “Check 21 Act”), and has sent the Act to the President for his approval and signature, which is expected shortly. The Check 21 Act, one of the most significant pieces of federal check legislation ever enacted, facilitates the increased use of check images in the check clearing process by authorizing banks to create a paper “substitute check” from an electronic image of an original paper check. Banks can then deliver this substitute check, in lieu of the original paper check, to paying banks and their customers. The Act becomes effective one year from the date it is signed into law.

**SUMMARY OF THE MAJOR PROVISIONS OF THE CHECK 21 ACT**

*Scope Of The Act*

The Check 21 Act establishes rules for the creation and exchange of substitute checks. Essentially all checks that are processed today through the check collection system are eligible for conversion into a substitute check. This includes: consumer and business checks, Treasury checks, official checks, cashier’s checks, teller’s checks and traveler’s checks. The Act makes it optional for a depository bank or collecting bank to create a substitute check. The Check 21 Act does not mandate check truncation or the use of check images either in the check collection process or in customer statements. However, the Act requires a paying bank and the bank’s customers to accept a substitute check that is presented to them in lieu of the original paper check. The Check 21 Act does not affect: (i) bi-lateral or multi-lateral arrangements between banks whereby banks agree to exchange images of checks instead to paper checks, or (ii) arrangements that banks have with customers for check-safekeeping or check image statements.

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### *Basic Requirements For Substitute Check*

Under the Act, a substitute check must: (1) contain an image of the front and back of the original check; (2) bear a legend that identifies the substitute check as the legal copy of the original check; (3) be MICR line encoded with the MICR line information from the original check; (4) conform to industry standards for substitute checks; and (5) be suitable for automated processing in the same manner as the original check. Given these requirements, the substitute check will look like the original check and will be processed on an automated basis like the original check.

### *Legal Equivalency Of Substitute Check*

The Act establishes that the substitute check is the legal equivalent of the original paper check for all purposes under federal and state laws (such as the UCC and Regulation CC).

### *Warranties And Indemnifications*

The Act establishes that each bank that either creates or transfers a substitute check provides subsequent transferees (including the drawer) with a warranty and a related indemnification. This warranty and indemnification provide the transferee of a substitute check with protection against losses arising from the receipt of a substitute check instead of the original check. A breach of the warranty can result in a warranting bank being liable to the transferee for damages, including proximate (or consequential) damages.

### *Consumer Protections*

The Act provides a consumer -- that receives a substitute check instead of an original check in his/her account statement -- with special expedited recredit protections. The consumer must make a claim within 40 days from the date the account statement containing information on the transaction at issue was sent to the consumer. If the consumer alleges that a substitute check was improperly charged against the consumer's account, the bank must investigate and either (i) resolve the consumer's claim within 10 business days after the claim is made, or (ii) provide the consumer with a recredit for the amount of the substitute check, up to \$2500, pending completion of the bank's investigation. In any case, the bank must complete the investigation and make a final determination of the consumer's claim within 45 days. If the bank determines during the investigation that the account was properly charged, the bank may reverse the recredit. When so reversing, the bank must provide the consumer with the original check or a copy of the original check (such as an image copy or another substitute check) and demonstrate to the consumer that the substitute check was properly charged

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to the account. The recredit procedures under the Act are similar, although not identical, to the error resolution procedures under Regulation E for consumer electronic fund transfers.

### *Inter-Bank Claims Resolution Procedure*

The Act provides a process and timeframes for banks to make and resolve claims among themselves relating to a substitute check that was improperly charged to a consumer's account. This interbank process complements the process whereby the paying bank has to provide expedited recredit to its customer, as described above. This interbank process will be used if a bank earlier in the check collection process breached a warranty that resulted in the paying bank improperly charging a substitute check against the consumer's account. This is the only section of the Act that may be modified by agreement of the banks.

### *Consumer Awareness Notice*

Banks must provide a consumer awareness notice to their customers who may receive substitute checks in their account statements. The notice must explain that the substitute check is the legal equivalent of the original paper check. The notice also must state that the consumer has a right to expedited recredit in the event the consumer's account is improperly charged for the substitute check. The Federal Reserve is required under the Act to prepare a model notice that banks may, but are not required to, use.

### *Regulatory Authority*

The Federal Reserve Board is provided with regulatory authority under the Act. While it is expected that the Federal Reserve will adopt regulations to provide guidance on the Act, the Act is self-implementing and will take effect one year from enactment.

### *Federal Reserve Reporting Of Revenue From Check Transportation*

The Act requires the Federal Reserve to disclose in its annual report for the next ten years the amount of operating costs attributable to, and an estimate of the Federal Reserve banks' imputed revenues derived from, the transportation of commercial checks between Federal Reserve bank check processing centers.

### *Provisions Unrelated to Check Truncation and Imaging*

The Act also includes two provisions that are not related to check imaging or truncation. First, the Act authorizes the Treasury Department to use alternative means other than compensating balances to compensate banks that act as fiscal agents for the Treasury

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Department. Second, the Act authorizes the Federal Reserve Board to change the way currency is collateralized to provide for greater liquidity in the case of national emergencies.

### **FUTURE DEVELOPMENTS**

In addition to the anticipated Federal Reserve regulations under the Act, bank clearinghouses, such as the Electronic Check Clearing House Organization (ECCHO), and industry standards groups will continue their efforts to establish technical standards and interbank rules for the creation and processing of substitute checks.

A copy of the conference report for the Check 21 Act is available on our website at [http://www.schwartzandballen.com/whats\\_new.html](http://www.schwartzandballen.com/whats_new.html).

If you have any questions concerning the Check 21 Act, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.