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## **Check Clearing E-Processes Move Forward While Proposed New Law Is Pending, Contracts And Product Features Can Minimize Risks**

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Prompted by the potential for significant savings, financial institutions have become increasingly “tech-savvy” about evolving electronic processes that can facilitate traditional paper check clearing. In recent years, many institutions and third-party service providers have developed check remittance and clearing processes whereby paper checks are converted into electronic form and transmitted for payment. However, the push to further automate check clearing and settlement can present legal obstacles to the various parties involved.

The Check Clearing for the 21<sup>st</sup> Century Act, also known as the Check Truncation Act (Check Truncation Act), currently under consideration in Congress, is designed to enhance the efficiency of the payments system by reducing some of the legal impediments that exist to check truncation under current law. (Check truncation is the process through which the original paper check is removed from the check collection process and in its place a substitute document or, by agreement, information taken from the original check or an electronic image of the check is presented to the paying bank for payment and, through it, to the bank’s customer for his/her records.) Until this or a similar bill is passed by Congress, the conversion of paper into electronic form must be accomplished within the traditional legal structure of the Uniform Commercial Code (UCC) as adopted by the states, regulations of the Federal Reserve, and the NACHA (National Automated Clearing House Association) Operating Rules.

While many of the legal issues raised by check truncation are already resolved by these various laws and rules, other aspects of check clearing alternatives are not so clearly resolved by reference to existing authority. Passage of the Check Truncation Act would certainly bring a greater level of uniformity and legal certainty to all parties to existing check truncation practices. Until the, industry participants continue to explore ways to reduce transaction risk through the combination of existing law, contractual arrangements, and other “risk-minimizing” product features.

### **Assessing the Options**

To assess the viability of any proposed check conversion service, the interests of the parties to a traditional check transaction must be considered.

A commercial entity that accepts payment by check (the “Merchant Payee”) is interested in getting provisional (and ultimately final) credit for customer checks as quickly as possible. The party (business or individual) writing the check (the “Drawer”) wants the payment honored and the personal information on the check protected. The financial institution where the Merchant Payee will deposit the checks (the “Bank of First Deposit”), and the Drawer’s account-holding institution (the “Paying Bank”), want to minimize exception item processing headaches. The Paying Bank also needs to know that the check is “properly payable” under existing law. And of course, all parties have an interest in fraud prevention.

There are several alternatives to traditional paper-based check clearing currently available to Banks of First Deposit, but three of the more popular choices include: (1) presenting the check directly to the Paying Bank in digital form, (2) converting the paper check to an automated clearinghouse accounts receivable conversion (ARC) item, and (3) transmitting the original item electronically to a remote location for creation of a substitute paper ("Replacement Check") item for processing through the financial payment system. Depending on the size and infrastructure of the Bank of First Deposit, any of these methods may involve the use of one or more third-party processors.

1. **Electronic Image Presentment.** If the Paying Agent is equipped to accept check images electronically from the Bank of First Deposit, and the Paying Bank and Bank of First Deposit are parties to an electronic presentment agreement (either bilaterally or through a third-party clearing network), the Bank of First Deposit can electronically transmit to a Paying Bank a file containing the images of Drawers' checks. If a Drawer usually receives cancelled checks with his periodic account statements, the Drawer instead would have access to a check image as well as a line item on the monthly statement reflecting those checks written to Merchant Payees.

2. **Accounts Receivable Conversion.** Under the ARC processing option, the paper check serves as a "source document" that is converted into an Automated Clearing House (ACH) item by the Bank of First Deposit or other ACH processor. Under the NACHA ARC Rules (ARC Rules), a paper check that is converted to an ARC item is not a check for the purposes of the UCC's provisions on negotiable instruments, bank deposits, or collections, or for the purposes of the regulations of the Federal Reserve Board. Under this method of delivery, the electronic transaction is reflected only in a line item on the statement. The ARC Rules prohibit corporate or business checks from being converted to an ARC entry, however.<sup>1</sup>

3. **Replacement Checks.** A Merchant Payee or Bank of First Deposit may also convert original paper checks into substitute items that are presented to the Paying Bank just like paper checks. Under this processing option, an institution can transmit check images and MICR (magnetic link character recognition) data to a remote print center located near the Paying Bank. At the print center, the electronic items will be converted back into paper form and presented to the Paying Bank through the check clearance and payment system. If a Drawer usually receives cancelled checks with his periodic account statements, the Drawer instead will receive a Replacement Check for those checks written to Merchant Payees.

## State Law Issues

There are three main questions that must be addressed under state law, and these relate to whether a check is "properly payable," whether the Drawer has a right to receive cancelled checks, and whether the Drawer has the right to the original check or to a copy.

1. *Is the check "properly payable?"* The UCC provides that a Paying Bank may not dishonor an item that is properly payable without incurring liability to the Drawer.<sup>2</sup> An item is properly payable if it is authorized by the Drawer and is in accordance with any agreement between the Drawer and the Paying Bank.<sup>3</sup>

In the case of ARC transactions, the ARC Rules dispense with this concern by requiring a Merchant Payee to provide a Drawer with a notice that states that the Merchant Payee's receipt of the Drawer's check constitutes the Drawer's authorization of a debt entry to the Drawer's account.<sup>4</sup> In addition, the Bank of First Deposit must warrant to the Paying Bank that

the proper authorization of the Drawer has been obtained.<sup>5</sup> For these reasons, the Paying Bank is not greatly concerned whether an ARC item is properly payable.

Drawer authorization is not the only relevant issue for the question of whether a presented item is properly payable. There is the possibility that checks could be double processed, either through re-introduction of the paper check into the processing system or other processing errors. Under the ARC Rules, the Merchant Payee warrants that the original check will not be presented as a check for payment.<sup>6</sup> In the case of a Replacement Check or electronic image, the Paying Bank would be liable to the Drawer for paying on an item that is not “properly payable.” This suggests that some party needs to assume responsibility for destroying or “voiding” the original check as it is converted to digital form.

2. *What is the Drawer’s right to receive cancelled checks?* Another concern is whether banks employing check truncation would be required, as a matter of state law, to return or make available original cancelled checks to Drawer customers.

We examined the UCC Article 4 and other provisions of roughly half of the states,<sup>7</sup> and discovered, with few exceptions, nothing that would require Paying Banks to provide Drawers with original cancelled checks. Most enacted versions of UCC Article 4 provide that a bank must “*either* return or make available to the customer the items paid *or* provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid.”<sup>8</sup> Thus, the Drawer would not have a right in most states to automatically receive cancelled paper checks.

However, in at least three states (New York, Massachusetts and Maryland), current law requires Paying Banks to at least offer to provide their customers with original cancelled checks. In New York, for example, §9-m of the Banking Law provides that “[a]ny banking institution ... which offers consumer accounts ... which can be accessed by check ... shall offer a consumer account on which the cancelled checks ... drawn on that account are returned to the customer with a periodic statement of the account.”<sup>9</sup> It is unclear whether a bank that offers to return the original checks to the customer would be in violation of §9-m if the customer elects instead to receive checks in imaged form, or not at all.

Massachusetts has complicated the issue by enacting §27 of chapter 167D, which provides that a bank must, if requested by an accountholder, return cancelled checks or, if a cancelled check becomes lost, provide copies of such checks at no additional cost to the accountholder. Section 27 modifies UCC §4-406. On its face, §27 is silent on how checks must be treated in the absence of an accountholder’s request, or whether the right to request a cancelled check can be waived.

Maryland has enacted the standard §4-406, but also enacted other laws imposing three requirements on banks that offer “truncated” checking accounts. First, such banks must “also offer customers a checking account plan that provides for the return of canceled checks on a monthly basis.”<sup>10</sup> Second, when customers open “truncated” checking accounts, banks are required to inform customers of the length of time the bank intends to keep the original cancelled check.<sup>11</sup> Third, when customers elect not to receive cancelled checks, the statute requires banks to, upon request, return any check or check facsimile “for tax audits or litigation,” at no cost to the customer, and to provide a minimum of two checks or copies per month, at no cost to the customer.<sup>12</sup>

3. *Does the Drawer have a right to the original check or a copy?* In the majority of jurisdictions, “[a] customer may request an item from the bank that paid the item, and that bank must provide in a reasonable time either the item or, if the item has been destroyed or is not otherwise obtainable, a legible copy of the item.”<sup>13</sup> New York’s statute makes no mention of a right to obtain copies of checks, but New York State Banking Department staff has told us that they are advising Paying Banks to provide original checks or copies upon customer request, not because it is required by law, but because failing to provide checks or copies would have negative public relations consequences.

While it is probably sufficient to provide a copy of a check in most cases, for some purposes, a copy of a check may not be sufficient. For example, in disputes alleging fraud, the original check may well be necessary in the resolution of the dispute – only from the original check would security devices such as microprinting and watermarks be reviewable.

The answer to this issue could lie in the retention policies adopted by the Bank of First Deposit and Merchant Payees, discussed below.

### **Filling Gaps, Minimizing Risks**

With the silence of the law in the absence of the Check Truncation Act, other issues to be considered include a Drawer’s authorization for check truncation, the length of time that checks, replacements or images must be kept, and warranties from the Bank of First Deposit.

1. ***Drawer Authorization.*** By agreement, the Bank of First Deposit can require its Merchant Payees to obtain from the Drawer his specific authorization to have his checks processed via a check truncation method. This authorization might be the Drawer’s express written authorization (e.g., physical signature), or it may take the form of a disclosure to the Drawer that would explain how his check, if tendered, would be processed by the Merchant Payee. Of course, it would be advisable to give the Drawer an opt-out opportunity.

2. ***Reasonable Time to Retain Checks or Copies.*** Whether the original items must be retained, and if so, for how long, is a matter of state law. The longer the period of time the original items are retained, the less risk to the bank participants. This also raises the question of who – the Merchant Payee, the Bank of First Deposit, or a third party – must accept responsibility for storing the original paper items, but this could easily be resolved by contract.

With respect to Replacement Checks or electronic images, the UCC provides that if the original checks are not returned to the Drawer, “the person retaining the items shall either retain the items or, if the items are destroyed, maintain the capacity to furnish legible copies of the items until the expiration of seven years after receipt of the items.”<sup>14</sup> Banks of First Deposit or Merchant Payees, as the case may be, must follow this guideline.

Even though a copy is often sufficient, there may still be occasions when the Drawer needs an original check for some reason (e.g., certain allegations of fraud or forgery). Merchant Payees and Banks of First Deposit will have to balance the interests of such Drawers against the costs of storing original checks in paper form and determine a reasonable retention period for original checks. This determination will necessarily be based on the risk tolerances of the party retaining the checks, but should consider that account agreements typically require the Drawer to notify the Paying Bank of disputed transactions within 30 days of receiving a periodic statement.

Additionally, the UCC provides that a Drawer must “exercise reasonable promptness” in examining his statement and “promptly” notify the bank of the relevant facts, but allows no more than one year to discover and assert against the Paying Bank a claim of unauthorized signature or alteration.<sup>15</sup>

In the case of ARC, the ARC Rules provide that a check that has been converted to an ARC transaction must be destroyed within 14 days of the settlement date of the ARC entry.<sup>16</sup> The Merchant Payee, as the originator of an ARC order, must retain a reproducible, legible image, microfilm, or copy of the front and back of the original check that is converted to an ARC entry for two years from the settlement date of the ARC entry, and provide the same to the Bank of First Deposit within 10 banking days from its request.<sup>17</sup>

3. ***The Bank of First Deposit Warranty.*** The proposed Check Truncation Act makes a “substitute check” the legal equivalent of the original paper check and codifies rules, warranties, and indemnities that would govern Replacement Checks. Operating in silence of the law as to these issues, it would be helpful for Banks of First Deposit to provide, perhaps in the endorsement, warranties to Paying Banks that, for example, Drawer authorization has been obtained and the original check will not be reintroduced into the payment system, thereby assuring the Paying Bank that Replacement Checks are “properly payable.”

Such warranties are unnecessary where the Paying Bank will be a party to an electronic presentment agreement, either bilaterally with the Bank of First Deposit, or as a party to a clearinghouse agreement. Such agreements will allocate the risk of loss inherent in an electronic presentment transaction.

When a check is presented using ARC, the NACHA Operating Rules<sup>18</sup> provide indemnities and warranties by the Bank of First Deposit that should provide the Paying Bank with sufficient legal comfort to honor checks submitted and processed through ARC.

## **Conclusion**

The Check Truncation Act is currently only proposed legislation, and yet, the absence of its protections do not appear to be hindering product and service development within the industry. Passage of the Check Truncation Act is clearly desirable for the uniformity and predictability it will bring to electronic check transmission. In the interim, however, a carefully crafted program of contractual arrangements and product features should allow those that desire to engage in check truncation to do so with minimal legal risk.

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- 1 NACHA O.R. 2.9.1.
- 2 UCC §§4-401(a); 4-402(a).
- 3 UCC §4-401(a).
- 4 NACHA O.R. 3.6.1 (2002).
- 5 NACHA O.R. 2.2.1.1.
- 6 NACHA O.R. 3.6.4.
- 7 Rather than surveying the relevant law of every jurisdiction, we focused on “key states” that, in our experience, tend to be more proactive on consumer and banking legal issues. While we refer herein to the UCC, we acknowledge that individual states’ enactments can vary substantively from the model UCC provisions, although we discovered a large degree of uniformity among the relevant legal provisions in these states.
- 8 UCC §4-406 (emphasis added).
- 9 N.Y. Banking Law §9-m (2002).
- 10 Md. Fla. Inst. Code Ann. §5-513.
- 11 Id.
- 12 Id.
- 13 UCC §4-406(b).
- 14 UCC §4-406(b): see also N.Y. Banking Law §128 (applying a six-year retention period to “records of final entry,” including checks).
- 15 UCC §4-406.
- 16 NACHA O.R. 3.6.5.
- 17 NACHA O.R. 3.6.3.
- 18 See NACHA O.R. §§2.2 (general warranties and liabilities): 2.9.3.1-.4 (ARC warranties): 2.9.3.5 (indemnity for breach of warranty).

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