Introduction to Check Truncation

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By Alvin C. Harrell

The Check Truncation Act (CTA) also known as the "Check Clearing for the 21st Century Act" or more commonly as the "Check 21 Act" is designed to increase efficiencies in the processing of checks by facilitating the truncation (i.e., destruction) of paper checks by banks, so as to allow electronic processing of the relevant information, without the consent of the owner of the check. The Act authorizes the creation of "check substitutes," as a substitute for destroyed checks in certain circumstances, and provides a new system of warranties and indemnities to supplement certain traditional rights of the holder and/or owner of the check. In addition, consumers and banks are given expedited remedies in the event of disputes over changes to their accounts involving substitute checks.

II. Definitions

The CTA definitions generally follow those of Uniform Commercial Code (UCC) Articles 3 and 4, with a few additions and variations. The terms "account," "depository bank," "collecting bank," "customer," and "person" have largely the same meanings as in the UCC definitions such as "consumer account," "paying bank" (basically the Article 4 "payor bank"), "returning bank" (basically an UCC Article 4 collecting bank), "business day," and "nuncupate item" are derived from (or referenced to) the Federal Expedited Funds Availability Act (EEFA). Terms not otherwise defined in the CTA are referenced to the UCC definitions.

However, the CTA also includes some new, important definitions. The term "check substitute" is defined to include not only the original check but also substitute checks. New terms such as "forward collection," "standardizing bank," "MICR line," "reconverting bank," "substitute checks," and "truncation" are defined. For example, "reconverting bank" is defined as a CTA section 3(13) bank that creates a substitute check, i.e., by re-converting electronic check information back into paper form (or the first bank that creates a substitute check created by a non-bank). "Substitute check" is defined at 12 C.F.R. section 229.2(aas) as a paper reproduction of the original check meeting certain enumerated requirements. These terms provide a glimpse into the thrust and unique purposes of the CTA, although they are defined pretty much as one would expect in this context and do not appear to include any surprises.

The Permanent Executive Board for the Uniform Commercial Code (PEB) provided a comment to a request for the PEB to date March 11, 2004, suggesting various changes to the proposed CTA regulations to improve the relationship between those regulations and UCC Articles 3 and 4. These suggestions included a slight change to the proposed definitions of the terms "transfer" and "consideration," to make clear that the terms have the same meaning as in the UCC and, in addition, for purposes of Regulation CC, instead of including the definition of a substitute checks to a non-bank (e.g., the payor bank customer).

This change makes clear that, unlike the UCC, in Regulation CC, implementing the CTA the warranties, indemnities, and recidivism that accompany the transfer of a substitute check (for consideration will apply to a payor bank delivering substitute checks to its customers with their periodic bank account statements. Note, however, that, customers will have these new rights under the CTA and Regulation CC, while other customers, who receive only substitute check images (rather than substitute checks) will not. This provides a considerable increase for payor banks to move their customers away from both checks and toward more purely electronic systems (where the CTA warranties, indemnities, and recidivism rights will not apply). The PFA adopted this PEB recommendation (clarifying the language, and not otherwise changing the proposed rule) at 12 C.F.R. section 229.2(aas).

On other terminology changes, the PEB suggested that the CTA regulations use the term "take" rather than the term "accept" when offering the consumer a substitute check (e.g., to take the item for value or consideration). Use of the word "accept" in this context in the proposed regulations, could cause confusion for financial institutions responding to the UCC Article 3 concept of "acceptance." (see sections 3-408-3-418). It appears that the PEB considered this advice, although the final regulations are not revised, the term "receive" rather than the UCC term "take" (e.g., the bank that "receives" the item...). The PBE also urged use of the UCC term "person" rather than "party" as in the proposed regulations. It appears that the final regulations.

III. Truncation and Substitute Checks

A. The Basics

The heart of the CTA is the provisions facilitating truncation of paper checks and the use of substitute checks. The term "truncation" means:

(a) No Agreement Required.—A person may deposit, present, or send for collection or return a substitute check without an agreement with the recipient, so long as the bank has made the warranties in section 5 of the CTA with respect to such substitute check.

This is a legal copy of your check: You can use the same way you would use the original check.

The purpose of these rules is to allow the paper check to be truncated and converted to electronic processing, then

CFTA section 4(b) further provides that:

A substitute check shall be the legal equivalent of the original check for all purposes (subject to certain requirements).

These provisions make clear that the purpose of the CTA is to enhance the efficiencies by facilitating the electronic processing of traditional checking transactions (though not by authorizing pure "electronic checks").

A substitute check must accurately represent all information on the front and back of the original as of the time the original was truncated, including all encroachments of parties who have handled the check, in paper or electronic form and in the forward collection or return process.

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reconverted to a paper substitute check as needed, without the need for agreement by affected parties such as the owner’s secondary obligors. As a substitute for the common law and UCC rights of these parties, which may be adversely affected by the truncation, the CTA provides a system of warranties and indemnities.

B. Recommitting Banks

As noted, the term "recommitting bank" is defined at 12 C.F.R. section 229.2(a) to mean the bank that creates a substitute check or that is the first bank to transfer, present, or return a substitute check created by a non-bank (or the first paper or electronic representation of that substitute check). A recommitting bank has certain duties as specified at 12 C.F.R. section 229.51(b), including ensuring that the substitute check (1) bears all endorsements of parties who have previously handled the check in any form; (2) identifies the bank; and (3) preserves the identification of any recommitting bank in accordance with ANSI X9.100-140 and Regulation CC appendix D and (3) identifies the bank that truncated the original check, again in accordance with ANSI X9.100-140 and appendix D.

C. Endorsements

Regulation CC appendix D provides standards for endorsements and for truncating and recommitting bank duties. For example, a depository bank endorsements must include: the bank’s nine-digit routing number, set off by an ‘X’ at each end; the name of the drawer at least; the endorsement date; and the bank’s name or location, if the endorsement is physically applied. Other information may be additionally inluded, e.g., a branch location, a trace or sequence number, and a telephone number for return-item notification, so long as the additional information does not interfere with the readability of the endorsement.

The depositary bank endorsement must be on the back of the check and within certain space limitations (e.g., one and one half to three inches from the leading edge for paper checks, 1.88 to 2.74 inches for substitute checks).

There are also standards for substitute collecting bank endorsements, which must include: the bank’s nine-digit routing number without arrows (but with asterisks if it is also a recommitting bank); the endorsement date; and an optional trace or sequence number. Again there are location requirements: Zero to three inches from the leading edge for paper checks, 0.25 to 2.50 inches from the trailing edge for a collecting or returning bank and also is a recommitting bank.

D. Identification of the Recommitting Bank

A recommitting bank that is a depository, collecting, or returning bank must place its own endorsement on the back of the substitute check in accordance with the standards noted above, as required by Regulation CC appendix D paragraph 3. In addition, if the recommitting bank is the paying bank (the bank that would be the paying bank under UCC Article 4), it must also identify itself by placing its nine-digit routing number (without arrows, but with asterisks) between 0.25 and 2.50 inches from the trailing edge of the substitute check.

In all cases the recommitting bank must also place on the front of the substitute check, outside the image of the original check, its nine-digit routing number (without arrows, but with asterisks at each end), in accordance with ANSI X9.100-140. The recommitting bank also must place on the front of the substitute check, outside the image of the original check, the truncating bank’s nine-digit routing number, without arrows but with a bracket at each end of the number, in accordance with ANSI X9.100-140. All of the above must be printed in black ink.

It is believed that the above requirements, as incorporated in Regulation CC appendix D by the CTA final regulations, address common concerns raised by the FRB on page 6 of its March 11, 2004 Comment Letter to the FRB. The January 2004 proposed regulations would require the recommitting bank to identify itself on the front of the substitute check. The PEB Comment Letter raised the concern that such an identification is not a "true" acceptance as defined in an "acceptance" as defined in the draft under UCC section 3-409. To avoid this, the PEB recommended modifying the recommitting bank identification to the back of the item, or specifying in the form of identification and in Regulation CC that the CTA identifier is not UCC Article 3 acceptance.

In the final regulations and the FRB supplementary commentary on 12 C.F.R. sections 229.35, 229.38, 229.51, and appendix D, the FRB ruled that the identifier required on the face of substitute checks are: (1) to be made outside the image of the original check; (2) to consist only of an identifying number (the routing number, with asterisks to denote a nine digit number) that is considered for identification only and not an acceptance; and (4) not an endorsement.

IV. Warranties and Indemnities

Every bank that transfers, presents, or returns a substitute check (or a paper or electronic representation of a substitute check) for consideration warrants to the transferee and other interested parties (namely, subsequent collecting and returning banks, the depositary bank, the drawer, the payee, the depositor, and any endorser) that the substitute check is not a duplicate substitute check under the original check section 4(b), and that a warranty that pays on the substitute check will not be asked to pay again on the original or a duplicate substitute check.

Specifically, as provided at 12 C.F.R. section 229.52(a), the bank warrants that the substitute check meets the legal equivalence requirements at section 229.51(a)(1)[2] and that the recipient of the check is not entitled to make payment on a substitute check that the recipient has already paid. As noted supra this text at Part II, transfer for consideration includes extended substitute checks returned by the payor bank to customers with their periodic account statements.

The apparent point is to allow each party who handles a substitute check to rely on that substitute check as representing the original check, and to pay or deposit for the substitute check accordingly, by providing a warranty to protect against any resulting loss. These warranties, in turn, create a chain of liability leading to the person who recommitted the check and, presumably, to on the truncating bank.

In addition, CTA section 6 along 12 C.F.R. section 229.53 require a bank that transfers, presents, or returns a substitute check (or a paper or electronic representation of a substitute check) for consideration to indemnify any of the interested parties (enumerated supra) in the first paragraph of this Part IV for any loss incurred by reason of receiving the substitute check instead of the original check.

That indemnity is a true and proper purpose as is in compensation those whose rights may be damaged by reason of truncation of the original check without their permission. The CTA section 6 warranties are separate from the CTA section 6 indemnities, although the two are related. This relationship, and the implications with regard to a specific scenario, may require study and consideration by interested parties.

In the absence of a breach of a CTA section 5 warranty, the amount of indemnification under CTA section 6 is to be the amount of the loss (including interest, costs, and reasonable attorney fees) caused by a breach of warranty under CTA section 5.

If there is no breach of warranty (i.e., the loss did not result from a breach of warranty), the indemnity is for the amount of the loss up to the amount of the substitute check plus interest and expenses (including costs and reasonable attorney fees) and other expenses related to the substitute check. There is also a system of comparative negligence rules, similar to those in UCC Article 4 and the EFTA, for cases where the loss was caused in part by the negligence or lack of good faith of the indemnified person.

The time limit for bringing an indemnity claim, as specified under the CTA, is one year pursuant to 12 C.F.R. section 229.56.

If the indemnifying bank produces the original check, or a copy that accurately represents all of the information on the front and back of the original at the time of truncation or that is otherwise sufficient to determine the validity of the claim, the indemnifying bank is liable under the CTA only for indemnified losses incurred up to the time the copy or information is provided and the indemnifying bank is entitled to any refund of any indemnity paid in excess of those losses. But this does not absolve the indemnifying bank of liability on a warranty claim under the CTA or other law.

Among other things, this allows a customer’s expedited refund rights to provide the bank a claim against the consumer if the customer’s request demand is honored and later turns out to be unfounded.

Notice of a breach must be given within thirty days after the claimant has reason to know of both the claim and the indemnifying bank’s failure to indemnify under 12 C.F.R. section 229.56. Failure to do so discharges the warrantor or indemnifier to the extent the loss was caused by the delay. This is intended to be consistent with UCC sections 4-207(4) and 4-208(1). There is also one year statute of limitation based on the date the cause of action accrues.

In addition, each indemnifying bank is subrogated to the rights of the indemnified party, to the extent of the indemnity, and is also as applicable a bank that pays an indemnity under the CTA can then attempt to recover for breach of warranty (or other claim) from other parties. Under 12 C.F.R. section 229.53(c)(2), each indemnified person has an obligation to comply with reasonable requests for assistance from the indemnifying bank with regard to the latter’s claim for breach of warranty against other persons, relating to the indemnity.

The FRB Section-by-Section Analysis of the proposed regulation (Section 5, Indemnity) includes the following basic example: Suppose a depositing bank creates an illegible substitute check, presents it to the paying bank, and recommitting bank, and the check was not properly payable (e.g., due to forgery or alteration), and a legitimate check is necessary in order to determine that the claim. The paying bank records the drawer’s account, and seeks indemnity from the recommitting bank. If the recommitting bank does not produce the original or a legible copy, the bank must indemnify the paying bank under section 5(a). If, however, the recommitting bank produces the original check or a legible copy, showing that it was properly payable, the recommitting bank is not liable except for losses incurred prior to production of the original check (e.g., by reason of delays in that production), and is entitled to a refund of any indemnitization paid. Likewise, the paying bank as to any record given its...
QUARTERLY REPORT

VI. Delays; Damages; Limitations Period; Consumer Awareness

The CTA section 9 and 12 C.F.R. section 229.56(b) allow exceeded delays for various emergency situations beyond the control of the bank. This applies to have been obtained from UCC section 4(109). CTA section 10 and 12 C.F.R. section 229.54(c) 2 provide a measure of claim for breach of warranty (the amount of the loss by the amount of the check) similar to UCC section 4(105), except that the CTA and Regulation CC additionally provide for recovery of interest and expenses, including costs and reasonable attorney fees. This change may have a significant impact on the dynamics of the litigation in this area of law.

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### Check 21 Matrix
(From perspective of payor bank customer)

<table>
<thead>
<tr>
<th>Customer receives substitute checks with bank statements</th>
<th>Customer does not receive substitute checks with statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Payor bank is the reconverting bank.</td>
<td>1. Payor bank is not a reconverting bank.</td>
</tr>
<tr>
<td>2. Payor bank creates substitute check, makes CTA warranties and indemnity.</td>
<td>2. There are no substitute checks or CTA warranties or indemnity.</td>
</tr>
<tr>
<td>3. Payor bank provides expedited recredit right.</td>
<td>3. There is no CTA expedited recredit right.</td>
</tr>
<tr>
<td>4. Payor bank gives CTA customer disclosures.</td>
<td>4. No CTA disclosure is required.</td>
</tr>
<tr>
<td></td>
<td>5. All issues are governed by agreement of the parties; the CTA does not apply.</td>
</tr>
</tbody>
</table>

This matrix makes clear the incentives built into the CTA for banks to steer their customers away from substitute checks and toward purely electronic alternatives such as check imaging, ACH payments, and statement accounts. The costs and risks associated with substitute checks may mean that the charge to customers will increase significantly, providing an incentive to customers to avoid receiving substitute checks. Moreover, it seems likely that only the most credit-worthy customers will be able to qualify for substitute check accounts, due to the inherent fraud risks. This may reverse a fifty year trend of increasing the availability of full-service consumer checking accounts.

Finally, in the immediate aftermath of the October 28, 2004 effective date of the CTA, your author received isolated reports indicating that surprisingly few substitute checks were being created, and reporting instead an increase in check-generated ACH transactions. While these reports were very preliminary, and further experience may prove otherwise, it is possible that these reports indicate the beginning or expansion of a trend: That, instead of making the check collection system more competitive, the CTA is having the opposite effect and is encouraging a further expansion of alternatives such as the ACH system.