Some Surprising New (and Old) Perspectives on Check-Kiting

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QUARTERLY REPORT

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By Alvin C. Harrell

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often happens, a recent review of the is-

sue revealed some surprising (and

old) developments.

Check-kiting has long been something of a sleepy backwater in banking and

commercial law. A review of several

well-regarded banking law texts failed to

discuss check-kiting at all, even a reference to check-kiting under Article

3, a very different standard from that in-

volved in the criminal check-kiting cases, laws, and regulations.

Edinburgh in fact represents a tradi-

tional type of "check-kiting" case: one that involves check-kiting as it relates to

"notice" under the UCC for holder-in-

due-course purposes, but implicates no

criminal law or reporting issues. Edinburgh provides a fairly low defini-

tional "trigger," sometimes interpreted with the related "good faith" issue.

This version of "check-kiting" issues has gen-

erated many law review articles, and is well deserving of separate treatment.

But it should be carefully distinguished from other types of "check-kiting" issues, e.g.,
those involving allegations of criminal activity, as the standards for the two cases

typically differ very significantly. As

we shall see, some of the current prob-

lems in check-kiting may derive from a failure to recognize this distinction.

The "Check" section also cites State

v. Woodington, a criminal check-kiting case in which the defendants were

prosecuted under a Wisconsin criminal statute, for submitting false financial

statements to the state Department of

Securities. The financial statements were

inflated by a check-kiting scheme, essen-

tially defined as a mutual exchange of worthless checks drawn on different

banks "occurring for some time." This is

about as good a definition as any court has provided, though the Black's dictio-

nary definition hardly describes the

Woodington court's test, or distinguish it from UCC issues noted above. Thus,

not surprisingly, the dictionary definition of "check-kiting" are illustrative, not
dispositive, and are very broad, and could include an interested party who con-

cludes his or her research at that point.

To your author's knowledge, there is no

applicable statute or regulation that

adequately defines "check-kiting" in a

legal sense, and the best of the cases

attempt little more than to illustrate the

concept, on a case-by-case basis. Thus,

unlike "check-kiting" involved ordi-

nary NSF checks, there is a large number of those checks would constitute illegal

transactions, and there would be a

huge increase in business for the crim-

inal reporting system and enforcement

agencies.

II. "Check-Kiting" Is Not a Defined Term

Check-kiting is a little like "predatory

lending," in that it has been often illus-

trated, but never fully defined in an

adequate or uniform manner. Like preda-
y

tory lending, some apparently believe that

they will "know it when they see it," and

that is enough. Indeed that may be

enough, for purposes of assessing bank-

ing and business risks. But it is not

enough as the basis for legal rules and
criminal penalties that could be trig-
gered by a single "check-kiting" incident.

Clearly a more specific and objective

standard is needed for such purposes.

Ballentine's Law Dictionary (1969) de-

fines "check-kiting" as a practice "not

rarely seen in the banking community, and

is entirely consistent with the law as

comprehended by the courts. . . ."

And it is a close lean on meaning,

meaning different things for different purposes, used more often to describe aggrega-
tive behavior than to define it. But this may be changing, as check-kiting issues
coupled with a number of other, related issues to create some new causes of ac-

tion, banking risks, and compliance burdens.

1. Introduction

Your author thought he knew a little

about check-kiting, having studied and

written about this and related issues prob-

ably as much as the next person. But, as

often happens, a recent review of the is-

sue revealed some surprising (and

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III. ADVISORY LETTER

In the Office of the Comptroller of the Currency (OCC) issued an Advisory Letter on check-kiting. This Advisory Letter is a mixed bag, containing useful information but also clear indications of why not all checks are honored in a timely manner.

The Advisory Letter provides guidance on how to identify suspicious activity involving the use of illegal check-kiting schemes, and offers recommendations for banks on how to respond to such activity. The letter also discusses the potential risks associated with check-kiting and provides guidance on how to identify and prevent potential deceptive practices.

This letter suggests a focus on the financial risks posed by check-kiting, emphasizing the importance of monitoring and reporting suspicious activity. The letter also highlights the potential for banks to collaborate with law enforcement to address this issue.

The letter concludes with recommendations for banks to monitor their own check-kiting activities, and to work with other financial institutions to prevent these activities from spreading.

The OCC Advisory Letter serves as a useful tool for banks in identifying and preventing check-kiting activity, and provides a framework for banks to address this issue in a comprehensive manner.

IV. OCC ADVISORY LETTER

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V. EXTREME VIEWS ON CHECK-KITING ISSUES IMPlicate CRIMINAL REPORTING REQUIREMENTS, BONNE PROTECTION PLANS, BANKING CRIMES, AND THE PAYMENT SYSTEM

The confusion evident in the discussion of the potential risks and status of NSF checks and "check-kiting" as criminal behavior may become even more problematic when coupled with increased awareness of the risks and criminal activity that poses.

The courts, in defining "check-kiting" broadly to include many NSF checks for certain non-criminal purposes, e.g., fraud, may inadvertently facilitate such conduct, especially when state-of-the-art electronic systems, e.g., real-time, on-line, or near real-time, mechanisms, may have understood, and anticipated, that check-kiting per se
is not illegal. But those definitions may be picked up and used by others who intuitively believe that check-kiting, however defined, is or should be a crime. The result could be to criminalize a considerable number of the roughly 445 million NSF checks written each year, and then to interact with other laws to create new liabilities and disruptions for banks and their customers nationwide. Countries that previously have allowed "check-kiting" to be deemed included in ordinary commercial transactions without the kinds of limited parameters customarily recognized in commercial crises like the case of 

"or unusual lifestyles, or suspicions about
unwise transactions," Nor does the SAR require the bank's reporting of non-criminal activity that somebody might regard as inappropriate or "suspicious" in any general or financial sense. Federal law does not require reports based on, e.g., odd behavior generally, like throwing gasoline on this fire, reinforcing arguments that there is a new, affirmative duty for banks (and others) to look out, search, investigate, and report a wide array of non-criminal behavior that someone might consider broadly suspicious or "obscene." Every time a Kansas bank customer in a position of "trust" or another party conducts a banking transaction that the other party considers to be "obscene," the aggrieved party may have a claim against the bank for failing to discover and report (and thereby render preventable) the bank customer's obscene behavior. Cases like Eisenberg v. the U.S. Supreme Court's decision in Williams,14 and most of the other authorities cited in this article, along with 200 years of banking law and practice, may have been significantly overrated by state legislators and regulators inadverting to bring any ordinary NSF checks under the rubric of financial abuse and criminal "check-kiting," thereby requiring criminal reporting of these customary and lawful transactions. For instance, plaintiffs' attorneys may now have a new basis or suing the bank every time a customer suffers "financial abuse" by reason of an NSF check, if the bank has previously failed to report it to the proper authorities for "check-kiting" and "financial abuse." VI. It Couldn't Really Happen, Could it? A. Components of the Problem At this point the reader may have concluded that all of this is just a chattering aside to be outside the realm of serious possibility. No responsible person would go so far as to interject the criminalize ordinariness to the time of maybe 445 million per year) NSF checks, especially as courts from the U.S. Supreme Court on down have specifically rejected the notion. Don't be so sure. As noted, there may be a political dynamic at work here. Check-kiting, like predatory lending, is intuitively a bad thing. Perhaps with the opportunity to stamp it out without much further thought (except, perhaps, to make sure what it is). If a court, considering testimony from accountants on a largely unrelated holder-in due-course issue, decided that every NSF check is a check-kite, and that if that is sufficient for the definition of check-kiting in Black's Law Dictionary, then why shouldn't that also be a sufficient definition of unlawful activity for another court, or a cautious banking regulator? In some venues, the innocent and ordinary NSF check thus becomes a check-kite, perhaps triggering state and federal criminal referral and SAR requirements and other assorted obligations and liabilities that were created on the assumption that they apply only to illegal activities. Still unconvinced? Several banking departments have apparently taken something like this position, and the OCC Advisory Letter (discussed supra at Part IV) can be read to support it. As previously reported in this journal, the Indiana Department for Financial Institutions (DFI) has indicated that it should reject the following of an NSF check as constituting a criminal activity, thereby triggering the full range of consequences, reporting requirements, and potential consequences noted above at Part V. But the OCC did apparently raise the same issue.13 Reportedly the Indiana DFI also wants banks to significantly raise their NSF fees to customers, an interesting step toward privatizing the regulatory function that is likely to come true once banks
understand the new legal risks being cre
ated by the DFI view. It is a small step from this to a plaintiff's lawyer realizing that a bank's failure to report its customer's NSF checks to the proper authorities, under state financial abuse reporting laws, might subject the bank to a criminal "check-kiting" charge and thereby compound the fraud that has already been perpetrated against the bank's customer in violation of the law's purpose to protect the public from financial abuse.

The issue may also arise in the context of state banking laws or regulations requiring a criminal referral for such things as theft, embezzlement, "check-kiting," misappropriation, or other deficiencies. Your author views this kind of rule as requiring a crimi
nal referral only if there is a suspicion of a crime, e.g., a defalcation, which is typically defined as an embezzlement or criminal misappropriation of funds.2

Thus would be consistent with the courts' interpretation of the equivalent federal rules. "Thus a check-kite would be reportable as a criminal referral only if it meets the traditional tests for criminal activity, e.g., theft, defalcation, or other violation of fraud, theft, or tender.

"b. Legal Sanctions Against Work"

It may be appropriate to consider fur
ther the interplay between the concepts and rules at work in these scenarios. The problem may begin with a regulatory interpre	ation that broadens the definition of "check-kiting" or "productively" brings NSF checks within a criminal referral or financial abuse reporting requirement, potentially equating NSF checks with thefts of the state law by the bank's customer. As noted above, certain state and federal jurisdic
tions have interpreted a referral requirement to broadly define a crime. Thus, a state law or regulatory interpretation of a reporting requirement may broadly recognize a duty to file a criminal referral report for activities such as "financial abuse" or "check-kiting," which are not easily defined and as defined by the courts are not necessarily illegal.3

Any of these scenarios could result in a requirement to file a referral report covering lawful NSF activity. A failure to file the required report could then provide the basis for enforcement actions and/or private litigation.

Some regulators have apparently accepted a very broad definition of "check-kiting," perhaps incorporating concepts from "check-kiting" cases which were based on the minimal and unrelated level of notice needed to bar holder-in

"c. Legal Sanctions Against Work"

documents, the plain meaning of the reporting rules in question, is that a refer
ral report is required upon suspicion of a check-kiting scheme or financial abuse that would constitute a defalcation or other crime, i.e., would violate the law.4

Thus, for example, the broad meaning of "check-kiting" or "financial abuse" under the definition used by state or federal regulators may broadly encompass the federal crime of fraud or financial abuse. The former, for example, is an example of fraud, while the latter would be a violation of the state's consumer protection laws. This could thus subject some accounts to a referral requirement for activities that would not otherwise trigger such a requirement.

Furthermore, this broad interpretation could subject some activities to referral requirements that would not otherwise trigger such a requirement. For example, a bank might be required to file a referral report for activities that would not otherwise trigger such a requirement.

b. Privacy and Damages

In addition to the potential for viola
tions of criminal laws, financial abuse statutes, and criminal referral requirements, a number of common NSF checks as check-kiting and potential criminal activity, and the obvious risk to bounced protection pro
grams if NSF checks are deemed to be broadly illegal, there are other emerging risks for banks in this situation. This is not the place for a full restitution of custo
mers' privacy rights, e.g., under the Gramm-Leach-Bliley Act (GLBA) 5 and the Right Financial Privacy Act (RFPA) 6

The RFPA is a federal law that protects against illegal disclosure of personal financial information by banks and other financial institutions. The law was enacted to provide consumers with greater control over their personal financial information. It requires financial institutions to disclose to customers information about their right to control their personal financial information. The law also requires financial institutions to obtain a customer's written authorization before disclosing their personal financial information.

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These statutes can be interpreted to re
quire reporting of common commercial transactions, e.g., NSF checks or "check-kiting," that are deemed "abusive" in some particular way. These statutes also could be viewed as creating new sub
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could not be a holder-in-the-course.68 Similarly, a bank which sells a check-kite and in bad faith attempts to shift the loss to another bank may have to absorb the loss.69 But these are ordinary UCC good faith issues, not matters of criminal law or financial abuse.

The concept of good faith in the 1998 revisions to the uniform text of UCC Article 3 may have a significant impact on the law pertaining to check-kiting schemes. Previously, the applicable standard of good faith meant simple, usually subjective, "honestly in fact."70 In the 1990 revision to the uniform text of Art. 3, honestly in fact is supplemented with an additional requirement for "observance of reasonable commercial standards of fair dealing."71 The revision to article 4 revised UCC section 3-103 explains:

The definition of [good faith] requires not only honesty in fact but also "observance of reasonable commercial standards of fair dealing." Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely separate and distinct concept than failure to deal fairly in conducting the transaction. Both fair dealing and ordinary care...are to be judged in the light of reasonable commercial standards, but those standards in each case are directed to different aspects of commercial conduct.

The definition of "good faith" has raised some new issues with regard to how "fair dealing" should be determined, and has made it significantly more difficult for holders-in-course to qualify as a bank for purposes of a commercial paper law.43 The result seems to be a greater likelihood that awareness of any kind of "check-kiting" operation which fails to impose sufficient notice and bars a bank from holder-in-the-course status, regardless of whether banking regulators treat such activity as requiring a SAR.

IX. Conclusion

It is important to recognize that check-kiting, at least to the extent the term includes ordinary NSF transactions, is not necessarily a criminal, abusive, or suspicious activity. It is easy to associate the term "check-kiting" with crimes such as fraud, embezzlement, or even money-laundering, and in a given scenario that may be the case, but these other crimes also include well-defined, wrongful behavior while check-kiting does not.

Knowingly and purposefully to impose criminal referral or other reporting requirements on NSF checks involves, in the form of "check-kiting" or "financial abuse," behavior without room for interpretation that is inherently meaningful, absent an interpretation that includes an appropriate definition of the operative terms, and those requirements should not be taken to encompass ordinary NSF transactions. If there is no meaningful definition of the trigger terms, further guidance must be provided by regulators or the courts, before such requirements can be properly applied. Thus, suspicious activities and financial abuse reporting laws need to be cautiously considered and interpreted in this context, by legislators, lawyers, regulators and the courts.

To date the courts, including the U.S. Supreme Court, have spoken with some clarity on these issues. It is not a crime to merely write and/or deposit a NSF check without any discriminatory intent, misuse of a position of trust, a pattern of multiple exchanges of worthless checks, or some other delicta- tion.71 A crime is committed only when all of the $4.5 million NSF-checks written each year are not evidence of a crime. Those who assume that writing or depositing of an ordinary NSF check is check-kiting, which equates a crime and therefore requires a SAR or similar report, are simply wrong.

Fraud, embezzlement, and money-laundering are crimes. Writing and/or depositing an NSF check, overbidding a bank account, or "riding the float," is not per se a crime. These may have financial implications; they represent business risks and opportunities for banks, and should be addressed and managed accordingly. But absent criminal implications, these are business decisions, to be handled by contract or similar arrangement between the bank and the customer based on risk profiles and customer service considerations. Bounce protection programs are but one example. This may or may not be "check-kiting," depending on how that term is defined; but alone it is clearly a commercial transaction, not a criminal, abusive, or even a suspicious activity.

This analysis may require subtle, even lawyerly distinctions, as opposed to a knee-jerk reaction that check-kiting and NSF checks are bad and therefore must be suspicious or unlawful. It may be difficult to recognize that some forms of "check-kiting" are a lawful activity. But making such distinctions is what lawyers, banks, courts, and bank regulators do, or at least are supposed to do.

In many cases, that role includes making and articulating meaningful distinctions between: (1) "check-kiting" in the form of ordinary NSF transactions that are not fraudulent, suspicious, or illegal; (2) check-kiting that may constitute an irregularity and serve as notice to book holding banks in out-of-state states, but that is not criminal (the issue in much of the commentary and reported case law); and

(3) check-kiting that involves a significant potential for fraud, breach of trust, or other deliction in a criminal sense. Criminal referral procedures, financial abuse reports, and SAR requirements are properly directed only at the latter, and should not be interpreted to charge the former.

Appendix

Check-Kiting, Funds Availability, Wire Transfer Activity

OCC Advisory Letter AL-96-6, August 6, 1996

Purpose

The Office of the Comptroller of the Currency wants to ensure that all national banks prudently manage the risks posed by fraudulent activity involving the use of illegal check-kiting schemes, and to provide useful information to help bank management identify and prevent potential deceptive practices.

Background

The OCC has become aware of instances where banks have incurred significant losses through elaborate schemes to draw against uncollected funds. Typically the banks are most susceptible to this type of fraud do not have proper internal controls and reporting systems to monitor title and other suspicious activity, or have failed to properly enforce internal procedures that already exist. In addition, liberal practices regarding funds availability and wire transfer activity further increase the potential for loss.

Summary

Check-kiting may occur in various ways, and involve numerous financial institutions. The underlying promise is the customer's ability to gain access to deposited funds before they are collected from the institution on which they were drawn, often, exceptions to sound internal controls for approving drawings against uncollected funds, overdrafts, and wire transfers become a routine practice in many institutions. Since these exceptions do not frequently involve fraud or translate to losses, it becomes easier for bank employees and management to overlook the risks involved.

To combat check-kiting the board and senior management need to ensure the effectiveness of internal controls used to identify suspicious activity and minimize risk. While fraudulent conduct cannot be detected or prevented in every case, there are certain minimal controls that should be implemented to reduce the likelihood that a check kiting will go unnoticed. The types of internal controls which banks should consider include:

- Official approval on drawings against uncollected funds, over- drafts, and wire transfers. Such activity should be reviewed and authorized by someone in the bank's senior management. The process for approving such requests should be documented and available to bank auditors, examiners, and other personnel in the bank.

- Daily reports on drawings against uncollected funds, overdrafts, large items, and significant balance changes.

- Designated individual to regularly review internal reports to spot unusual transactions, and to ensure proper investigation when warranted.

- Secondary level of administrative control that is distinct from other leading functions to promote objectivity when granting significant drawings against uncollected funds or overdrafts.

- Frequent requests by the customer for account balances, which is required to receive approval of the transactions before an overdraft activity report is forwarded.

- Periodic review through an independent audit function to assess and report on the adequacy of all established internal controls in this area.

In addition, although banks are required to adhere to the time frames on availability of funds established by Regulation CC, 12 CFR Part 229, bank management should also be aware of the regulation's exceptions to the normal availability schedules, and use those exceptions in circumstances require. See 12 CFR 229.11 and related commentary at Part Appendix E.

With proper controls, banks will increase their ability to flag suspicious activity. Although not all questionable conduct is the result of fraud, the board and senior management should recognize potential warning signs and monitor each such conduct to help identify potential illegal activity. Examples of suspicious circumstances which may indicate a check-kiting scheme include:

- Several accounts with similar names, owned or controlled by the same individuals.

- Regular or excessive drawings against uncollected funds.

- Frequent daily negative ending balances or overdrafts that eventually get covered in a short time frame.

- Identifiable patterns of transactions such as deposits, transfers between accounts, withdrawals, and wire transfers, often with similar or increasing amounts.

- Deposits of large checks drawn on out-of-area banks or foreign banks.

- Frequent requests by the customer for account balances.


70. 12 U.S.C. § 3591 (Ally’s) (emphasis added) (Virgil, supra).
71. See 18 U.S.C. §§ 1014, 1029(a), (b), (c), (4) (criminal conduct related to the use of a computer), 18 U.S.C. § 1030 (criminal activity including, but not limited to, fraud).
collected items, or cleared items.

- Deposits drawn on other institutions by the same maker or signer.

- Large debits and credits of even dollar amounts.

- Frequent check withdrawals to the same institution, with the maker listed as payee.

- A low average daily balance in relation to deposit activity.

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The Conference on Consumer Finance Law was organized approximately 76 years ago by leaders of the American Bar Association and the financial services industry. Membership dues are $75 per year, and this includes a subscription to the Quarterly Report. Members should have demonstrable expertise in the field of financial services, including but not limited to: consumer credit, secured transactions, real estate, banking, bankruptcy, or debtor-creditor law. If you would like to become a member or if you know another who meets these qualifications and would like to recommend him or her for membership in the Conference, please forward name and a summary of professional background, along with your recommendation, to the Editor of the Quarterly Report.

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