

**CHECK 21: CHANGES AHEAD FOR MUTUAL FUNDS
AND THEIR CHECKWRITING PROGRAMS**

The Check Clearing for the 21st Century Act (“Check 21”) takes effect October 28, 2004. This legislation permits anyone in the check collection system to convert an original check into a “substitute check” and deposit, present or send the substitute check for collection, instead of the original check. Check 21 is intended to speed up the collection of checks and to prepare the system for electronic check collection, without at this time requiring banks to receive checks electronically. This memorandum is to alert you to this important change in our evolving payment system.

Substitute Checks

A substitute check will be a paper reproduction showing the front and back of the original check. Check 21 will permit a bank of first deposit, for example, to transmit an image of the original check to an agent located near the payor bank, so that the agent may print the image and create a substitute check for presentation, thus avoiding the physical transportation of the original check. This shortcut will not require the payor bank that receives the substitute check to do anything different; it will receive a paper check that can be processed in the same way as the original check. There are standards for the creation of substitute checks, of course, and a proper substitute check is the legal equivalent of the original check for all purposes. Among other things, it may be returned to the drawer in lieu of the original check.¹

Warranties. A bank that transfers, presents or returns a substitute check *warrants* to the transferee bank and all subsequent transferee banks, as well as the depository bank, the payor bank, the drawer, the payee, the depositor and all endorsers—

- first, that the substitute check satisfies the applicable standards, and
- second, that no depository bank, payor bank, drawer or endorser will receive presentment or return of the substitute check or the original check, or a paper or electronic copy of either of them, and be asked to make a payment based on the check that the depository bank, payor bank, drawer or endorser already has paid.

The latter warranty is intended to shift one of the risks raised by the creation of a substitute check to the party who creates it. The problem is that a substitute check, unlike an original check in the present payment system, is easily reproduced. With sufficiently lax security, a check could be reproduced several times and presented more than once to the payor bank. There may be some question as to whether the legal right under this warranty is adequate compensation for an actual loss of the size typical in check fraud, which often is too small to permit vigorous pursuit of a claim.

¹ The Board of Governors of the Federal Reserve System has adopted final regulations under Check 21 (*Federal Register*, August 4, 2004 (47290-47328)) in Regulation CC.

Indemnity. A substitute check will not be as useful as the original check in detecting or proving forgery, alteration, forged endorsement or other forms of check fraud. A condition of converting an original check to a substitute check is that the converting bank or, if the substitute check is created by a person who is not a bank, the first bank to transfer the substitute check (in either case, the “reconverting bank” under the statute) and each bank that transfers the substitute check subsequently, must *indemnify* the transferee bank and all subsequent transferee banks, as well as the depository bank, the payor bank, the drawer, the payee, the depositor and all endorsers—

- against a loss that is due to receipt of the substitute check rather than the original check.

The reconverting bank must identify itself on the substitute check. An indemnifying bank may cut off the indemnity by producing the original check.

Expedited Recredit—for Consumers. This indemnity may be a satisfactory legal remedy for the loss of access to the original check when a check has been forged or altered, but it can hardly be a practical remedy for an individual who no longer can obtain the original check in order to show his or her bank that the check has been forged or altered. Check 21 addresses this problem by granting a *consumer* the right to make a claim against his or her payor bank for *expedited recredit* of the account if the payor bank has charged the account for a substitute check and the charge was improper or the consumer has a claim for loss under a warranty related to the substitute check. The consumer must submit a claim for expedited recredit within 40 days after the later of receipt of the relevant account statement or receipt of the substitute check. The consumer’s bank must recredit the account for the amount of the substitute check (unless it has provided the original check) within the earlier of ten business days or one business day after determining that the consumer’s claim is valid.

A “consumer” is an individual who draws a check on a “consumer account,” which is an account used primarily for personal, family or household purposes. Banks must provide their consumer customers with notices that explain substitute checks and expedited recredit rights. At least two important groups of checkwriters who are not “consumers” will not enjoy expedited recredit rights: those who are not individuals and those who draw checks against accounts that are not consumer accounts.

Checks Drawn by Mutual Funds

The first group of non-consumers includes corporations, partnerships, limited liability companies, trusts, and even associations and clubs, as well as sole proprietorships. This includes mutual funds, which write a lot of checks. Currently, when a check drawn by a mutual fund is altered, the fund can obtain the original check, examine it, and determine whether it has been altered and whether the fund has a claim against its bank. Now it will need to rely on its records to convince the bank that the check that the mutual fund wrote was different from the check that was presented. It will not have a right of expedited recredit.

Forged endorsement does not present much risk to drawers of checks. Those who deposit checks bearing forged endorsements normally bear the resulting losses, because they warrant to everyone downstream in the collection system that existing endorsements are valid. It is the bank of initial deposit that has the opportunity to detect a forged endorsement—the endorser is its customer—and that bank will handle the original check, not a substitute check, at least initially. Check 21 won't change the position of a mutual fund that writes checks with respect to forged endorsements.

Provided that banks will accept the records of their business customers to prove that checks have been forged or altered, Check 21 should not make a great deal of difference to mutual funds in their capacity as drawers of checks.

Checkwriting Programs

The second group of non-consumers includes shareholders who participate in mutual fund checkwriting programs. These programs generally involve omnibus accounts held by agents of the mutual funds for their customers.² Customer checks are presented each day to the mutual fund's service provider, which debits shareholder accounts and pays the checkwriting bank the amount necessary to pay the checks. The shareholders who participate in these programs write checks on accounts that are not their accounts and are not consumer accounts, and so they will not have expedited recredit rights.³ When their mutual fund accounts are charged for checks they did not write, or for checks that have been altered, these shareholders will have to satisfy the mutual fund that they did not write the checks, or that the checks were altered. They will not have original checks to help them. Even when they are successful, they may be without funds for extended periods of time.

As consumers become aware that they have expedited recredit rights for checks they write in their bank accounts, they will become aware that they do not have these rights for checks they write in checkwriting programs of mutual funds. Indeed, in order to avoid confusion, mutual funds may wish to provide notices to their shareholders who participate in checkwriting programs that explain briefly the nature of substitute checks and inform shareholders that expedited recredit rights are not available in those programs. This is bound to be perceived by consumers as a disadvantage associated with such programs.

² The same will be true for customers of securities brokerage firms who participate in the firms' checking programs.

³ A Regulation CC commentary includes the following two sentences on the definition of "consumer account":
A clearing account maintained at a bank directly by a brokerage firm is not a consumer account, even if the account is used to pay checks drawn by consumers using funds in that account. The bank's relationship is with the brokerage firm, and the account is used by the brokerage firm to facilitate the clearing of its customers' checks.

Brokerage firm checkwriting arrangements do not differ materially from mutual fund checkwriting arrangements.

Checks Received by Mutual Funds

Mutual funds not only write checks and offer checkwriting programs, they also receive checks from investors. Currently, they are at risk for receiving and depositing checks with forged endorsements, to the extent they accept third-party checks, because as depositors they warrant the validity of existing endorsements. They are less at risk, however, for receiving altered and forged checks because their transfer agents or other service providers have an opportunity to detect alterations by examining the checks they receive. After Check 21 takes effect, a mutual fund's transfer agent will have the same opportunity as now to examine each check it receives. But, if it fails to detect an alteration in the course of the necessarily routine and cursory examination of a check received in the mail, then, later, when the substitute check of the altered check it did not notice is returned, the mutual fund and the transfer agent will be at a disadvantage in determining whether the altered check should have been detected in the first place. Without the original check it will be much more difficult to see that someone has changed Three to Thirty or added a word to the payee's name or otherwise altered a check to his or her advantage, and it will be impossible to determine how obvious the alteration was on the original check. I have seen a check on which carbon typewriter characters were erased, oh so carefully, probably with one of those scratchy gray erasers we used to have for erasing ballpoint writing, and you could barely detect the alteration with the original in hand. On a substitute check the alteration would have been undetectable and the subtlety of the alteration would have been impossible to judge.

In order to see how this will affect a mutual fund, let us consider an example. ABC Funds receives a check drawn by Telephone Company for the benefit of John Doe and payable to ABC Funds in the amount of \$30,000. The fund's Transfer Agent examines the check routinely, finds nothing amiss, and endorses and deposits it. The depository bank converts the check to a substitute check, destroys the original check, and presents the substitute check to the payor bank, which pays it. Telephone Company discovers that it did not write a check in the amount of \$30,000 to ABC Funds (but wrote a check of the same number and date in the amount of \$3,000 to ABC Foods). It has never heard of John Doe. Telephone Company obtains the substitute check and, using its records, demonstrates to its bank that the check must have been altered and should not be charged against its account. The payor bank recredits the account and returns the check to the depository bank, which debits the ABC Funds account and notifies Transfer Agent of the alteration. John Doe has redeemed his shares by this time and cannot be found.

The alteration, being done well, is impossible to detect on the substitute check. The question for ABC Funds is—was the alteration reasonably detectable on the original check? If so, ABC Funds will hold Transfer Agent accountable for its error in failing to detect the alteration; if not, ABC Funds will have to accept the loss. But ABC Funds cannot get the original check and, without it, ABC Funds cannot make a rational determination.

ABC Funds can assert against the depository bank (which is the likely reconverting bank) a claim under the indemnity against a loss that is due to receipt of the substitute check rather than the original check. Or can it? Whether the mutual fund will be able to prove, and whether it can afford to prove, that it has incurred a specific loss by being deprived of the original check is an interesting question.

This is a new hurdle—remember, ABC Funds is merely trying to ascertain whether its transfer agent erred in not catching the alteration. Check 21 provides that, when there is no claim under one of the warranties described above, the reconverting bank’s indemnity covers “the amount of any loss, up to the amount of the substitute check,” along with reasonable attorney’s fees, costs, interest and other expenses. The loss suffered by ABC Funds due to the unavailability of the original check is the loss of the opportunity to determine whether its transfer agent made an error in not detecting the alteration. Whether such a loss will be covered by the reconverting bank’s indemnity and whether it will be feasible to make the claim for this loss are questions that remain to be answered.⁴

Check 21 takes effect on October 28. Those of us who receive original checks with our account statements will begin to find some substitute checks among them. Undeniably, these will not be as helpful to us as the originals. Check 21 is a step toward the electronic collection of checks; the transition is bound to be bumpy and both consumers and businesses who write and receive checks should prepare for this change in the check processing and collection system.

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⁴ The Conference Report for Check 21 (H. Report 108-291, 108th Cong., 1st Sess.) is silent on the question as to whether the indemnity covers such a loss, as is Regulation CC. New sections of the commentary for Regulation CC also do not address this question. An example in the commentary makes clear that a bank that issues a cashier’s check that is altered and then converted into a substitute check has an indemnity claim if it can show that its fraud detection procedures could have detected the alteration of the original check, but could not detect the alteration as depicted on the substitute check. In our example, however, ABC Funds is trying to determine whether its transfer agent’s fraud detection procedures—routine examination of every check received—should have detected the alteration. This is a different question.