The Check 21 Indemnity Provision, Remote Deposit Capture, and Check Fraud…in Layman's Terms

The Check 21 Indemnity provision is an obscure part of the Check 21 rules that will seriously affect an organization's liability for check fraud, under certain conditions. Because this provision is buried on page 58 of the 100+ pages of rules, very few people, including bankers, are aware of it, and even fewer fully understand its implications. When organizations understand the Indemnity provision, they are usually motivated to use high security checks. Therefore, it would be important for those in an organization who are responsible for check fraud prevention, and/or responsible for obtaining checks, to understand and be able to explain this law to their colleagues and superiors.

The Indemnity provision is somewhat difficult to understand if one is wading through the legalese included in most articles written about the subject. The following is a brief, understandable description of the Check 21 Indemnity provision and how it relates to Remote Deposit Capture and check fraud.

Check 21 is a banking law that was passed in 2004 which gives financial institutions, or other organizations, the right to make electronic images of the paper checks they receive, to process those electronic images instead of the original paper checks, and to shred or otherwise destroy those paper checks after a period of time. If necessary, they can print a copy of the electronic image, which is known as a "substitute check" or Image Replacement Document (IRD) to replace the original check.

The right to image and then shred the original check raises the question, "What if a fraudulent check is imaged and then shredded?" The Indemnity provision answers that question.

The Indemnity, in its most basic terms, provides that if a loss occurred because the paying bank received a substitute check instead of the original check, a claim can be filed against the bank that presented the substitute check to the paying bank. The claim can be filed if <u>two</u> conditions are met.

<u>First</u>, the original paper check had to have security features that could <u>not</u> be seen in the substitute check. These are known in the banking industry as features that "do not survive imaging." *[When someone refers to a feature that "does not survive imaging," it does <u>not</u> mean that the imaging process somehow destroyed that feature and it no longer exists on the original check. It simply means that you cannot SEE that feature in the electronic image or the substitute check made from that electronic image.]*

Features that do not survive imaging include a true watermark in the paper, thermochromatic (heat sensitive) ink, chemical sensitivity, etc. Not surprisingly, these also happen to be some of the best features to prevent check fraud in the first place.

<u>Second</u>, the dollar amount of the check had to be sufficiently high that the paying bank would have physically inspected it for those security features to make sure it was authentic, if it had received the original check instead of the substitute. This is known as the Sight Review process, and every bank has a different threshold. For example, one bank might have a threshold of $5000, and every check that is over $5000 will be physically inspected. A different bank might have a threshold of $50,000. It may be of interest to know your bank's Sight Review threshold.

Both conditions must be met to make an Indemnity claim. The Indemnity is valid for one year from the time the injured party finds out about the fraud (not from when the check was written). Clearly, this type of fraudulent situation falls well outside the 24-hour rule that governs many banking transactions.

It is important to note that the exact same fraudulent situation can exist, but if the original check did not have security features that could not be seen in the substitute check, it does not qualify for the Indemnity. Hence our belief that when a company fully understands the Indemnity provision, it will choose to use high security checks.

How does this relate to Remote Deposit Capture (RDC)? Under RDC, the bank's client does the original imaging, not the bank. The client scans the checks it would normally send to the bank for deposit and then electronically transmits the check images to the bank for deposit. The bank processes the images and sends them, or substitute checks, out to the various paying banks for collection. After a period of time, the company can then destroy the original paper checks.

Under Check 21, the entity that originally images the check is the entity that provides the Indemnity, whether it be the financial institution or the financial institution's client. While there are many benefits for using RDC, it is important for companies to weigh those benefits against the risks, one of which is this obligation to provide an Indemnity against certain types of check fraud.

(For an in-depth article, read "Check 21, Remote Deposit Capture and Check Fraud", written by Frank Abagnale and Greg Litster, and reviewed by the Federal Reserve Board. The article can be found at www.fraudtips.net.)

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The Abagnale **SuperBusinessCheck** has 16 security features and **SAFEChecks** have 12 security features, including heat sensitive ink, a true watermark and chemical sensitivity. Both are strictly controlled, high security check stock that were designed with Frank Abagnale, one of the world's foremost authorities on fraud prevention. Both are manufactured and sold by SAFEChecks.