

# CHECK 21 and CHECK FRAUD

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Check Clearing for the 21st Century Act, aka “Check 21” was passed unanimously by the House of Representatives and the Senate in October 2003. It was signed by President George W. Bush on October 28, 2003 and became effective October 28, 2004.

Check 21 allows banks to (1) convert original paper checks into electronic images; (2) truncate the original check; (3) process the images electronically; and (4) create “substitute checks” for delivery to banks that do not accept checks electronically. The legislation does not require a bank to create or accept an electronic check image, nor does it give an electronic image the legal equivalence of an original paper check. Check 21 does give legal equivalence to a “substitute check” that is properly prepared. A substitute check, also known as an image replacement document (IRD), is a new negotiable instrument that is a paper reproduction of an electronic image of an original paper check.

A substitute check must: (1) contain an image of the front and back of the original check; (2) bear a MICR line containing all the information of the original MICR line; (3) conform to industry standards for substitute checks; and (4) be suitable for automated processing just like the original check. To be the legal equivalent of the original check, the substitute check must also (1) accurately represent all the information on the front and back of the original check, and (2) bear a legend that states “This is a legal copy of your check. You can use it the same way you would use the original check.” While Check 21 does not mandate that any check be imaged and truncated, all checks except checks drawn on foreign banks<sup>1</sup> are eligible to be converted into images and reconverted<sup>2</sup> into substitute checks. Bank customers do not have the option to “opt out” of Check 21.

## **CHECK 21 CONVERSION Vs ACH CONVERSION**

A check converted into an electronic image and reconverted into a substitute check is not the same thing as a check that is converted into an ACH debit. They are entirely different processing mechanisms and are governed by different rules. A substitute check is

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<sup>1</sup> Federal Reserve Board’s Final Rule issued July 26, 2004. See Pages 81-82 AAA.229.2(aaa).3 Substitute Check. Visit [www.FraudTips.net](http://www.FraudTips.net) to download a copy of the Check Clearing for the 21<sup>st</sup> Century Act, aka Check 21, and the Federal Reserve Board’s Final Rule governing Check 21.

<sup>2</sup> *ibid.* Page 11, Footnote 15. “Reconverting” is the statutory term and reflects the fact that the original check is converted to electronic form and then later reconverted back to a paper substitute check.

governed by the Check 21 Act and the Fed's Final Rule. A check converted into an ACH debit is governed by ACH rules.

## **WARRANTIES AND INDEMNITY**

Contrary to what some bankers are saying, Check 21 does not require a bank to convert and truncate paper checks. It is entirely voluntary. A bank that chooses to convert a paper check into an electronic image that is then reconverted into a paper substitute check provides two warranties and an indemnity that travel with each substitute check. The two warranties are (1) that the substitute check is properly prepared as described in the paragraph above, and (2) that no bank will be asked to make payment on a check that has already paid (no double debit). Companies that are considering converting checks should be aware that they bear the identical risks as banks that convert checks.

The warranties and indemnity are very powerful, and give banks and companies a clear defensive strategy against losses that result directly from an original paper check being converted into an electronic image and the image reconverted into a substitute check. It may also deter banks from converting high-dollar checks because the warranties and indemnity provided by the converting bank continue for one year from the date the injured party first learns of the loss. The Final Rule is very clear that a "...claim shall be brought within one year of the date on which the person's cause of action accrues. ...a cause of action accrues as of the date on which the injured person first learns, or by which such person reasonably should have learned, of the facts and circumstances giving rise to the cause of action, including the identity of the warranting or indemnifying bank against which the action is brought."<sup>3</sup>

It is important to note that the one-year timeframe begins when the injured party learns or should have learned of the loss, not when the loss actually occurred. Thus, the actual risk tail to the converting bank or company is greater than one year.

The Final Rule states, a bank "that transfers, presents, or returns a substitute check...shall indemnify the recipient and any subsequent recipient...for any loss incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check instead of the original check."<sup>4</sup> It goes on to say that if a loss "...results in whole or in part from the indemnified party's negligence or failure to act in good faith, then the indemnity amount ...shall be reduced in proportion to the amount of negligence or bad faith attributable to the indemnified party."<sup>5</sup>

The Fed gives this example.

"A paying bank makes payment based on a substitute check that was derived from a fraudulent original cashier's check. The amount and other characteristics of the original cashier's check are such that, had the original check been presented instead, the paying bank would have inspected the original check for security features and likely would have

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<sup>3</sup> *ibid.* Page 67(c) Jurisdiction.

<sup>4</sup> *ibid.* Page 58, Substitute Check Indemnity

<sup>5</sup> *ibid.* Page 59, Comparative Negligence

detected the fraud and returned the original check before its midnight deadline. The security features that the bank would have inspected were security features that did not survive the imaging process. Under these circumstances, the paying bank could assert an indemnity claim against the bank that presented the substitute check.

“By contrast with the previous example, the indemnity would not apply if the characteristics of the presented substitute check were such that the bank’s security policies and procedures would not have detected the fraud even if the original had been presented. For example, if the check was under the threshold amount the bank has established for examining security features, the bank likely would not have caught the error and accordingly would have suffered a loss even if it had received the original check.”<sup>6</sup>

The indemnity does not cover a loss that is not directly attributable to the paying bank receiving a substitute check instead of the original check.

### **CHECK SAFETY FEATURES**

The two primary purposes for using many safety features in checks are (1) to deter criminals by thwarting the different methods used to alter or replicate checks, and (2) to authenticate an original document.<sup>7</sup> The minimum number of safety features a check should have is eight, and more is better. Among the best safety features are fourdrinier (true) watermarks in the paper, thermochromatic ink, and paper or ink that is reactive to at least 15 chemicals. These safety features cannot be imaged and replicated, which, in an age of desktop publishing, is precisely why they are the best! In addition to their fraud-deterrent value, when an individual or organization uses high security checks that include these safety features that do not survive the image conversion process, they position themselves for a built-in indemnity claim against the converting bank. This assumes that the paying bank has a sight review threshold such that the original check would have been examined.

Out of fear of the indemnity, the largest banks in America have been actively looking for check safety features that will survive the imaging process while still being useful, ie. not replicable by forgers. Not coincidentally, these are the same banks that have the most to gain from Check 21. Unfortunately, according to Frank Abagnale and The Standard Register Company, there are no check safety features that are image survivable that are useful.<sup>8</sup> A contrarian view is, even if there were image-survivable safety features that were useful, would it make sense for a company to add them to their checks and possibly mitigate a converting bank’s risk, at the company’s peril?

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<sup>6</sup> *ibid.*, pages 99-100, Substitute Check Indemnity

<sup>7</sup> Frank Abagnale publishes a 16-page color brochure titled *Check 21, Check Fraud, Identity Theft and Embezzlement*. Check security features are discussed in detail and shown in color. It is available through his office or through SafeChecks. Copies are free. Call (800) 755-2265 ext.3303.

<sup>8</sup> A white paper titled “Check 21 and Image Security” by Frank Abagnale and The Standard Register Company is reprinted in its entirety following the end of this chapter. It is used with permission from Frank W. Abagnale. The original pdf document can be downloaded at [www.FraudTips.net](http://www.FraudTips.net), under Check 21.

## CHECK 21 FRAUD STRATEGIES

In a Check 21 world, the strategies are straightforward: (1) Every bank should offer Positive Pay at an affordable price, and every company and municipality should use the service. Most banks charge for Positive Pay; companies deterred by the price should consider the fee an insurance premium that is far less expensive than a check fraud loss or attorney fees. For useful information about Positive Pay, visit [PositivePay.net](http://PositivePay.net) and [SafePay123.com](http://SafePay123.com). (2) Make large dollar payments electronically. (3) Every company, municipality and individual should use high security checks with 8 or more safety features. The checks should include a true watermark, thermochromatic ink and 15+ chemical sensitivity. The **Supercheck**, the **SuperBusinessCheck**, and **SafeChecks** are highly secure checks that were designed by Frank Abagnale with these and many additional safety features so prudent individuals, companies and municipalities could enjoy maximum security with a controlled check. Visit [Supercheck.net](http://Supercheck.net) and [SafeChecks.com](http://SafeChecks.com) to request a sample check. (4) Avoid using laser checks that can be purchased by multiple people entirely blank, because the stock is not controlled. (5) Banks and their service providers should lower their sight review thresholds and re-train inspectors, and encourage their customers to use high security checks and Positive Pay.

### About the authors

Frank Abagnale is one of the world's most respected authorities on the subject of forgery, embezzlement, and other forms of fraud. For over 25 years he has lectured to and consulted with hundreds of financial institutions, corporations and government agencies around the world, including the FBI. More than 14,000 financial institutions, corporations, and law enforcement agencies use his fraud prevention materials. He is the author and subject of *Catch Me If You Can*, a Steven Spielberg movie that starred Tom Hanks and Leonardo DiCaprio. Mr. Abagnale can be contacted at (800) 237-7443.

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