

# Handling Bad Checks

## *Optimizing Your Chances of Avoiding Losses From Fraudulent Checks*

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# Terminology



**BOFD – Bank of First Deposit**



**PB - Paying Bank**



**COLA – Cost of Living Adjustment**



**FED – Federal Reserve Bank**



**ECCHO – Electronic Check Clearing House Association**



**REG CC – Regulation CC**



**UCC – Uniform Commercial Code**



***For additional terminology definitions, don't hesitate to ask at the end of the presentation.***

# Checks: The Good, the Bad, and the Ugly

- **When a paying bank receives a presentment file of checks and runs that file through day one processing, the paying bank sees**
  - **The good**—98% or so of the checks will simply post to the drawers' accounts
  - **The bad**—the majority of the checks that can't be posted get kicked out to return processing because they are NSF, duplicate, stale dated, stop pay, account not found, etc. And checks that fail positive pay....
- **The paying bank bears little risk with respect to a check that it returns “timely” because the check is not properly payable**
  - Midnight return rule under UCC – initiate the return by midnight on the banking day after the day the item was presented or be “accountable”
  - 2 Day “Expeditious return” under Reg CC – use a process that will get the return to the BOFD by the second banking day after presentment

# Checks: The Good, the Bad, and the Ugly

- **Later, the ugly checks come to light—fraudulent items that were not returned timely**
  - Paying bank need to minimize the occurrence of the “ugly”
  - Paying bank needs to know exactly how to handle the “ugly” when it does occur
- **Meanwhile, the BOFD, bound by the funds availability schedule in Reg CC, bears the risk that a bad check will come back after the BOFD has released the proceeds of the deposit**

# Risks: Availability vs. Expeditious Return

- **Bank of First Deposit (BOFD) risk is created by Reg CC funds availability schedule**
  - “Next Day” deposits
  - “Two Day” deposits
  - Exceptions—permissible 5 day holds
    - Large dollar item; redeposited item; repeated overdrafts; new customer; reasonable cause to doubt collectability; emergency conditions
- **Paying Bank (PB) risk of late return is created by two return rules:**
  - UCC--A PB that dishonors an item must initiate return by its midnight deadline, or PB becomes “accountable” for the amount of the item
  - Reg CC Expeditious Return: PB that dishonors an item must route it back to BOFD “expeditiously”

# Availability Rule Changed July 1, 2020

- Amounts that must be made available are going up, tied to Cost of Living Adjustments (COLA)—available in table form
- Depository institutions must update the following:
  - Your practices—adjust the amounts in your funds availability schedule to conform to amended Reg CC
  - Policies and procedures--update
  - All Reg CC funds availability disclosures and notices
    - One-time disclosure of updated FA policy
    - Required/permitted notices
    - Deposit slips
  - Your employee training

# Real World Check Fraud Paradigms

- **Counterfeit checks**
  - Very small volume of large dollar items
  - Large volume of small dollar consumer items
  - Targeted counterfeits drawn against one compromised RTN/account number
- **Stolen checks**
  - Original check book lost or stolen, checks issued over forged signatures
  - Checks issued by drawer, then stolen and deposited over forged/missing endorsements
  - Checks issued by drawer, *stolen or copied and altered* (payee, amount, or both)
- **Duplication**
- **“Insider” theft by account holder’s employee/agent**

# Legal Typology of Fraudulent Checks

- Forged drawer's signatures (generally, the paying bank's risk)
  - Completely counterfeit items
  - Genuine checks over unauthorized signatures
- Altered checks (generally the BOFD's risk)
  - If it's an image, how can you differentiate forgery/alteration?
- Unauthorized Remotely Created Checks (special rule under Reg CC)
- Checks that were stolen or "converted," with forged or missing indorsements (generally the BOFD's risk)
- Duplicate deposits (special rule in Reg CC re image deposits)



# Legal Allocation of Risks—Warranties & Regs

- **Basic allocation of risk under UCC 3 & 4**
  1. Drawer's (paying) bank is liable to the account holder if it doesn't pay a properly payable check or does pay a check that is not properly payable (UCC 4-401-4022).
  2. Drawer's (paying) bank is not liable to presenting bank or BOFD if PB dishonors and returns a check timely for any reason (UCC 4-301).
  3. Drawer's (paying) bank has a claim against the presenting bank for breach of a presentment warranty (UCC 4-208).
  4. Paying bank and presenting bank have a claim against any prior banks for breach of a transfer warranty (UCC 4-207).
- **Generally, PB has the risk if it pays a check over a forged or missing drawer's signature, and BOFD has the risk that a return will arrive after the funds have been released and a longer term risk of a warranty claim based on alteration or forged/missing endorsement**

# Special Cases Under Regulation CC

- **Unauthorized Remotely Created Checks**
  - Reg CC shifted the risk of counterfeit RCCs to the BOFD by creating a unique RCC warranty (Reg CC 229.34(b)).
- **Can't tell if a fraudulent imaged item was issued as a counterfeit or was altered after issuance?** In the absence of an original check, Reg CC presumes an imaged check was altered unless BOFD proves the contrary (Reg CC 229.38(i)).
- **Remote deposit, followed by deposit of original check - New Regulation CC indemnity applies unless a restrictive indorsement was obtained by BOFD that accepted remote deposit(Reg CC 229.34(f)).**

# Depository Bank's Risks & Remedies

- **Funds will be released before the BOFD learns that a check was “bad”**
  - Funds availability requirements versus return timeframes
  - Warranty/indemnity claims.
- **BOFD due diligence**
  - Training: CSRs and Operations staff need to know how to spot altered checks, converted/stolen checks, and forged checks
  - Screening:
    - Examine the checks—security features present or not? All required indorsements present?
    - Automated anti-fraud, BSA/AML, and OFAC tools
    - Heuristics based on unusual deposit dollar/item volumes, returns higher than normal
  - KYC—depositor/drawer relationship? If the check is bad, can depositor cover it?
  - Escalation: investigating and/or rejecting suspect deposits
- **Remedies if an item is returned or adjusted back to BOFD**
  - Get funds back from depositor or make a claim versus the PB
  - Pay only valid warranty claims to PBs

# The Paying Bank's Remedies

- **Timely return**
  - Routing bad checks back to BOFD within the return deadline has two effects
    - Legally, maximizes paying bank's protection against loss
    - Practically, maximizes chances that the BOFD will be able to recover the funds from its depositor
- **Asserting a claim under a warranty made by the presenting bank**
  - Exception processes that operate by agreement or "rules"—for example
    - Adjustments processes, e.g. Fed adjustment platform (limited coverage!)
    - Extended windows for using the return "rails" to assert warranty claims, e.g. Rules 8, 9
    - "Dealing directly" with BOFD or presenting bank
    - Legal recourse via demand for repayment

# Returned Checks

- **A paying bank can dishonor a check upon presentment for any reason and not be liable to the presenting bank or BOFD**
  - But--PB cannot dishonor a “properly payable” item without incurring potential liability to the drawer. (This potential risk can be addressed in deposit agreements.)
- **PB dishonors a check by returning it within the midnight/expeditious return deadline**
- **BUT be careful--Reg CC, ECCHO rules, and ANSI check image standards require PB to indicate return reason, and it can be important to use return reason codes appropriately.**

# Maximizing Timely Return of Bad Checks

- **Up to date fraud prevention filters/screens**
  - Stop pay
  - Duplicates
  - Stale dates
  - Use heuristics to identify suspicious items and kick them out for review before posting—unusual amounts, numbers of items, suspect payees.....
- **Up to date BSA/AML/CTF screening.** Some products can do both fraud and compliance screening.

# Maximizing Timely Return of Bad Checks

- **Maximize positive pay utilization and enforce it!**
  - The losses from bad checks are bigger on business checks than on consumer checks, so start by pushing business account holders to agree to positive pay, and train them to use it, and then require them to use it.
- **Educate consumers** to go online every day and look at checks that posted overnight. Then act immediately on consumer notifications of suspicious items—if within return window, return first, ask questions later.

# Exceptions, Adjustments, & Extended Returns

- If the PB does not return by its midnight/expeditious return deadline, and a check turns out to be bad, the PB still can seek to recover via
  - the exceptions processes that banks agree to follow when checks are presented or returned
  - informal to formal requests/demands
- Exceptions/Adjustments are not part of the UCC or Reg CC, but the laws and regs permit variation of the law/regs by agreement, by clearing house rules, and by Federal Reserve Bank Operating Circular



# “Rules” of Exceptions & Adjustments

- Fed adjustments structured by OC3 and the Adjustments Quick Reference Guide.
- ECCHO exceptions processes laid out in ECCHO rules, esp. Rules 8 & 9.
- Private sector clearing house rules or contract provisions likely apply if you run your checks through a third party processor that operates as a clearing house or through a correspondent bank.

# How Exceptions/Adjustments Work

- Paying bank reaches out to either the presenting bank or a prior collecting bank or to the BOFD to indicate that PB has received a “bad” check for which it should not be liable and asks for credit.
- BOFD reaches out to returning bank to indicate that a check was returned late and asks for credit.
- Fed automates this process and may automatically credit the requesting bank.
- ECCHO banks decided to use the return “rails” with extended “return” deadlines to automate the processing of two kinds of warranty claims
  - Breach of transfer/presentation warranties (“Rule 9” claims)
  - Breach of warranty with respect to a Remotely Created Check (“Rule 8” claims)
- **NOTE: a bank that receives an exception/adjustment claim can decline it!**

# Adjustments—Complicated & Imperfect

- Every adjustment type has a deadline within which the requesting bank must start the adjustment process.
- Every adjustment type has its own specific requirements for forms to fill out, documents to attach/submit, and/or the appropriate return reason type to use for the “extended return” warranty claims.
- Some banks will refuse to accept the debit for an item by claiming that the requesting bank breached a warranty, missed the deadline, failed to provide all the required info or documentation, or used the wrong reason code. “Ping” and “pong.”
- ECCHO member banks can entirely opt out of participation in the “extended return” processes in Rule 8 and 9.

# Necessary Homework on Every Bad Check

- If a “bad” check comes to light after the return deadline...
- Nail down the processing history. Determine whether you can return the item “late.” If so, return the item. If not....
- Determine whether you have a valid adjustment type that you can use. If so, ask for an adjustment. If not....
- If you can find a contact at the BOFD, notify that contact of the fraud.
- Potential dilemma: no return, no adjustment, no contact

# Necessary Homework on Every Bad Check

- **Facts are crucial to determining which bank will be liable.**
  - What's "bad" about the check? Need an affidavit?
  - Who is responsible for what? Who breached which warranties? Who was negligent? Is there a financial loss? Who's got the loss on their books? Which bank caused the financial loss to occur?

# Find Your Bad Check's Position on the Rules Map

- **Based on the processing history, you need to determine which rules apply**
  - If your bank received the “bad check” as a Fed presentment, the applicable rules include Reg J and OC3, and the Fed’s adjustments rules, on top of the UCC and Reg CC.
  - If you received your “bad check” presentment through a clearing house that follows the ECCHO rules, the UCC and Reg CC apply, as modified by the ECCHO rules and any other modifications by your clearing house. You must use the right return code!
  - If you received your “bad check” presentment from a correspondent bank under a correspondent banking agreement, that agreement may have modified the underlying UCC and Reg CC provisions.

**Your exceptions policies and procedures should identify all of the different rule sets that apply to the way that you send checks for collection, receive presentments, and make or receive returns. The “rules map” should be relatively constant.**

# Pursuing an Adjustment - Armed with the facts and the identity of the appropriate rule set you can next determine.

1. Whether you have a good claim
2. From which bank.
3. And what specific procedures your bank will need to follow to assert its claim
  - For example, Fed adjustments procedures are available only if the Fed handled the bad check, and only for the specific types of claims that are supported by an “I-type” in Fed adjustments. There is no adjustment type to assert a claim of alteration, but there is a type for an unauthorized RCC
  - If you’re dealing with Fed procedures, there are no extended return procedures for warranty claims. If you failed to meet the midnight/expeditious return deadline, you cannot use the return process.
  - If you miss the Fed’s deadline for requesting an adjustment, or if your claim is not supported by a Fed adjustment type, you cannot use the adjustments platform for that bad check and must “deal direct”.
  - If you’re dealing with ECCHO rules, make sure you use the right forms within the right deadlines using the correct return reason code!



# The Adjustment Process Doesn't Always Work...

- There is no Fed adjustment type for certain types of warranty claims, including claims related to fraud: alteration or forged or missing indorsement. The PB always has to pursue these cases outside of Fed adjustments.
- The bank that receives an adjustment request can almost always decline the adjustment and push the loss back to the requesting bank, even if the adjustment request appears to be valid.
  - Exception: under Fed adjustments, a BOFD has no ability to decline a “URCC” claim by pushing the debit back to the PB via the adjustments platform.

# Asserting Your Claims Outside Adjustments

- Sometimes, you can get the other bank to play fair.... But not so much if there's a big loss on a check and the proceeds of the deposit have left the banking system.
- You can ask, wheedle, cajole, and beg, but in the end, if the other bank refuses to accept your warranty claim so your bank has the loss on its books, you will have to decide if:
  - You're sure that you're right and your legal claim is valid AND,
  - It's worth the cost to pursue your claim legally.

# Before Filing Suit, Try a Demand Letter

- If you're being stonewalled, your bank **can compose a “demand” letter reciting the facts about the bad check**, asserting that your bank has suffered a financial loss, applying the specific rules that apply, and asserting/explaining why the bank to which you are sending the letter is liable to your bank under the applicable rules.
- You can phrase this as a demand for payment or as a request for payment with an express assertion that if the bank does not pay you the amount of your loss, you will be forced to initiate litigation.
- You can make demand to the BOFD or to the presenting bank or a prior collecting bank.
- Never bluff.

# Demand Letters to the Fed

**Although banks are generally careful about their relationship with the Fed, there are significant advantages to the paying bank that sends a demand letter to the Fed if the Fed has presented a “bad” check that was altered or presented over a forged indorsement.**

# Demand Letters to the Fed

- **Under Reg J, which applies to Fed check collection and return,**
  - The FRB makes the presentment warranties to the PB, so if a check was altered or presented over a missing or forged indorsement, the PB's warranty claim runs back to the Fed—and the court that has jurisdiction is the Federal District Court where the Federal Reserve Bank is located.
  - If the PB demands payment from the Fed and threatens to sue, the Fed “tenders the defense” through to the BOFD, which has to pay up or come to the Fed's “home” district court to defend the case. If the BOFD does neither, the Fed will default in the resultant litigation, take the money from the BOFD and credit the PB.

# Demand Letters to the Fed

- Demand letters sent to the Fed create incentives for the other bank to play fair.
- Use this tool only if you are confident in your claim.
- Don't bluff.

# What should your financial institution do?

- Make sure your institution has updated its funds availability program to conform to updated Reg CC. (Use slide 6 as checklist; find a table of the 2020 availability amounts online)
- Take steps to catch bad checks at the earliest point in the process
  - Identify suspect deposits
  - Identify and timely return suspect checks when presented
- Optimize your exception handling process.
- Have an escalation path for the “ugly” cases, where large dollars are at stake and the informal adjustments process leaves your bank with the loss.

# Steps to Catch Bad Checks Early

- Sometimes you're the BOFD, sometimes the PB. Both roles can help to combat fraud.
- Consider implementing anti-fraud plus BSA/AML/CTF software including heuristics when you process check deposits **and** when you do day one processing of check presentment files.
- When you're the BOFD, have a policy/practice to reject suspect deposits



# Steps to Catch Bad Checks Early

- Consider expanding positive pay to as many of your corporate account holders as you can, training those customers, and really requiring them to do their due diligence.
- Screening incoming check files and broadening positive pay will maximize the percentage of bad checks that your bank identifies and returns before its midnight deadline.
- The goal of these steps would be to decrease your losses due to fraud. Your avoided losses might completely offset the costs of these steps.

# Optimize Your Exception Handling Process

- **Review and update your procedures**
  - Create a “rules map” that includes all the ways you send and receive checks for collection/presentation or return.
  - Create a standard process for gathering and recording all the relevant information about each bad check.
  - Create a standard process for initiating and managing exceptions cases and strictly adhering to the deadlines, documentation requirements, and use of return reasons
    - In Fed adjustments
    - Under the ECCHO rules or clearing house rules if your bank is a clearing house member
    - With your correspondent bank if your checks come and go through a correspondent

# Escalating the Ugly Cases

- Identify your internal decision makers & stakeholders
  - Assign somebody to be your skilled “contact tracer” for finding a person to talk to at the other bank when you have to “deal direct”
- Identify expert resources and use them efficiently. Not every claim is a good one.
  - Sometimes you get the loss under the facts and the law
  - Sometimes you have a case that’s not worth what it would cost to pursue a legal claim
- Use every tool short of litigation before you turn to litigation.



# Questions?

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