

REMOTE DEPOSIT CAPTURE –RISKS AND SOLUTIONS

When the Check 21 Act, went into effect in October, 2004, one of its stated purposes was “to foster innovation in the check collection system.”¹ One emerging innovation made possible by the Act is “remote deposit capture,” the process by which a bank customer can scan checks and deposit them electronically, without physically bringing the checks to a bank office or ATM.²

By permitting the customer to retain the original checks and process them into the electronic form in which they will enter the payment system, a bank that offers remote deposit capture is effectively ceding control of a portion of its back office operation to the customer, which creates additional risks for the bank. This article discusses some of these risks and offers some possible solutions.

Substitute Checks

The heart of the Check 21 Act is the concept of a “substitute check.” Any bank that receives and forwards or returns an item in the course of the check collection cycle, or for that matter the customer who originally deposits the item, may create a substitute check. A substitute check is essentially a paper reproduction of the front and back of the original check with a magnetic ink MICR line matching the original check added to it.³

Under the Check 21 Act, a substitute check is the legal equivalent of the original check so long as it accurately represents the original and bears the legend: “This is a legal copy of your check. You can use it the same way you would use the original check.”⁴ Thus, any bank that is electronically furnished with the means to reproduce the original check has the ability to create the legal equivalent of the original check and forward it through the payment system. More specifically in the context of remote deposit capture, a bank can permit its customer to scan checks and deposit them electronically because it can use the scanned image to create a substitute check.

Risk Factors

Multiple Posting. A significant new risk introduced by remote deposit capture is the possibility a check will be deposited more than once as a result of mistake or fraud.

¹ 12 U.S.C. § 5001(b)(2). The Check 21 Act can be found at 12 U.S.C. § 5001 et seq. See also Federal Reserve Regulation CC, 12 CFR Part 229 and accompanying Federal Reserve Board Commentary.

² According to the Arkansas State Bank Department’s March 31, 2008, newsletter, 30% of Arkansas state banks currently offer remote deposit capture, and another 25% have plans to do so. The newsletter also reported that a survey by the American Bankers Association found that two out of three banks responding either offer remote deposit capture or plan to do so by the end of 2009.

³ See 12 U.S.C. § 5002(16) and 12 CFR § 229.2(aaa).

⁴ 12 U.S.C. § 5003(b) and 12 CFR § 229.51(a).

A customer who deposits a check electronically remains in possession of the original check. The customer could mistakenly deposit the original check after having deposited the same check electronically, or the customer or an employee of the customer could fraudulently deposit the original check, most likely at another bank, after having deposited it electronically at your bank. They could even create multiple electronic images and deposit each of the images and the original at different banks.

A bank that creates a substitute check (in Check 21 Act parlance, the “reconverting bank”⁵) assumes the risk that arises from the creation of multiple legally enforceable copies of the same item. The reconverting bank warrants to each subsequent handler of the check that it will not receive multiple presentations of the checks such that it will be asked to make a payment based on a check it has already paid.⁶ Thus, if a customer electronically deposits a check at Bank 1 and later deposits the original at Bank 2, and if the bank on which the check is drawn pays both the original check and the substitute check created by Bank 1, the drawee bank has recourse against Bank 1 for its overpayment based on Bank 1’s Check 21 Act warranty. If the customer had made both deposits electronically, the drawee bank would have had recourse for its overpayment against either or both of Bank 1 and Bank 2 (but only one recovery), because each of them would have created a substitute check and thereby made the warranty. Finally, if a check is deposited electronically at both Bank 1 and Bank 2 and the original is deposited at Bank 3, and if the bank on which the check is drawn pays all three checks, the drawee bank has overpaid by twice the amount of the check. It has full recourse for this amount against either or both of Bank 1 or Bank 2 under their warranties. The point to remember is that the act of accepting the electronic deposit and creating the substitute check is what places the responsibility for any multiple payments on the bank. If an employee of the customer manages, a month later, to get his hands on the original check and cash it, the liability falls on the bank that created the substitute check.

How can you minimize the risk of loss from the possibility of a check’s being deposited more than once? There are a number of possibilities:

- You can require the customer to endorse the check to the bank prior to scanning it for electronic deposit, e.g., “Pay to the order of X Bank. [Customer signature].” This will make it less likely the original check or a subsequently scanned image could be deposited at another bank. (Of course, it does not eliminate the possibility the check could already have been scanned and deposited at another bank before it was endorsed to your bank.)
- Along the same lines, you can require the customer to mark the face of the check in some way, such as a “Scanned” stamp or a hole punched in the check.

⁵ 12 U.S.C. § 5002(15) and 12 CFR § 229.2(zz).

⁶ 12 U.S.C. §§ 5004 and 5005 and 12 CFR §§ 229.52 and 229.53.

- You should consider requiring the customer to retain the original checks for a reasonable period of time so that they are available if needed to aid in the clearing and collection process or to resolve claims of third parties. However, it is important that the customer be required to keep them in a secure location to minimize the possibility of fraud by employees and that they be destroyed in a manner approved by the bank when the retention period has expired.
- You can require the customer to use a scanner dedicated to your bank only. This may reduce the likelihood of inadvertent deposits of the same item at different banks and will at least complicate any conscious attempt to make electronic deposits at multiple banks.
- Your remote deposit service agreement should include warranties from the customer to you that track the Check 21 Act warranties you give to subsequent handlers of the check, and the customer should indemnify you against loss you suffer as a result of your Check 21 Act warranties.

Image Quality. The quality of the scanned image of an electronically deposited check is critical. A substitute check is not the legal equivalent of the original unless it accurately represents the original check. There are a number of ways a bank can help insure adequate image quality, including setting forth minimum image quality standards in the remote deposit capture service agreement, giving the bank the right to specify the scanner model the customer must use, or actually furnishing the scanner to the customer. The bank should also retain the right to reject any electronically deposited item with an inadequate image.

Risks Traditionally Associated With Checks. Remote deposit capture raises new risks for banks, but it will also likely exacerbate some risks with which banks have long grappled, such as check alteration, counterfeiting, forged endorsements, kiting and employee fraud. A person inclined to engage in any of these fraudulent activities is likely to perceive, probably correctly in some cases, that the risk of detection is lower with an electronic deposit than it is when the original checks are physically delivered to the bank. There is no foolproof way to counteract this increased risk, but banks should be selective about the customers to whom the service is offered, be familiar with their employees and employment practices, examine electronic deposits to the extent practicable, and perhaps limit the dollar amount of items that may be deposited electronically.

Conclusion

The Check 21 Act has given rise to new and still evolving methods of processing checks through the payment system. With these new methods come new risks and new legal issues, some obvious and, probably, others which have not yet come to light. A bank offering remote deposit capture must provide education and establish risk-reducing

procedures, not only for its own employees but also for customers using the service, and it must have in place a comprehensive remote deposit capture services agreement to properly allocate the inevitable risks that cannot be completely controlled.