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Mobile Check Deposits: With Soaring Use, Increasing Risks

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Introduction

Consider the following hypothetical scenario (and a typical scam involving mobile check deposits) in which an employer (the “Company”) issues a paper check to one of its employees (the “Employee”). The Employee remotely deposits the check with his or her bank (“Bank A”) by snapping an image of it with his or her smartphone and using Bank A’s mobile deposit app. Bank A electronically creates a substitute check, and presents it to the Company’s Bank (“Bank B”) for payment. Meanwhile, the Employee retains the original paper check and later cashes that original check at a check-cashing store (or at another bank or currency exchange).¹ The check-cashing store then deposits the original paper check with its depository bank (“Bank C”). Bank C converts that check to an electronic item and presents it to Bank B (the Company’s bank), through an electronic forward-collection cash letter.² Bank B will at this time likely identify the check as a suspected duplicate, because the substitute check has already been presented for payment. When Bank B dishonors the check as a suspected duplicate, the check will bounce back to Bank C, which will charge the item back to its customer’s (the check cashing store’s) deposit account.

The duplicate deposit might have been an accident or it might be the result of fraudulent intent. Either way, the Employee is double-depositing a check, begging the question as to who is left to make good on these multiple transactions, especially if the parties are unable to recover directly from the Employee? The check-cashing store is likely to assert that it is entitled to payment from the “drawer” (in this scenario, the Company) as a holder in due course. Does the Company have any defense to the check-cashing store’s holder in due course claim? Furthermore, does the Company or its bank (the “drawee” or “payor bank”) have any recourse against Bank A, which created the substitute check (the “reconverting bank”³)?

¹ Because of funds availability rules, there are often several days between the date of deposit and the date the funds are actually received by the depository bank. Thus, the customer depositing the check for the second time has access to the funds represented by the check before the check has been honored by the payor bank. Of course, where the second deposit was at a check-cashing store, the funds availability window is not a factor because the check is being cashed, rather than deposited.

² A “cash letter” is a group of checks packaged and sent by a bank (i.e., any depository financial institution) to another bank, clearinghouse, or a Federal Reserve office. A cash letter is accompanied by a list containing the dollar amount of each check, the total amount of the checks, and the number of checks in the cash letter. “Forward collection” refers to the transfer of a check by a bank to a “payor bank” for payment. That is, the bank forwards the check to another bank directly or through an intermediary. For a description of the three basic models used by banks involving electronic forward-collection cash letters, see Stephanie Heller, *An Endangered Species: The Increasing Irrelevance of Article 4 of the UCC in an Electronics-Based Payments System*, 40 LOY. L.A. L. REV. 513, 527–28 (2006).

³ 12 U.S.C. § 5002(15).

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Since the 2004 introduction of the Check Clearing for the 21st Century Act (“Check 21 Act”),⁴ mobile deposits of checks have become increasingly popular. The Check 21 Act created a new negotiable instrument called a “substitute check”—a digital version and legal equivalent of an original check—paving the way for electronic check presentment by retail bank customers. Electronic check presentment has two major benefits: first, presentment occurs more quickly than if the physical check had to be transported for presentment; and second, the process is less costly.⁵ However, with the increasing use of mobile check deposit technology comes an increasing risk of checks being deposited more than once (“duplicate presentment”). The loss resulting from duplicate presentment is one of the principal risks posed by mobile check deposits.

Prior to the introduction of mobile deposit technology, the existence of a single, unique paper check meant that only one “holder” was capable of possession. The existence of a digitized “substitute check”—indeed, one that can be replicated multiple times—results in a situation where multiple parties can claim to be “holders in due course,” each with a claim of entitlement to payment of the same instrument.

The “holder in due course” doctrine governs negotiable instruments such as checks.⁶ The doctrine says that a party who acquires a negotiable instrument in good faith, for value, and without notice of certain facts,⁷ takes the instrument free of competing claims of ownership⁸ and most defenses to payment.⁹ The underlying idea is that a party acquiring a check should be free of concerns that the creator of the check or anyone else who owns the instrument will have particular grounds for refusing to pay.

This article provides an overview of the legal framework governing mobile check deposits, focusing on duplicate deposits where one party holds the original paper check, and suggests strategies for mitigating the risk of duplicate presentment.

Uniform Commercial Code

The provisions in Articles 3 and 4 of the Uniform Commercial Code (“UCC”) provide some answers to the questions posed above, although revisions are sorely needed in the face of technological advances in check collection and payment practices, particularly given that the current provisions were designed for a paper-based system.

⁴ Check Clearing for the 21st Century Act, Pub. L. No. 108-100 (2003), codified at 12 U.S.C. § 5001 *et seq.* (2004). The Check 21 Act is implemented by regulations adopted by the Federal Reserve Board. 12 C.F.R. § 229.1 (2006).

⁵ Electronic check presentment reduces expensive air and land courier transport costs as well as costs associated with storage. See Peter J. Muckleston, *The Journey of a Check*, PROF. LAWYER, 2006, at 40; see also David B. Humphrey & Robert Hunt, *Getting Rid of Paper: Savings from Check 21* 10–15 (Research Dep’t, Fed. Reserve Bank of Phila., Working Paper No. 12-12) (estimating that the Federal Reserve reduced its per item check processing costs by over seventy percent (70%) by shifting to electronic presentment).

⁶ U.C.C. § 3-104(a) (defining negotiable instrument, in part, as “an unconditional promise or order to pay a fixed amount of money” that is payable to bearer or identified person).

⁷ U.C.C. § 3-302(a)(2) defines a “holder in due course” as one who takes an instrument:

(i) for value, (ii) in good faith, (iii) without notice that the check is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in Section 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in Section 3-305(a).

⁸ *Id.* § 3-306.

⁹ See *id.* § 3-305(b) (making certain defenses inapplicable to holder in due course claims).

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The current presentment and transfer warranties in Articles 3 and 4 depend upon transfer or presentment of a physical piece of paper.¹⁰ Thus, a transferor or presenter does not make these warranties if the item being transferred or presented is an electronic image of a check. Importantly, the UCC imposes no warranty obligation for potential double deposits such as the one outlined in the hypothetical scenario presented above (i.e., payments on both the electronic image (substitute check) and the original paper check). Simply stated, the UCC does not address the possibility that a single instrument could be presented for payment multiple times since, prior to mobile deposit technology, presentment or negotiation of an instrument required physical possession of the original instrument.¹¹

In the hypothetical scenario above, the payor bank (Bank B) will be required to credit its customer's (the Company's/drawer's) account for one of the payments, as only one was properly payable. Here, if the payor bank (Bank B) returns the suspected duplicate item and refuses to pay either the reconverting bank (Bank A) or the check-cashing store, the drawer of the original check (its customer, the Company) will then likely face a holder in due course claim.

Traditionally, the right to enforce an instrument has been given to the holder of that instrument,¹² with the holder, in turn, defined as the person in physical possession of the instrument.¹³ The entity that retains the original check (here, the check-cashing store) might have a holder in due course claim and, thus, might demand payment from the drawer (the Company). The check-cashing store has a strong argument for holder in due course status if it took the check by proper endorsement, in good faith, for value, and without notice that it was a duplicate.¹⁴

With a "substitute check" treated as a legal equivalent to a paper check under the Check 21 Act (discussed below), a person in possession of the substitute check is entitled to enforce it. Thus, if the reconverting bank (Bank A) creates a substitute check, it might also obtain "holder in due course" status.

However, as detailed below, even if the reconverting bank (Bank A) creates a substitute check, the bank might not qualify as a holder in due course if the electronic image created by its customer and transmitted to the bank does not satisfy the applicable requirements for such a check. Furthermore, the payor bank (Bank B) will likely be able to pursue a claim against the reconverting bank (Bank A) under the Check 21 Act's warranty provisions.

Check 21 Act

Prior to the passage of the Check 21 Act, banks and other financial institutions were required to physically present an original paper check (an act known as "presentment") in order to

¹⁰ See *id.* §§ 3-416, 3-417, 4-207, 4-208. A transfer warranty is given if transferor transfers an instrument for consideration to transferee and if the transfer is by endorsement to all future transferees. Transfer warranties can be enforced against all transferors for consideration by all transferees. *Id.* at §§ 3-416 and 4-207. When used in relation to an instrument, a presentment warranty refers to an implied promise as to the title and credibility of the instrument (e.g., a promise that the check has not been altered) given to the drawee by the person presenting a draft and receiving payment. Presentment warranties can be enforced against the presenter, all transferors by the payor bank and only the payor bank. *Id.* at §§ 3-417, 4-208.

¹¹ The Check 21 warranty against double payment (discussed below) only applies if a substitute check is created and would not apply to double presentment involving the original paper check.

¹² See *id.* § 3-301 (defining a person entitled to enforce the instrument as the "holder" of an instrument).

¹³ *Id.* § 1-201(b)(21).

¹⁴ See *id.* § 3-302.

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receive payment.¹⁵ The Check 21 Act authorized the use of a “substitute check”—an electronic reproduction of the front and back of the original check.¹⁶ Under the Check 21 Act, a substitute check is the legal equivalent of the original check provided that 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.”¹⁷ As a result, a bank may permit its customers to scan checks and deposit them electronically using the bank’s mobile deposit app so that the bank can then use the scanned image to create a substitute check. Like an original paper check, a substitute check is also subject to any provision of the UCC or applicable federal or state law, but only to the extent that such provisions are not inconsistent with the Check 21 Act.¹⁸

Notably, the Check 21 Act does not require the destruction of the original paper check after the creation of a substitute check.¹⁹ By permitting a customer to retain the original check and converting the image of the original check into the electronic “substitute check,” a bank offering mobile deposits effectively cedes control of a portion of its back-office operations to the customer. Thus, the scenario presented above, in which a customer deposits an original check after depositing the “same” check electronically, is a creature of the Check 21 Act.

The Check 21 Act imposes warranty and indemnity obligations upon a bank issuing a substitute check. A bank creating a substitute check—i.e., the reconverting bank—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 presentments of the check such that it will be asked to make a payment based on a check it has already paid.²⁰ Specifically, “no depository bank, drawee, drawer, or endorser will receive presentment or return of, or otherwise be charged for, the substitute check, *the original check*, or a paper or electronic version of the substitute check or original check such that the bank, drawee, drawer, or endorser has already paid.”²¹

Thus, if the Employee in the hypothetical example above electronically deposits a check using Bank A’s mobile deposit app and then later cashes the original check at a check-cashing store, and if the bank on which the check is drawn (Bank B) pays both the original check and the substitute check created by Bank A, the payor bank (Bank B) has recourse against Bank A for its overpayment based on Bank A’s Check 21 Act warranty.²² Liability for the loss falls to the bank that allowed a customer to use its mobile deposit app (Bank A).

¹⁵ S. REP. No. 108-79, at 1 (2003).

¹⁶ A substitute check is defined in Section 3(16) of the Check 21 Act as:

A paper reproduction of the original check that (A) contains an image of the front and back of the original check; (B) bears a MICR line containing all the information appearing on the MICR line of the original check, except as provided under generally applicable industry standards for substitute checks to facilitate the processing of substitute checks; (C) conforms, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks; and (D) is suitable for automatic processing in the same manner as the original check.

¹⁷ 12 U.S.C. § 5003(b).

¹⁸ 12 C.F.R. § 229.51(c) (2004).

¹⁹ Andrea McGlenn, *Check Clearing for the 21st Century Act: The Impact on Consumers*, 9 N.C. BANKING INST. 179, 182 (2005).

²⁰ 12 U.S.C. §§ 5004-5005. In terms of indemnity, the Check 21 Act provides that the reconverting bank and any bank subsequently transferring, presenting, or returning a substitute check must indemnify all involved parties, including the drawer, for any loss incurred due to the receipt of a substitute check rather than the original check. *Id.* § 5005(a).

²¹ *Id.* § 5004.

²² The indemnity is “to the extent of any loss incurred ... due to the receipt of a substitute check instead of the original check.” *Id.*

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The reconverting bank (Bank A) may, in turn, charge the loss against its customer, the Employee.²³ However, the key point is that the warranties described in the Check 21 Act dictate that the act of accepting the mobile deposit and creating the substitute check places responsibility for any multiple payments on the bank creating the substitute check.

Mitigation Strategies

The lack of a comprehensive cross-bank, real-time duplicate detection system is one of the key reasons that it is possible for a consumer to double deposit a check by initially making a mobile deposit and subsequently making a paper deposit at another institution. Thus, one possible way for banks to protect themselves from duplicate presentment is to make funds available not sooner than one to two days after they are deposited. This would allow banks to clear each check through the drawer's financial institution, verifying it as a legitimate instrument. However, this concept runs contrary to the business model of the check-cashing store.

Alternatively, as some banks already do,²⁴ all banks could require their customers to endorse each original check prior to scanning it for a mobile deposit, with language indicating that the item is "For Mobile Check Deposit Only," along with the deposit account number, thus making it less likely that the original check could later be deposited at another bank or check-cashing store.

Another key way for banks to shield themselves from losses caused by duplicate presentment is by building certain protections into the agreement between the bank and its customers using the mobile check deposit functions. Each bank's mobile deposit service agreement could include warranties from the customer to the bank that track the Check 21 Act's warranties given to subsequent handlers of the check. The bank could also require its mobile-deposit customers to indemnify the bank against any loss suffered as a result of the Check 21 Act warranties (again, assuming that recourse is available against the customer). The bank could effectuate this requirement through a modification to its demand-deposit account agreement forms in the case of future accounts or by amendments to the bank's demand-deposit account agreement in the case of existing accounts. In either case, the bank could require execution of such an agreement (or amendment to an existing agreement) in conjunction with downloading the bank's mobile app.²⁵

Conclusion

In conclusion, mobile check deposit technology creates significant risks of loss in the form of duplicate presentment. While some duplicate deposits are customer errors, others involve potentially fraudulent behavior. The proper allocation of the loss from such deposits depends upon the rules and interpretations of the UCC and the Check 21 Act. Currently, there is minimal case law interpreting these rules in mobile deposit cases, and, further, there

²³ This assumes that recourse is available against the Employee. Many times, in the case of fraud, recourse is limited against the party making the duplicate deposits either due to the employee being terminated, or otherwise.

²⁴ See, e.g., *Mobile Deposit*, MECHANIC'S BANK, <https://www.mechanicsbank.com/mechbank/MBwebsite.nsf/onlineservices/mobiledeposit> (last visited July 28, 2014) (requiring "For Mobile Deposit Only" language for endorsement prior to mobile deposit); *Mobile Deposit*, S&T BANK, <https://www.stbank.com/Content/Personal/Online-Banking/Mobile-Deposit.aspx> (last visited July 28, 2014) (same).

²⁵ Subject to applicable state and federal law, employers (and by extension, banks) might protect themselves by utilizing direct-deposit technology, thus eliminating the need for paper checks.

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is a need for a revision of the UCC to account for these advances in technology. Until such time as the UCC is revised, other statutes are enacted, or case law is decided to clarify these issues, banks, employers, and general consumers should be aware of the risks of duplicate presentment when issuing or depositing paper checks.

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