

“CHECK 21” - New Federal Law to Speed the Check Clearing Process

In order to improve the nation’s check payment system and the way in which banks process checks, Congress has enacted the *Check Clearing for the 21st Century Act*, known as *Check 21*. The new law became effective October 28, 2004, and is codified under 12 USC 5001 *et seq.* The main purpose of *Check 21* is to expedite funds availability by allowing banks to process more checks electronically, by capturing a picture of the check, along with the associated payment information, and transmitting this information electronically. If a receiving bank or its customer requires a paper check, the bank can use the electronic picture and payment information to create a paper “substitute check.” This process enables banks to reduce the time and cost of physically handling and transporting original paper checks. In the event a loss is suffered relating to an error in the processing of a substitute check, *Check 21* provides that a claim can be filed with the bank for a refund (called an “expedited recredit”) if the substitute check was incorrectly charged to the account and a monetary loss was suffered.

Under *Check 21*, checks are expected to clear much more quickly, dramatically reducing the “float period” associated with most traditional paper checks. *Check 21*, however, does not change the maximum hold times by which a bank must make funds available, although the *Expedited Funds Availability Act* requires the Federal Reserve Board to reduce maximum hold times in step with reductions in actual check-processing times. Over the longer term, therefore, it is likely that the Board will reduce maximum hold times in order to reflect the expected increases in the speed of processing checks.

In the meantime, however, attorneys should be mindful of the impact *Check 21* may have on real estate closings and the processing and clearing of payments through IOLTA accounts. Of particular concern is the likely scenario where the check an attorney takes in and deposits *into* an IOLTA account may take days to clear, while the check written *from* the IOLTA account could clear in hours, thus increasing the chances of bounced checks. To reduce the likelihood that checks will bounce, an attorney can request liquid funds via wiring of monies into and out of the trust account. Accepting certified checks is another alternative, although certified checks still may take time to clear. On a practical note, attorneys should take extra care to ensure that checks are deposited in a timely manner into the trust account and available to be drawn upon.

With the passage of *Check 21*, fewer original checks will be included in bank statements, replaced by paper substitutes. When a substitute check is created, the original check will usually be destroyed by the processing institution. Another implication of the new act, therefore, is the likelihood that an “original” check will be unavailable in instances in which a check is used as proof of payment of a debt, such as a mortgage. Accordingly, *Check 21* makes a substitute check the *legal equivalent* of the original check for all purposes, including any provision of any federal or state law. A substitute check appears as a slightly reduced image of the front and back of the original check, with this

statement on the front of the substitute check: “This is a legal copy of your check. You can use it the same way you would use the original check.”

The following material addresses some of the state-specific concerns which our members and agents may have as to the implications of the new law. We will continue to monitor the effects of this new law and will keep you posted as to any new developments.

Connecticut:

Overdraft Notification

An area of concern for practicing attorneys is that the enactment of *Check 21* may result in more bounced checks and, therefore, more instances of overdraft notification sent to the Statewide Grievance Committee. Given the speed at which checks will be processed, attorneys must be diligent in making deposits to their financial institutions as soon as is feasible. There may be situations, however, where sufficient funds are on deposit in an account, although those funds are deemed “uncollected.” Under Connecticut Practice Book Section 2-28, titled “Overdraft Notification,” when a check is presented against sufficient deposited funds in the bank, but the funds are *uncollected*, the financial institution is *not* required to report an overdraft. Section 2-28(a)(4) defines “uncollected funds” as funds deposited in an account and available to be drawn upon but not yet deemed by the financial institution to have been collected. No report to the Statewide Grievance Committee shall be required under such circumstances. [Section 2-28(d)]. Therefore, so long as the check is timely deposited and available to be drawn upon, the attorney has not committed misconduct. The Practice Book also provides, at Section 2-28(d), that “No [overdraft notification] report shall be required if funds in an amount sufficient to cover the deficiency in the trust account are deposited within one business day of the presentation of the instrument.”

Attorneys should be mindful that financial institutions sometimes report overdrafts in error, in that sufficient funds are on deposit although not yet collected, or in that they do not wait one business day to allow sufficient funds to be deposited. Even if an attorney believes that an overdraft notification was sent in error, the attorney must still respond to any correspondence received from the Statewide Grievance Committee.

Affidavit for Release of Mortgage, C.G.S. § 49-8a

In many instances, a release of a mortgage is not forthcoming, despite attempts to acquire one from the prior mortgagee. The encumbrance nevertheless needs to be cleared on the land records, and a copy of the negotiated payoff check is generally needed to provide evidence of payment. C.G.S. § 49-8a provides a mechanism for the filing of an affidavit in lieu of a mortgage release, which then will constitute a release of the mortgage. The affidavit shall have attached to it photostatic copies of documentary evidence that payment has been received by the mortgagee, including the mortgagee’s endorsement of any check. The affiant shall certify in the affidavit that the documentary evidence is a

true copy of the original. [§ 49-8a(e)]. Under *Check 21*, however, the original check will very likely be destroyed, so the attorney must obtain a substitute check and, perhaps, pay a fee to obtain the substitute check. Because *Check 21* makes a substitute check the legal equivalent of the original check for all purposes, including any provisions of any federal or state law, a copy of the substitute check may be attached to the § 49-8a affidavit, in lieu of the original check.

Massachusetts:

Pursuant to Mass. R. Prof. C. 1.15(f), a lending institution must report all dishonored checks to the Board of Bar Overseers. An area of concern for conveyancing attorneys in Massachusetts, therefore, is that the enactment of *Check 21* will result in more dishonored checks, subjecting the attorney to sanctions by the Board of Bar Overseers.

Massachusetts attorneys are also bound by Massachusetts General Laws Chapter 183, Section 63B, often referred to as the “Good Funds Statute.” This statute prohibits the recordation of real estate mortgages until the proceeds of the loan are fully funded. Therefore, the loan proceeds must be transferred to the mortgagor or mortgagee’s attorney, in accordance with the settlement statement, before the mortgage is recorded at the registry of deeds. Permissible means of funding are by wire transfer, certified check, bank treasurer’s check or cashier’s check. As mentioned above, one of the troublesome aspects of *Check 21* is that while it dramatically speeds up the processing of checks written on an account, there has not yet been a reduction in the maximum hold times by which a bank must make funds available. Therefore, the check which an attorney writes against an account may be processed immediately, while the checks deposited into that account may not be credited for a number of days. This raises a number of issues for the conveyancer. Problematic situations include the acceptance of IOLTA checks from other attorneys, as well as the lack of immediate availability of certified check, bank treasurer’s check or cashier’s check. *Check 21* also adds to the complication of “piggy back” or “sell buy sell” transactions and the timely tendering of payoffs. The only certain way to avoid returned checks is for attorneys to ensure that all funds are liquid in their account before issuing checks on the funds.

New Hampshire:

Check 21 will impact the conveyancing practice in New Hampshire. Settlement Funds will need to be ‘unconditionally available’ in the account of the settlement agent, whether an attorney or a non-attorney, in order to avoid the chances of a bounced check due to the faster processing speed of disbursement checks.

A disbursement check written against an account may be processed immediately, while the checks deposited, but not yet cleared, into that account may not be credited for a number of days. Check 21 also adds to the complication of “piggy back” or “sell buy sell” transactions and the timely tendering of payoffs. The only certain way to avoid returned checks is for attorneys or non-attorneys to ensure that all funds are liquid in their account before issuing checks on the funds.

In New Hampshire, Mortgagees are bound by NH RSA 477:52 Funding of Loans at Real Estate Closings. The obligation runs to the mortgagee to fund a loan secured by real estate at a real estate closing. Funds must be in the form of Cash; Wired funds or electronic transfer; Certified check; Checks issued by a governmental entity or instrumentality; Checks or other drafts drawn by a state-chartered or federally-chartered credit union; Checks issued by an insurance company licensed and regulated by the department of insurance; or Cashier’s check, teller’s check, or treasurer’s check or Any transfer of funds by check or otherwise that are finally collected and unconditionally available to the settlement agent. The last provision is the best rule of practice for a settlement agent whether an attorney or a non-attorney. Only when the funds are ‘unconditionally available’ to the settlement agent are they truly good funds. The statute does not address funds coming from non-mortgagees, such as seller’s deposits or buyer’s funds.

Attorneys in New Hampshire are ethically obligated not to commingle funds and are regulated by the New Hampshire Bar Association to concerning funds held in trust for clients. Non-Attorneys are not regulated.

Vermont:

Loan closers are subject to Vermont’s Good Funds statute, 9 VSA Chapter 4, including the obligation to make funds available at the closing or by 2 p.m. on the day the rescission period expires. The Vermont Supreme Court is considering an emergency amendment to Rule 1.15 of the Vermont Rules of Professional Conduct to address the types of funds that a loan closer can accept from lenders, realtors, brokers and other attorneys. Rule 1.15 entitled Trust Accounting System sets forth that every attorney in private practice or who otherwise receives client funds or the firm organization shall maintain a trust accounting system that includes minimum features, including a ledger, a separate accounting for each client for whom property is held, records documenting timely notice to clients of all receipts and disbursements from trust accounts and an index of all trust account. All such records and accounts are subject to a compliance audit by an accountant selected by the Supreme Court.

If Rule 1.15 is amended it will ameliorate the harsh effects of a recent Ethics Advisory Opinion concerning acceptance of checks at closings. The opinion responded to the question: What procedures are required in issuing checks from client trust accounts for real estate closings drawn on funds deposited via broker’s or lawyer’s trust account checks that have not yet cleared pursuant to applicable banking rules? The relevant portion of the Ethics opinion states: “The Committee understands that this inquiry arises

from the standard condition in real estate purchase and sale contracts that the buyer must provide cash or a certified check to the seller at closing. However, buyers often arrive at the closing with checks that cannot clear on the day of closing, including checks drawn on another attorney's IOLTA account or real estate broker's IORTA account, and lawyers are then asked to deposit those checks into their own IOLTA accounts and to issue a check for the closing funds on the same day the deposit is made. As written, relevant provisions of the Vermont Rules of Professional Conduct support the inference that client funds cannot be disbursed from the client trust account until the deposit upon which the withdrawal or check will be drawn has cleared and the client funds are available for disbursement under applicable banking rules. See, e.g., VRPC 1.15(b) (b) ('A lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive.') (emphasis added). If a check is drawn or a withdrawal is made from the client trust account before the corresponding deposit has cleared, then the funds that are being withdrawn from the account actually are the property of another client. If such withdrawals were allowed, the second client could impermissibly be denied access to her funds deposited in a lawyer's client trust account until the first client's check cleared. Under these circumstances, the only available response is for the attorney expressly to warn a client who will be involved in a closing that, unless liquid funds are available on the date of the closing, the closing will not be able to proceed. Checks from other lawyer's and broker's trust accounts are not liquid funds unless presented in a form that is immediately available, whether by way of wire transfer, transfer from another account within the same bank, or cash."