

Use of Check Images By Customers of Financial Institutions

Version Dated: July 14, 2006

This document provides an overview of the treatment of check images under the Check 21 Act and laws and regulations generally applicable to electronic records. This document considers the use of check images, as opposed to original checks, by banks and their customers in three specific contexts: (i) the use of check images to satisfy state recordkeeping requirements applicable to various businesses and occupations, (ii) the use of check images to satisfy recordkeeping requirements for taxpayers under rules of the Internal Revenue Service (the “IRS”) and the U.S. Trustee Program applicable to bankruptcy trustees; and (iii) the admissibility of check images in court proceedings. This document is not intended as legal advice or opinion to any person, and institutions should consult with their legal counsel as to particular legal issues arising with check images or substitute checks.

This document reviews the following laws and regulations as they relate to electronic images of checks:

- federal Electronic Signatures in Global and National Commerce Act (“E-Sign Act”);¹
- state Uniform Electronic Transactions Act (“UETA”);
- federal Check Clearing for the 21st Century Act (the “Check 21 Act”);
- Federal Rules of Evidence; and
- Federal Rules of Civil Procedure.

A. Executive Summary

A customer that receives a check image from its bank should be able to use that check image as a record of the check payment transaction to satisfy federal and state recordkeeping requirements.² While the Check 21 Act only addresses the use of a substitute check by a bank and its customers, there is nothing in the Check 21 Act that

¹ Public Law 106-229, 114 Stat. 464 (codified at 15 U.S.C. § 7001, et seq.).

² This memorandum does not address the use of check images in the interbank clearing system or the use of check images by banks to post check transactions to accounts of drawer customers (in the forward presentment process) or depositing customers (in the return check process). These processes are addressed in bank clearing house rules, exchange agreements and Federal Reserve Operating Circulars (with respect to interbank relationships) and customer deposit agreements, in conjunction with the Uniform Commercial Code and Regulation CC.

limits the enforceability or legal recognition of the check image as a record of the payment transaction under other applicable law.

With regard to such other applicable law, check images are specifically recognized under the federal E-Sign Act and the state UETA. The procedures of the IRS recognize the use of electronic records generally, and this would extend to check image records of paper checks. Similarly, the U.S. Trustee Program has issued guidance to bankruptcy trustees permitting the acceptance of check images from financial institutions subject to certain format and process requirements. In addition, check images are admissible in federal court cases under the Federal Rules of Evidence as a “writing and recording.” The Federal Rules of Civil Procedure also include electronic data in the definition of “document” and the Advisory Committee Notes state that the Rules should be interpreted to include emerging technology, such as computer data. Finally, the Uniform Rules of Evidence, adopted by approximately 38 states, follow the Federal Rules of Evidence and for these same reasons should provide for the admissibility of check images in those state courts.

B. Relation of the Check 21 Act To Check Images

The Check 21 Act does not specifically address the use of a check image, as opposed to an original paper check or a substitute check, in a court proceeding, or the use of a check image to satisfy recordkeeping or other data retention requirements under applicable law. Rather, the Check 21 Act only addresses the legal recognition of a “substitute check,” which is created from a check image by the reconverting bank. In this regard, the Check 21 Act provides that a substitute check is the legal equivalent of the original check for all purposes.³

Although limited in application to substitute checks, there is nothing in the Check 21 Act itself that limits or restricts the legal enforceability of check images under other applicable law or agreements. Indeed, the entire substitute check process is built on the assumption that banks and their customers will exchange and use check images in the check collection and return process. The substitute check is intended to be created only when a specific bank or customer does not agree to check image exchange.

The existence of the Check 21 Act does provide paying and returning banks with an option to address potential issues regarding a customer’s acceptability of a particular check image. A bank could use the authority under the Check 21 Act to create a substitute check in the limited situation where the bank or its customer had a specific concern with the check image. For example, the paying bank could print a substitute check from a check image if the bank or its customer felt that an image alone was not sufficient to meet the specific needs of the bank or its customer in a particular context. The Commentary to the regulation implementing the Check 21 Act makes it clear that a paying bank that receives a check image for payment from a presenting bank may subsequently create a substitute check for delivery to its customer.⁴ Moreover, the

³ Section 4(b), Check 21 Act.

⁴ See Regulation CC, Commentary, Section 229.2(ccc)-1(B).

Supplementary Information to the regulation (which is released by the Federal Reserve with the final regulation) contemplates that a bank can provide a substitute check to its image-receiving customer upon request, such as to satisfy a warranty claim made by that customer.⁵

Once the check image is converted to a substitute check, that substitute check could take advantage of the provision in the Check 21 Act that provides legal equivalency to the substitute check. It should be highlighted that there is nothing in the Check 21 Act that states that a bank must provide a substitute check to its customer, either upon request of the customer or in the general course of business.

C. Check Images Under the Federal E-Sign Act and the State UETA

The federal E-Sign Act and the state UETA are each designed to, among other purposes, legally validate electronic records. E-Sign Act § 101; UETA § 7. The E-Sign Act applies to federal and state legal requirements, but it is not applicable to a state legal requirement if that state has enacted a statute, regulation, or other rule of law that constitutes an adoption of the version of the UETA approved by the National Conference of Commissioners on Uniform State Laws (“NCCUSL”). E-Sign Act § 102. The UETA currently has been adopted by 48 states, the District of Columbia and U.S. Virgin Islands. The provisions of the E-Sign Act and the UETA as relevant to this analysis are virtually identical, so the analysis under both statutes should be comparable.

Check images are “electronic records” covered under the E-Sign Act and the UETA. The E-Sign Act and the UETA both include records formed by electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities within the scope of “electronic records.” E-Sign Act § 106(2),(4); UETA § 2(5),(13). The coverage of check images under the E-Sign Act and the UETA is confirmed by the fact that each statute provides that if a statute, regulation or other rule of law requires the retention of a check, that requirement is satisfied by retention of an electronic record of the information on the front and back of the check. E-Sign Act § 101(d)(4); UETA § 12(e).

The Official Comment to Section 12(e) of the UETA further confirms the coverage of check images. The Official Comment expressly addresses check images, stating that the requirements many states have for the retention or production of original paper checks “preclude banks and their customers from realizing the benefits and efficiencies related to truncation processes otherwise validated under current law. The benefits to banks and their customers from electronic check retention are effectuated by this provision.” UETA § 12, Com. 6.

The E-Sign Act and the UETA both exclude an electronic record “to the extent it is governed by” the Uniform Commercial Code (“UCC”) and certain other listed statutes. E-Sign Act § 103(a)(3); UETA § 3(a). The E-Sign Act and the UETA do apply, however, to electronic records and electronic signatures to the extent they are governed

⁵ See Supplementary Information to Final Rule, “Availability of Funds and Collection of Checks,” 47290 Fed. Reg. 47296 (Aug. 4 2004).

by a law other than the UCC or the other listed statutes. UETA § 3(b). Thus, Section 103(a)(3) of the E-Sign Act and Section 3(a) of the UETA exclude from these statutes check images for purposes of negotiability, interbank collectibility and the other issues addressed in the UCC and the other listed statutes, but they do not exclude from these statutes check images for all other purposes, such as for the evidentiary purposes discussed below.

As discussed above, the E-Sign Act and the UETA each generally provide that a record relating to a transaction may not be denied legal effect, validity or enforceability solely because it is in electronic form. E-Sign Act § 101; UETA § 7. The UETA specifically provides as an example of this general rule admissibility for evidentiary purposes. Section 12(f) of the UETA specifically states that a record retained as an electronic record satisfies a law requiring the retention of a record for evidentiary, audit, or like purposes, unless a subsequently enacted law prohibits the use of an electronic record for the specified purpose. Section 13 states that in a proceeding, evidence of a record or signature may not be excluded from evidence solely because it is in electronic form.

The UETA Official Comments confirm that the UETA provides for the court admissibility of an electronic record. Comment 1 to Section 12 states:

So long as there exists reliable assurance that the electronic record accurately reproduces the information, this section continues the theme of establishing the functional equivalence of electronic and paper-based records. This is consistent with Fed. R. Evid. 1001(3) and Unif. R. Evid. 1001(3) (1974). This section assures that information stored electronically will remain effective for all audit, evidentiary, archival and similar purposes.

Uniform Electronic Transactions Act, Com. 1, § 12 (July 1999).

D. Recognition of Image Records By the Internal Revenue Service

A question that may arise with respect to a customer's use of check images as a record of a payment transaction is the acceptability of a check image by the IRS for tax record purposes. The IRS has certain standards that must be met with respect to electronic records retention generally for tax record purposes. Under IRS Revenue Procedure 97-22, the IRS will accept an electronic record of a transaction provided the electronic record system meets certain general requirements set forth in the Revenue Procedure.

For example, the Revenue Procedure requires that the reproduction of books and records by the electronic storage system must meet a high level of legibility and readability. Pursuant to the Revenue Procedure, the reproduction must be "legible" to the extent that an observer can "identify all letters and numerals positively and quickly to the

exclusion of all other letters or numerals” and “readable” to the extent that an observer can “recognize a group of letters or numerals as words or complete numbers.”⁶

This Revenue Procedure does not expressly address the storage or treatment of electronic images of paper checks. A plain reading of the Revenue Procedure and its general applicability to “records” supports the view that it would encompass a system for storing and retrieving electronic images of checks. In further support of the applicability of this Revenue Procedure, in an informal telephone discussion with the staff of the IRS office responsible for this Revenue Procedure, the staff confirmed that the Revenue Procedure would apply to electronic image records of paper check transactions.

It is not possible to conclude that every check image recordkeeping system in use at a financial institution or at a customer location would meet the requirements of this Revenue Procedure without an actual review of such check image systems. However, one of the more significant requirements of the Revenue Procedure --- to reproduce “legible” and “readable” records -- is very consistent with the legal and operational goals of all the participants in the check image system. Banks and processors in the check collection process may need to convert a check image to a substitute check in order to complete collection of the check. Accordingly, banks seek to produce, exchange and maintain records of check images that meet the Check 21 standard of accurately representing all of the information on the front and back of the original check⁷ at the time of truncation.

E. Use of Check Images by Trustees In Bankruptcy

Given the widespread use of accounts at financial institutions for the administration of bankruptcy estates, this section reviews the use of check images to satisfy certain recordkeeping requirements applicable to bankruptcy trustees.

The U.S. Trustee Program of the U.S. Department of Justice oversees all bankruptcy trustees nationwide. The U.S. Trustee Program has issued a Policy Statement⁸ on the use of check images by bankruptcy trustees for cases filed under all of the Chapters of the Bankruptcy Code. The Policy Statement provides that the trustees can accept check images from the depository bank that holds the accounts for administering the bankruptcy estate. The Policy Statement does impose some format and process requirements on the check images provided by the depository bank. Among other requirements, for bankruptcy cases filed under Chapters 7, 11, 12 and 13, the Policy Statement requires that the depository bank must provide:

⁶ Rev. Proc. 97-22 § 4.01(3).

⁷ Section 4(b)(1), Check 21 Act.

⁸ United States Trustee Program Policy Statement, “Bank Statement and Canceled Check Requirements For Bankruptcy Trustee Bank Accounts Under the Check Clearing for the 21st Century Act”, dated October 28, 2004.

http://www.usdoj.gov/ust/eo/private_trustee/library/chapter11/index.htm

- Electronic images on paper of both the front and back of each canceled check with no more than four checks (front and back – eight images in total) per statement page.
- If a CD of images is provided, electronic images of all of the canceled checks on an unalterable CD (e.g., read-only and write-protected CD-R), with the front and back of the canceled checks segregated by account.
- Images on paper identifiable as coming from the depository bank (e.g., paper containing the depository bank’s logo).
- Upon request, a substitute check or an enlarged electronic check image in paper form to a trustee.

The Policy Statement indicates that, in the near future, the U.S. Trustee Program will incorporate this check image policy into its Handbooks for trustees. Accordingly, the requirements of the Policy Statement could change when incorporated into the Handbooks. To date, the U.S. Trustee Program has only issued one updated Handbook,⁹ for use by trustees in the context of Chapter 7 bankruptcies, that incorporates policy on check images. The Handbook describes a number of requirements of bankruptcy trustees relating to the bank account that the trustees must establish in order to administer the bankruptcy estate. In particular, the Handbook requires that the trustee maintain canceled checks for a period of two years, and that the bank furnish canceled checks with the monthly account statement. With respect to the use of images to meet these recordkeeping requirements, the Handbook expressly states that, in light of the Check 21 Act, “the term ‘canceled check’ has been broadened to include canceled original checks, canceled substitute checks, and electronic images on paper of both the front and back of each canceled check, with no more that four checks (front and back – eight images in total) per statement page.” The Handbook further states that “for depositories providing canceled check images printed on paper, the paper must be identifiable as coming from the depository (e.g., paper containing the depository’s logo).”¹⁰

A financial institution is typically required to execute a depository agreement with the trustee that sets forth certain requirements for the administration of the bank account of the bankruptcy estate. A financial institution should review these depository agreements when they are presented to the financial institution to ensure that the financial institution can meet any operational requirements imposed with respect to delivery of check images to the trustees.

F. The Federal Rules of Evidence

The Federal Rules of Evidence also support the conclusion that check images are admissible in federal court proceedings. Under the Federal Rules of Evidence, writings and recordings are admissible in federal court proceedings. Fed. R. Evid., art. X. Rule

⁹ U.S. Department of Justice, Executive Office for United States Trustees, Handbook for Chapter 7 Trustees, July 1, 2002 (includes technical amendments effective January 1, 2005). http://www.usdoj.gov/ust/eo/private_trustee/library/index.htm

¹⁰ See Handbook for Chapter 7 Trustees, page 9-5, footnote No. 9.

1001(3) of the Federal Rules of Evidence defines a “writing and recording” as consisting of “letters, words, or numbers, or their equivalent, set down by handwriting, typewriting, printing, photostating, photographing, magnetic impulse, mechanical or electronic writing, or other form of data compilation.” The Federal Rules of Evidence borrow the term “data compilation” from Rule 34(a) of the Federal Rules of Civil Procedure and state that the definition is “broadly descriptive of any means of storing information other than the conventional words and figures in written or documentary form. It includes, but is by no means limited to, electronic computer storage.” Notes of Advisory Committee on Rule 803, Fed. R. Evid. 803. Check images would appear to fall within the definitions of “writings” and “recordings” admissible in federal court proceedings.¹¹

The Federal Rules of Evidence also appear to include check images under the business records exception to the hearsay rule, which is further evidence of check image admissibility in federal court.¹² Rule 803(6) allows an exception for records of regularly conducted activities. Fed. R. Evid. 803(6). The exception includes memoranda, reports, records, and data compilations and requires that they: (1) be made at or near the time by, or from information transmitted by, a person with knowledge; (2) be kept in the course of a regularly conducted business activity; and (3) be the regular practice of that business activity to make the memorandum, report, record or data compilation, as shown by the testimony of a qualified witness, unless the source, method or circumstances of preparation indicate a lack of trustworthiness. Fed. R. Evid. 803(6).

In State v. Lombardi, an Illinois appellate court held that computer records of the defendant’s improper withdrawals from a bank, including check images and microfilm copies of checks, could be admitted as evidence under the Federal Rules of Evidence. State v. Lombardi, 711 N.E. 2d 426 (Ill. App. Ct. 1999), 1999 Ill. App. LEXIS 325. The Court found that it is well settled that computer-generated business records are admissible under the business records exception to the hearsay rule if (1) the electronic computing equipment is standard in the industry; (2) the input is entered in the regular course of business reasonably close to the time of the event; and (3) the foundation testimony establishes that the sources of information, method and time of preparation indicate its trustworthiness and justify its admission. Id. at 433 (citation omitted). The Court found these requirements for admission satisfied for check images because the software was

¹¹ Depending on the context in which the check image arises, the check image also may be admitted under the Federal Rules of Evidence as a duplicate of the original check. Under the Rules of Evidence, a duplicate is admissible to the same extent as an original, unless a genuine question is raised as to the authenticity of the original, or under the circumstances it would be unfair to admit the duplicate in lieu of the original, for example, if it is incomplete or there are erasures or defects. Fed. R. Evid. 1003. The Notes of the Advisory Committee to this Rule cite a decision in which the court admitted a photostatic copy of a check instead of microfilm original. Notes of the Advisory Committee to Rule, citing Myrick v. United States, 332 F.2d 279 (5th Cir. 1964).

¹² Hearsay is statement, offered in a court proceeding as evidence to prove the truth of the matter asserted, that is not made by the declarant while testifying at the trial or hearing. Hearsay is not admissible in a court action except as provided by an exception under the Rules of Evidence or other statutory or regulatory authorization. Fed. R. Evid., Rules 801 and 802.

used by a large number of institutions in the industry, the electronic records were created in the normal course of business, and the information was trustworthy. Id. at 434.

G. The Federal Rules of Civil Procedure

The Federal Rules of Civil Procedure also address the permissibility of using electronic records such as check images in federal litigation. Rule 34(a), relating to discovery, permits a party to “inspect and copy, any designated documents (including . . . data compilations from which information can be obtained, translated, if necessary, by the respondent through detection devices into reasonably usable form), . . . or to inspect and copy, test or sample any tangible things which constitute or contain matters within the scope of Rule 26(b).” Fed. R. Civ. P. 34(a). The Advisory Committee Notes include electronic data in the definition of the term “document”:

The inclusive description of ‘documents’ is revised to accord with changing technology. It makes clear that Rule 34 applies to electronic data compilations from which information can be obtained only with the use of detection devices, and that . . . respondent may be required to use his devices to translate data into usable form. In many instances, this means that the respondent will have to supply a print-out of computer data.

Notes of Advisory Committee on 1970 Amendments to Rules, Fed. R. Civ. P. 34.

H. State Rules Regarding the Admissibility of Electronic Evidence

The admissibility of evidence in a state court is governed by the law of that state. Approximately 38 states have adopted the model Uniform Rules of Evidence, which are almost identical to the Federal Rules of Evidence. For the same reasons discussed above in the context of the Federal Rules of Evidence, check images should be admissible in the state courts of these 38 states. See Unif. R. Evid. 1001(3), 803(6) (1974) (amended 1986 and 1988). While we have not reviewed the rules of evidence in the remaining states, for the reasons indicated above, the E-Sign Act (for those states that have not enacted the UETA) or the UETA (for those states that have enacted the UETA) should provide for the admissibility of check images in these other states. In addition, other statutes in these states may provide for the admissibility of electronic records, including check images. See e.g., People v. McFarlan, 744 N.Y.S.2d 287, 290-91 (N.Y. Sup. Ct. 2002) (a criminal case holding that, under the New York Electronic Signatures and Records Act, the electronic form of photographs existing in computer memory is an electronic record and an “original,” as opposed to a second print out, of the photographs in question).

* * * *