

Check Warranties and Indemnities- Understanding UCC 3 & 4

Kari Kronberg, AAP, APRP, NCP

Director of Education

kkronberg@macha.org

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Uniform Commercial Code (UCC)



A set of standardized state laws that govern financial contracts

- Adopted in 1952
- Articles 3 & 4 revised in 1990
- Other updates in the interim

Establishes general duty standards for parties to

- Act in Good Faith
- Exercise Ordinary Care

Together with case law, articles 3 & 4 document legal boundaries for most aspects of check processing

Uniform Commercial Code

1. General Provisions-
Definitions, rules of interpretation

2. Sales-Sales of goods

2A. Leases-Leases of goods

**3. Negotiable Instruments-
Promissory notes and drafts**

**4. Bank Deposits-
Banks and banking, check collection process**

4A. Funds Transfers-
Transfers of money between banks

5. Letters of Credit-
Transactions involving letters of credit

6. Bulk Transfers and Bulk Sales-Auctions and liquidations of assets

7. Warehouse Receipts, Bills of Lading

8. Investment Securities-Securities and financial assets

9. Secured Transactions-
Transactions secured by security interests

UCC Article 3 - Negotiable Instruments



Covers

Definition and requirements of a negotiable instrument

Negotiation, transfer and endorsement of these instruments, and

Liability of the parties



Sample topics:

Standards of care required for processing checks

Establishing the identity of the payee
Negligence of maker in case of forgery or alteration

Forgery and fraud loss allocation

Employer's responsibility for employee fraud

UCC Article 4 Bank Deposits and Collections

Covers check collection, payment, liabilities, time frames and responsibilities

Sample topics:

When a bank may charge a customer's account

Customer's right to stop payment

Bank's option not to pay stale-dated items

Customer's obligation to report unauthorized signatures

Any provision under Article 4 may be varied by agreement between bank and customer, except bank's duty to act in good faith and to exercise ordinary care

A Negotiable Instrument Is:

A written order
signed by the
drawer

An unconditional
promise or order
to pay a fixed sum
of money

Payable on
demand or at a
definite time

Payable to order of
a named payee or
to bearer

Instrument

- Draft= order
- Note= promise

Negotiable Instrument

Payable on demand or at a definite time

- On Demand
 - Payable on demand or at sight, or otherwise indicates that it is payable at the will of the holder
 - Does not state any time of payment
- Payable at a Definite Time
 - Payable on elapse of a definite period of time after sight or acceptance or at a fixed date or dates or at a time readily ascertainable at the time the order is issued

Payable to Payee or Bearer

Payable to bearer if:

- States that it is payable to bearer or to the order of bearer or otherwise indicates that the person in possession of the promise or order is entitled to payment
- Does not state a payee
- States that it is payable to or to the order of cash or otherwise indicates that it is not payable to an identified person

When a Bank May Charge a Customers Account

Overdraft

- Customer is not liable for overdraft if they didn't sign or benefit from the proceeds of the item

Post-dated checks:

- A bank may charge a customer's account even though payment is made before the date on the check unless the customer gives the bank notice of the postdating

Stale-dated checks:

- A bank may, but is not obligated to, pay a check presented more than six months after its date

Customers Duty to Report

Customers Duty to Discover and Report Unauthorized Signature or Alteration

- Bank sends or makes available a statement showing payment of items
- Return or make available the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid
 - Furnish legible copies of items for seven years if requested
- Customer must exercise reasonable promptness in examining the statement and must promptly notify the bank of the relevant facts
 - Report an unauthorized signature to the bank within one year from the date that the statement was made available
- Bank Deposit agreement can vary this timing

Definitions

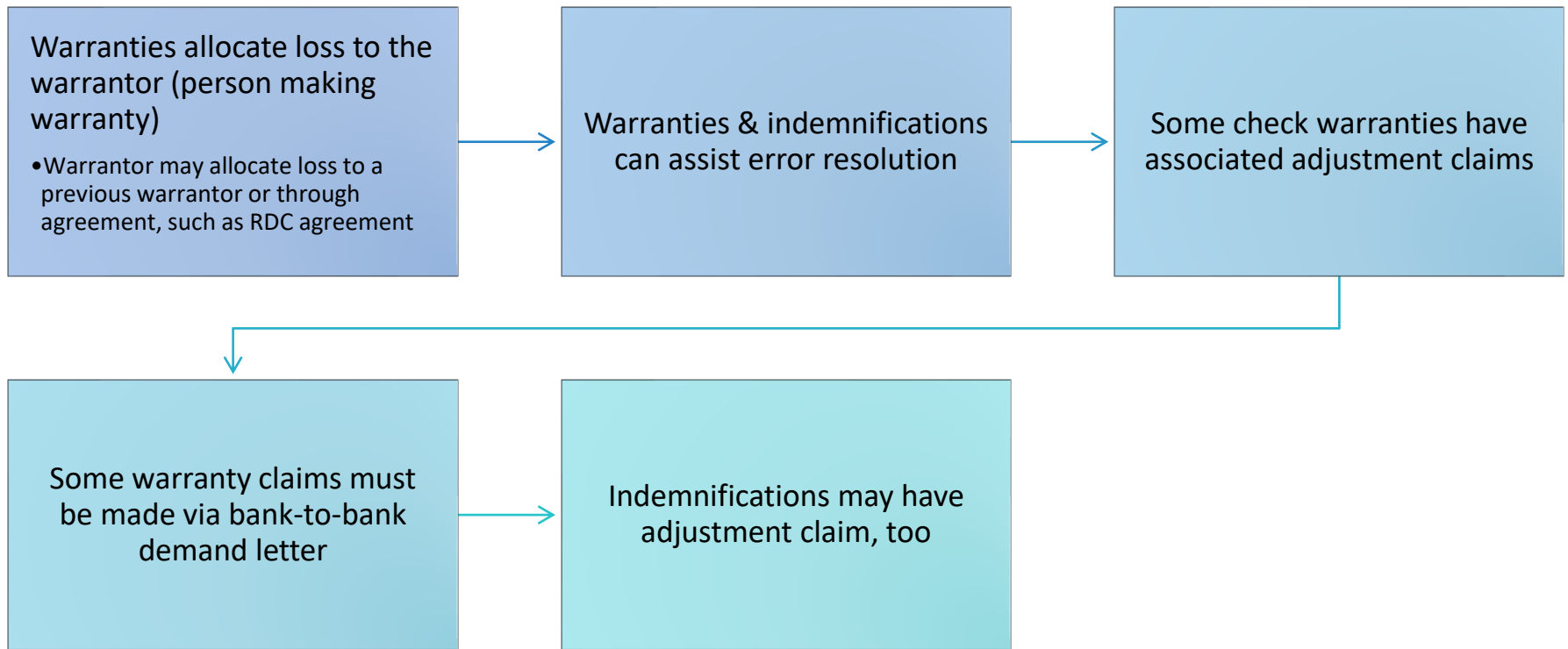
Warranty

- Collateral undertaking that a fact regarding the subject of a contract is, or will be, as it is expressly, or by implication, declared or promised to be [Merriam-Webster]
- Promise that some consideration of the contract is guaranteed by one of the contractors [Wikipedia]

Indemnification

- Action of making compensation to [someone] for incurred hurt, loss, or damage [Merriam-Webster]

Warranties & Indemnifications Allocate Loss



Forged Drawer's Signature Example

Thomas steals Dorothy's checks, forges Dorothy's signature as drawer on a check, and makes the check payable to the order of Thomas (himself)

Thomas indorses the check by signing his name on the back and cashes it at a local retail store, Mom's & Pop's

Mom's & Pop's then deposits the check in its account at depository bank, which presents the check to paying bank

Thomas' signature is not effective as the drawer's (Dorothy's) signature

- Forgery does *not* create liability for the drawer because it's not the drawer's signature

Forged Drawer's Signature Warranties



Thomas makes both the transfer warranties and the presentment warranties

Transfer warranties to Mom's & Pop's and depositary bank
Presentment warranties to paying bank



Mom's & Pop's makes both the transfer warranties and the presentment warranties

Transfer warranties to depositary bank
Presentment warranties to paying bank



Depositary bank makes the presentment warranties to paying bank



UCC Transfer Warranties

Person or
collecting
bank
transferring
item
warrants to
the
transferee
and any
subsequent
transferee

Entitled to enforce the item

All signatures on the item are authentic and authorized

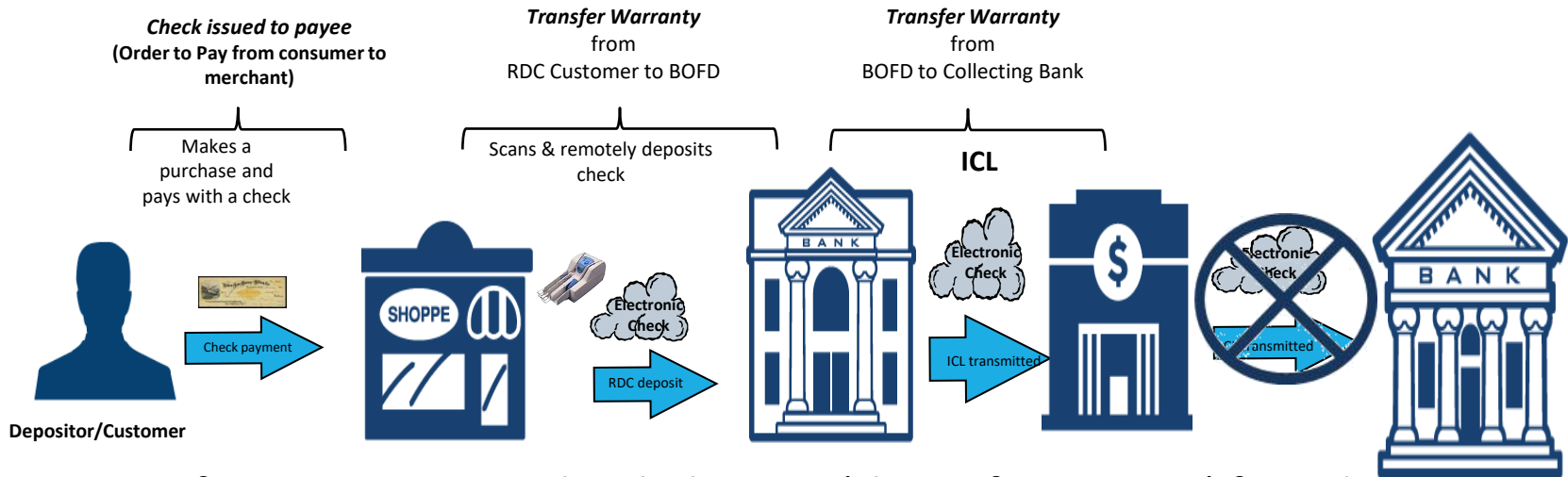
Item has not been altered

Item is not subject to a defense or claim

Warrantor has no knowledge of any insolvency proceeding with respect to the maker

For remotely created consumer item, person on whose account the item is drawn authorized item and amount for which it is drawn

UCC Transfer Warranties



- Transfer Warranties travel with the item (chain of warranties) from drawer to payee, payee to Depository Bank and Depository Bank to Intermediary/Collecting Bank
- Presentment Warranties are made from the Presenting Bank to the Paying Bank
- Warranties **provide recourse** if breach of warranty occurs

Presentment Warranties

Person presenting item and every previous transferor warrants to the drawee

Entitled to enforce draft

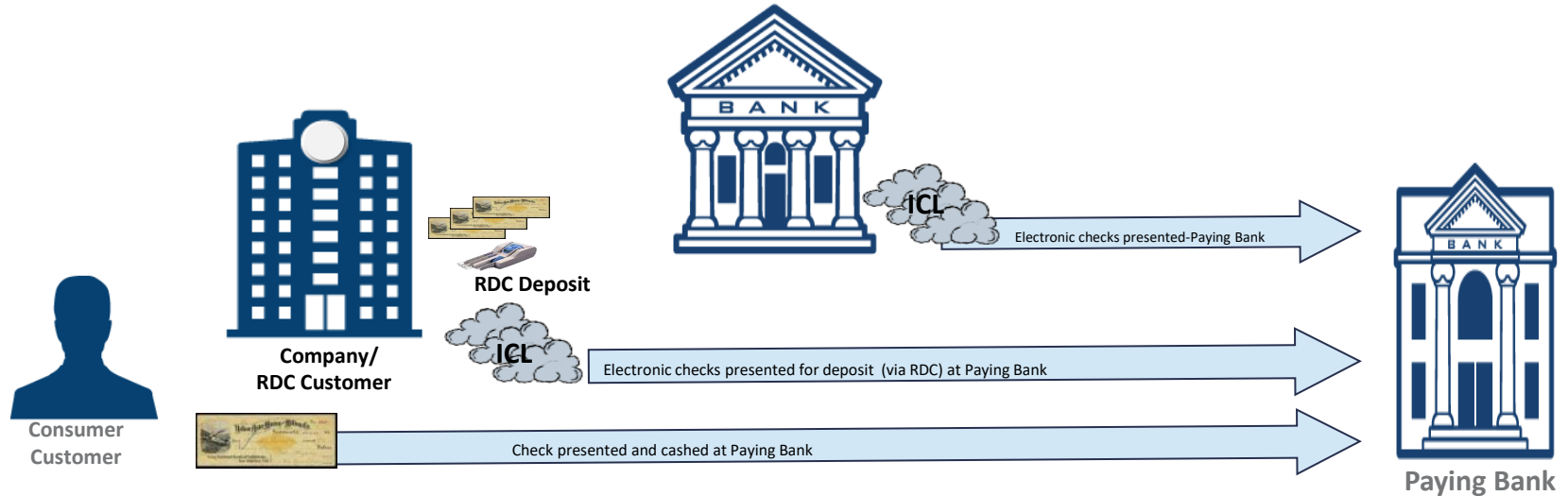
Item has not been altered

Warrantor has no knowledge that signature of the purported drawer of the draft is unauthorized

For remotely created consumer item, person on whose account the item is drawn authorized item and amount for which it is drawn

Or authorized to obtain payment / acceptance of draft on behalf of a person entitled to enforce the draft

UCC Presentment Warranties Flow



Which institution receives the UCC presentment warranties?
Paying bank only



Forged Drawer's Signature Warranties

Thomas' unauthorized signature is a breach of the transfer warranties

Assuming usual case where only Thomas is aware of the forgery, Thomas is the only person with 'knowledge' the signature of the drawer is unauthorized

- Only Thomas breaches the presentment warranty

Forged Drawer's Signature

Initial claim made by drawer to paying bank

Paying bank must make claim through return

No breach of warranty occurred*

Paying bank may return check timely using

- L – Signature(s) irregular, suspected forgery
- Z – Forgery – an affidavit shall be available upon request

Forged Drawer's Signature Responses

After returning the check timely

- Depository bank makes transfer warranty breach to Mom's & Pop's
- Mom's & Pop's makes transfer warranty breach to Thomas (if they can find him)

If return time passed do the following

Determine if drawer met their 'duty to report'

- Stated in check writing agreement (customer / member agreement)
- 1 year generally the outside limit for drawer to make claim to paying bank

Determine if the exchange is governed by the ECCHO rules

- No: No breach of warranty for forged Drawer's signature except by Thomas (good luck finding him)
- Yes: Make Rule 9 claim thanks to extra warranty under rules

Speaking of Returns Timing....

All returns must meet UCC and Reg CC return deadlines

- UCC requires the determination to pay or return the item by midnight of the banking day following presentment (UCC §4-301)
- Reg CC requires the return to be handled expeditiously (§229.30)
- Return must reach depository bank by 2:00 p.m. (local time of depository bank) 2 business days after presentment

There is no such thing as
“doing a late return”

Beyond return time frame,
paying bank must complete
adjustment or make
warranty claim, if applicable

Returned Check Warranties

Returning bank makes Regulation CC returned check warranties to the transferee returning bank, to any subsequent returning bank, to the depository bank, and to the owner of the check

- Paying bank is a returning bank when check returned

Warrants

- Returned the check within its deadline under the UCC or Regulation CC
- Authorized to return the check
- Check has not been materially altered

Returned Check Warranties

Paying bank in breach of returned check warranty that returned the check within its deadlines under UCC or in an expeditious manner such that the check would normally be received by the depository bank not later than 2 p.m. (local time of the depository bank) on the second business day following the banking day on which the check was presented [§229.34(d)]

- UCC midnight deadline found in UCC §4-401

Depository bank can make breach of warranty claim if expeditious return time frame not met

Late Return Claim Responses by Depository Bank

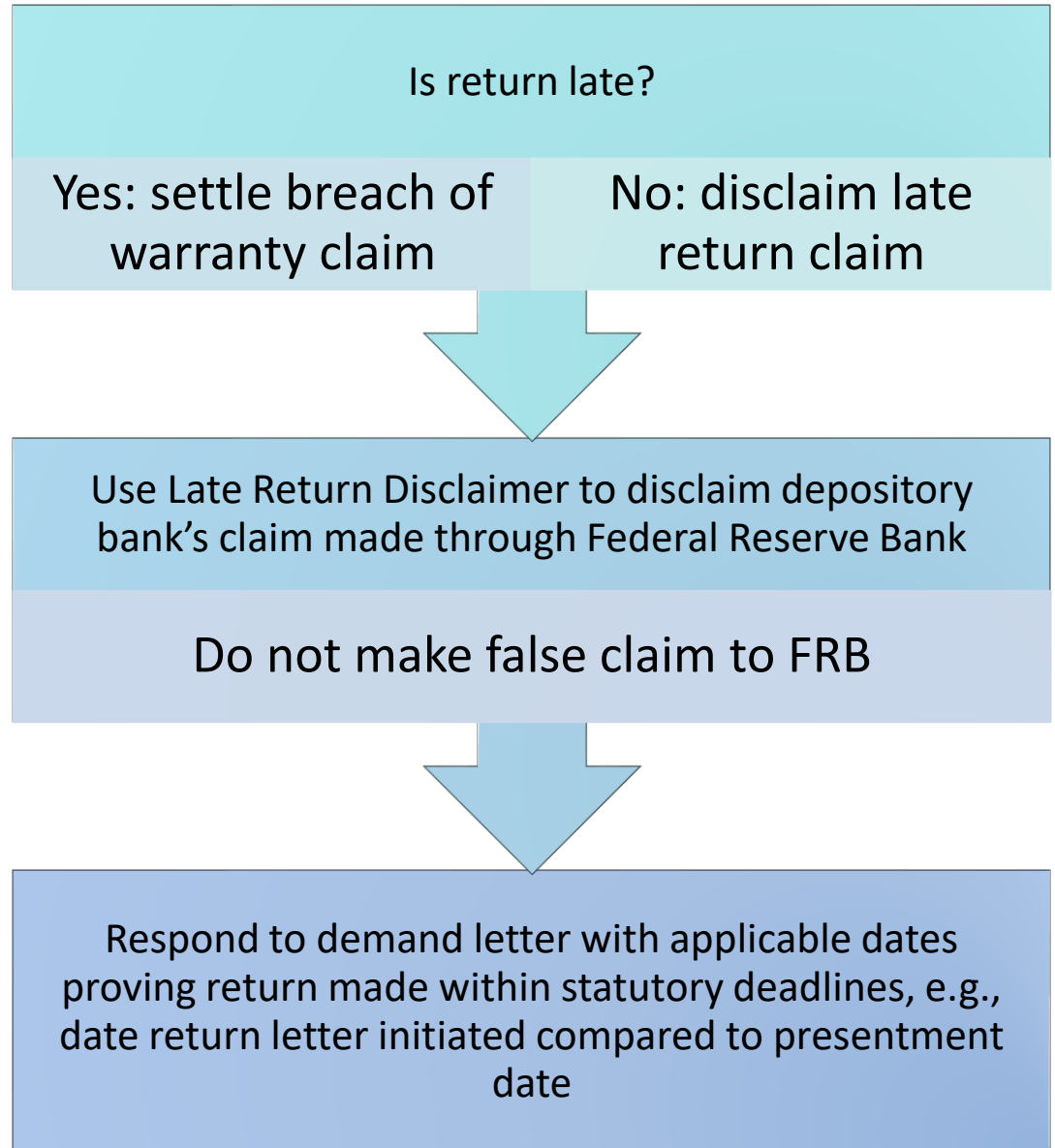
Is check greater than \$100?

- Yes: make claim through Late Return Claim adjustment
- No: make demand letter bank-to-bank

In either circumstance, initiate 2 adjustments to build supporting evidence

- Disposition (DISP) identifies where / when the item was presented
 - Documents when presentment occurred
- Source or Receipt (SOR) identifies the source of item including date initiated
 - Documents when FRB sent return image cash letter to you, typically same or next banking day paying bank initiated RICL to FRB
- Supporting evidence to make late return claim to paying bank

Late Return Claim Responses by Paying Bank



Forged Indorsement Example

Thomas steals a check payable to Peter and drawn on Dorothy's account

Thomas forges Peter's signature and now claims to be a holder of the check

Thomas indorses the check by signing his name on the back and cashes it at a local retail store, Mom's & Pop's

Mom's & Pop's then deposits the check in its account at depository bank, which presents the check to paying bank

Forged indorsement breaches both transfer and presentment warranties

Forged Indorsement Applicable Warranties

Thomas makes both the transfer warranties and the presentment warranties

- Transfer warranties to Mom's & Pop's and depositary bank
- Presentment warranties to paying bank

Mom's & Pop's makes both the transfer warranties and the presentment warranties

- Transfer warranties to depositary bank
- Presentment warranties to paying bank

Depositary bank makes the presentment warranties to paying bank

Forged Indorsement Breaches of Warranty

Thomas' forged indorsement is a breach of the transfer warranty that all signatures are valid

- Even though Thomas is the only person aware of the forgery, all transferors make the warranty

Thomas' forged indorsement is a breach of the presentment warranty that the transferors and presenters are persons entitled to enforce the check

- Forged indorsement is not effective to change the person to whom the check is payable
- Consequently, no one else can be a holder of that check (except Peter)

Forged Indorsement

Initial claim
typically made by
payee to drawer

Drawer relates
claim to paying
bank

Paying bank may
make claim
through return if
within time frame

Paying bank may
return check using

- I – Indorsement
missing

Forged Indorsement Responses

Return check timely

If return time passed: make breach of presentment warranty claim to depository bank

- Send demand letter bank-to-bank
- Include reference to UCC presentment warranties
- Include settlement information (where respondent remits payment)

No adjustment claim to assist making claim

Depository bank can make transfer warranty breach claim to depositing customer / member (Mom's & Pop's)

Mom's & Pop's can make transfer warranty breach claim to Thomas (if they can find him)

Alteration Example

Dorothy issues a check payable to Thomas

Thomas alters the \$50.00 check to read \$500.00

Thomas deposits check at depository bank

Typically, the paying bank will pay the check when presented and rely on the drawer to notify of the alteration

Dorothy notifies the paying bank of the alteration

Alteration breaches both transfer and presentment warranties

Alteration UCC §3-407

Payor bank or drawee paying a fraudulently altered instrument may enforce rights with respect to the instrument either

- According to its original terms
- In the case of an incomplete instrument altered by unauthorized completion, according to its terms as completed

Alteration Applicable Warranties

Thomas makes both the transfer warranties and the presentment warranties

Transfer warranties to depository bank

Presentment warranties to paying bank

Depository bank makes the presentment warranties to paying bank

Difference between alteration and forged indorsement scenario is check remains properly payable as originally written, i.e., for \$50.00

Alteration Breaches of Warranty

Thomas' alteration is a breach of the transfer and presentment warranties that the check has not been altered

Thomas' alteration puts the depository bank in breach of presentment warranty that the check has not been altered

Alteration

Initial claim typically made by drawer to paying bank

Paying bank may make claim through return if within time frame

Paying bank may return check using

- N – Altered / fictitious item / suspected counterfeit / counterfeit

Alteration (Amount) Responses

Return

- Return check timely

Make

- If return time passed: make breach of presentment warranty claim to depository bank
 - Send demand letter bank-to-bank
 - Include reference to UCC presentment warranties
 - Include settlement information (where respondent remits payment)

Claim

- Claim for altered amount is made for damages
 - Damages include difference between amount check written for and amount paid (\$450.00 in example) plus expenses and loss of interest, if applicable

Make

- Depository bank can make transfer warranty breach claim to depositor (Thomas)

Alteration (Payee) Responses

Return

- Return check timely

Make

- If return time passed: make breach of presentment warranty claim to depository bank
 - Send demand letter bank-to-bank
 - Include reference to UCC presentment warranties
 - Include settlement information (where respondent remits payment)

Claim

- Claim for altered payee is very similar to forged indorsement because true negotiation cannot occur
 - No one but the true payee can be a holder of the check

Make

- Depository bank can make transfer warranty breach claim to depositor (Thomas)

No Double-Debit Warranty

‘No duplicate’ warranty is really a ‘no double-debit’ warranty

- No person will receive a transfer, presentment, or return of, or otherwise be charged for an electronic check or electronic returned check, the original check, a substitute check, or a paper or electronic representation of a substitute check such that the person will be asked to make payment based on a check it has already paid [Reg CC warranty §229.34(a)(ii)]



DUPLICATE

Double-Debit Breaches of Warranty Examples

Depository bank #1 takes deposit from Thomas through mobile RDC

- Presents item to Paying bank the next banking day

Depository bank #2 takes deposit from Thomas through drive-through

- Presents item to paying bank the next banking day

Both depository banks in breach of warranty when check paid more than once

Paying bank returns the same check 2 or more times

- Paying bank in breach of warranty if depository bank pays return more than once

Double-Debit

Initial claim typically made by drawer to paying bank

- But may be identified by paying bank through duplicate detection processes

Paying bank may make claim through return if within time frame

Paying bank may return check using

- Y – Duplicate presentment

Double-Debit Responses

Paying Bank

Return

- Return check timely

Make

- If return time passed: make breach of electronic check warranty to depository bank either
 - Send PAID adjustment through FRB or DUP adjustment through ECCHO exchange agreement
 - Send demand letter bank-to-bank

Charge

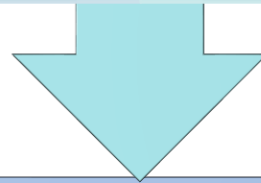
- Depository bank can charge item back to depositing owner based on its account holder agreement

Double-Debit Responses Depository Bank

For double-debit with respect to electronic returned check, make breach of electronic returned check warranty to paying bank either

Send PAID adjustment through FRB or DUP adjustment through ECCHO exchange agreement

Send demand letter bank-to-bank



For double-debit with respect to multiple adjustment claims for same check

Send DUP adjustment through FRB or DUP adjustment through ECCHO exchange agreement

Statute of Limitations

Designed to prevent fraudulent / stale claims from arising after all evidence lost or after facts have become obscure through passage of time

- Defense ordinarily asserted by defendant to defeat an action brought after appropriate time has elapsed
- Enacted by the legislature, which may either extend or reduce time limits, subject to certain restrictions

Statute of Limitations:

- Under UCC = 3 years



What Did We Learn?

Thomas is a JERK!



Questions



For Your Records

Continuing Education Credits

Check Warranties & Indemnities –
Understanding UCC 3 & 4

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This session is worth 1.8 credits

