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To all Agents and Approved Attorneys who close loans

Dated: October 21, 2004

## **Check 21 - Title Industry and Title Agency Concerns**

On October 28<sup>th</sup>, 2004 "Check Clearing for the 21<sup>st</sup> Century" Act (hereinafter referred to as 'Check 21') becomes effective. This new federal legislation significantly changes how checks are processed and supercedes any state law, including the relevant portions of current Uniform Commercial Code.

While these changes affect everyone with a business or personal checking account, it is particularly important for those title agents and approved attorneys who close real estate loans to be aware of the changes in bank procedure and possibilities of increased risk of overdraft situations and fraud.

One of the most significant changes in the law is anticipated to cause *some* of the checks written or received in the loan closing process being processed through the banking system much quicker than in the past. While this is generally perceived as a positive consequence, for a period of 3-5 years, these new laws could result in checks written out of an escrow account being processed *before* you are given credit for loan funding deposits. This could result in bank overdraft situations, customers receiving "NSF" notices and loss of reputation in the community.

Loan closers who have been depositing the lender's funding check the same day they disburse proceeds checks to closing participants need to be aware of the significant risks associated with continuation of this practice. In areas where 'at the table' disbursement has been the standard, we anticipate pressure from Realtors, Sellers and others for that practice to continue but, in order to do so safely, you will need to require lenders to make changes in how you receive loan funds. The attached Memo, "Check 21...Time for Good Funds" provides more detail to this issue and urges you to support any legislative efforts to enact "Good Funds" laws that require Lenders to provide funds for immediate credit or mandate delayed disbursement to insure you are free from the risk of overdraft situations.

Additionally, the new law will result in the implementation of new technology that unfortunately gives rise to new forms of fraud that pose new risks to your personal, business and escrow accounts. Under the law, Lenders and those making deposits are allowed to convert the original paper check into a scanned image that will thereafter be used for the remainder of the check processing process. While this will result in speed of processing, use of a scanned image eliminates many of the security protection features (watermarks, chemical alteration prevention features, etc.) that were built into the paper check. Since all you will receive from the bank in the future is a 'copy' of the check that was cleared through your account,

this may impair your ability to prove forgery or alteration in the event they have occurred.

Additionally, in addition to account activity information previously available online, now actual images of checks with signatures will now be accessible to successful computer hackers who secure your password or hack into the bank systems. If you access your account online, protect your passwords because unauthorized access could be more devastating than in the past.

But most troublesome is the fact that some entities who receive your checks will have equipment in their offices that allow the scanning of your checks and creation of an 'electronic deposit' via the internet. This hardware and software enables the check recipient to remain in their office and yet have original checks they have in hand be credited to their bank account electronically. While this is a convenient way to make deposits, several of the systems on the market allow this scanned check to remain un-marked and continue to appear as an original check that could be further re-deposited into *another* account. This would result in both the 'electronically' deposited check and the 'paper' deposited check to be submitted to your account for payment! The new law provides no provisions for commercial accounts to receive immediate re-deposits of funds debited as a result of fraudulent 'double deposits' hitting your account.

All of these new risks require new procedures to be considered and implemented. While monthly escrow reconciliation has always been a recommended practice, it may now be necessary to implement a daily reconciliation process to detect and prevent fraudulent activity. Use of 'Positive Pay' cash management tools may become a necessity and tighter controls on access to online bank account passwords mandated. In short, banking law is changing and you need to understand the changes and make appropriate adjustments in your internal and external office procedures.

**Please take a few minutes and call the bank account representative servicing your bank accounts.**

Although I would ask that person about how Check 21 will affect how your bank handles your account, I think you would be better advised to talk to a person in the "Cash Management" department of your bank because they will be better able to answer your questions. Take time to explain how you handle funds in a real estate closing. Be sure they know *when* you deposit funds in relation to *when* you hand out checks and ask them how they anticipate this will affect your escrow account. It is better to get their insight before a situation arises than wait for a problem to arise.

For your convenience and reference, I have posted a complete copy of the Check 21 statute (12 USC 5001) on the "Front Porch" area of our website at [www.stichome.com](http://www.stichome.com). The reference number is 210. The attached memo will give you a more detailed explanation on how Check 21 works.

Finally, I think you will agree that these changes make it important for "Good Funds" legislation be enacted in states where such legislation does not already exist. By passing laws that require a delay in disbursement until the bank is willing to allow funds associated with that transaction to be withdrawn from your account, you help insure there is a level playing field for all real estate loan closers. Without such a law, competition will arise urging you to disburse at the table and that requires you take serious and unnecessary risks just to retain your business relationships. Support "Good Funds" Legislation to help our industry deal with the changes in banking law.

Sincerely yours,

Eugene R. McCullough

## Check 21 ....Time for Good Funds Legislation ?

On October 28, 2004 'Check Clearing for the 21st Century Act' or 'Check 21' (12 USCS § 5001) goes into effect and may dramatically affect our business practice in certain circumstances. In order for you to avoid the possibility of an overdraft in your accounts, you need to be familiar with the changes in banking law that will take place on October 28, 2004.

### Banking 101

In order to understand the changes, it is first important to understand the basics of how checks were processed up until recently. I will focus on a typical escrow transaction in states where closing proceeds are disbursed at the closing table. In most cases, a lender will send a paper check or wire as closing funds for the closing agent. Note, there is a very significant difference between a 'paper check' and a 'wire'. Wired funds are immediately deemed to be "collected funds" by your escrow bank upon receipt and are therefore available for immediate disbursement. In cases where you timely receive wired funds for closings, Check 21 will not result in much change in you closing practices.

However, Check 21 has a significant impact on cases where funding checks are in paper form. This is because even when the closing has been properly completed and the paper check has been 'deposited' with the bank teller, it only achieves the status as a 'ledger credit' with your bank and is not available for immediate disbursement. In order for the check to be available for disbursement from your account, in the pre-Check 21 world, that paper check had to be physically transported to the bank upon which it was drawn. This took place by bank courier, truck, plane or train depending on the distance between the bank where it was deposited (Depositing Bank) and the bank upon which the check was drawn (Paying Bank). Once the paper check was delivered to the Paying Bank, current banking law allowed it until midnight of the day after posting to verify whether it would honor or dishonor that check. Once that decision was made and communicated to the Depositing Bank, they would change the status of those funds in your escrow account from a 'ledger' credit to 'collected funds' credit and allow you access to those funds for payment of transaction activity.

This time consuming, labor intensive check clearing process applies equally to Lender's checks received to fund the loan as well as those written by the closing agent and disbursed at closing table. Although most closing agents never intend to issue checks at the table that could not be immediately debited from their escrow account, the truth is that standard banking procedures prohibit use of that *particular* transaction's Lender's funding check until the 1-3 day clearing process is completed. Rightly or wrongly, most closing agents understand that you have some 'collected' funds from *previous* closings still lingering in your account (the "Float") and this fact allowed your bank to pay any checks from that transaction that were presented early.

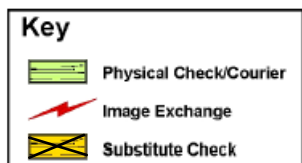
Over the years, the float came to be relied upon as a hedge against that occasionally eager seller demanding cash within hours of closing. The process of handing out checks at the closing table in residential closings has now become commonplace and is expected by the closing participants. It was never good practice, but competitive pressures, along with bank laws that resulted in the float, allowed the practice to evolve without many overdrafts or otherwise dire consequences. However, Check 21 changes banking laws and is designed to ultimately eliminate the float. Therefore, after October 28<sup>th</sup>, those who continue to take paper funding checks and comply with closing participants' demands for disbursements at the table can no longer anticipate the float will be available and risks of overdrafts will increase.

## What gave rise to Check 21?

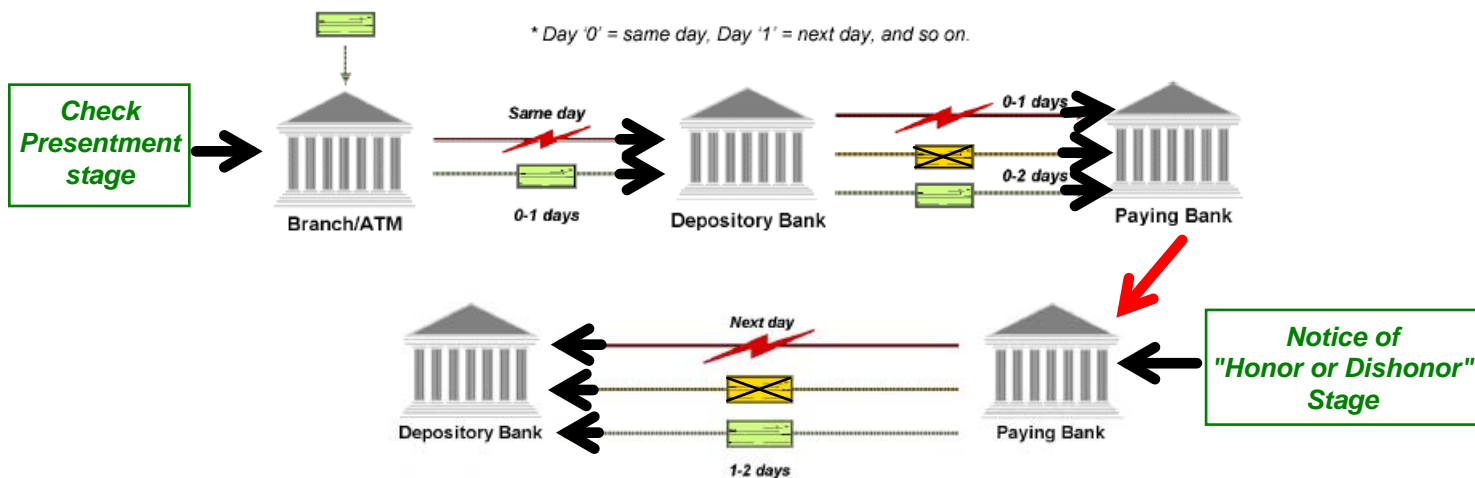
Immediately after 9/11, the banking system came perilously close to collapse when paper checks could not be flown from bank to bank for processing. Congress reacted and passed this act which allows Depository Banks to scan images of checks and then 'electronically transmit' only those 'images' of the checks to the bank upon which it was drawn (Paying Bank) for processing. No more planes, trains or automobiles and the trip through the entire clearing process is as quick as a couple of e-mails. This process is significantly less costly for banks and ultimately reduces the amount of time necessary to 'clear' a check to the point where a deposit is deemed 'collected funds'. The ultimate goal of the law is to eliminate the 'float'.

### Problems of Operating in a Mixed Processing Environment

In spite of the fact that the 20,000 + financial institutions are now 'allowed' to electronically process checks by image exchange, Check 21 does not 'require' any bank to accept or send images electronically. As a result, many of those institutions have not taken the expensive steps to purchase and install the necessary software required. This creates a 'mixed processing' environment. Many financial reporters project that for a period of 3-5 years, a significant number of banks will still conduct business the same 'slow tech' way they have done in the past; i.e. planes, trains, automobiles and paper check reading equipment. In those cases, the 'non image enabled banks' will be serviced by Depositing Bank printing a *copy* of the image and transmitting it to the Paying Bank in hard paper form for processing the way it was done for years. (This printed image is called a "substitute check" in the new law.) Paying Banks receiving substitute checks can employ the same "midnight of the next business day" or longer rules to authorize or decline payment as has been the law for the past 10 years. Thus, an image enabled Depository Bank may continue to experience returned check notices from Paying Banks as late as midnight on Day '2' from other image-enabled recipients. For this reason, Depository Banks ( and possibly the one where you make your escrow deposits) may not give you credit for that deposit for 1-3 days *after* you receive a printed deposit slip and yet the checks you disbursed at closing could be debited from your account the *next morning*.



The following graphic (from an internal banking analysis of the effects of Check 21) illustrates how electronic images make their way from the Depository Bank to the Paying Bank and back by the next day but both physical checks and substitute checks can take up to 2-3 days to make the same route. This creates a timing crisis we must anticipate.



Once all banks are 'image enabled', both the deposits you make and escrow checks you write, will be processed and cleared in almost real time and the time delay crisis described above will go away. However, so long as we have a 'mixed processing' environment, some checks will clear very fast and others will take 1-3 days before they are fully "credited to" or "debited from" your account.

Several in our industry have a concern that some banks may find it advantageous to move very slowly in adopting the new technology. Some may cater to account holders who want their accounts to hold onto their balances a couple of days longer than would be the case with an image enabled bank. Some thinly capitalized mortgage brokers who are used to issuing their own funding checks regularly rely upon the fact that their funding checks won't hit their account for several days. This gives them time to get the loan closed, receive the note and package and resell it for real funds that can go into it's account to cover the check already written. Once again, a bad practice that the 'float' has perpetuated.

Unfortunately, when you take a paper funding check, you often have no idea of whether the bank on which the check is drawn is 'image enabled' or not. Even if you think both are image enabled, you have no idea of whether either your Depository Bank or the Paying Bank is going to process that check immediately or take a conservative position and wait until midnight of the next day after initial processing to decide how to handle the check or deposit. All that uncertainty makes it prudent to assume the deposited paper check funds will not be available earlier than 2-3 days. Understanding Check 21 also leads one to the assumption that if you are banking with a local image enabled bank, almost all the checks you write from your escrow account will be debited from your account by the next morning at the latest. This puts 'at the table' disbursement in jeopardy.

### **What Can You Do?**

1. Insist on wired funds for every closing, or
2. Place your escrow account with a bank that is not 'image enabled' to insure that *your* escrow checks are on the 'slow tech' route and will take several days to be debited to match the time necessary for any funding checks to be deemed 'collected funds' in your account.
3. Continue to take paper checks but refrain from disbursement of sales proceeds, payoffs, commission checks, etc. at the closing table. Advise clients that disbursements will be made only when you have verified 'collected funds' status of loan funds.
4. In any event, talk with the personal banker responsible for overseeing your escrow accounts and explain *in detail* how you conduct your closing business. Get him or her to provide you assurances that the procedures you both agree upon will protect you and your escrow accounts from overdrafts or "insufficient funds" rejection of your escrow checks.
5. Support efforts to enact "Good Funds" legislation that will create a level playing field for all closing agents, both lawyers and non-lawyers. As noted above, disbursement before actual 'collected funds' credit is a bad practice that needs to be prohibited. Good Funds legislation can be drafted to impose a mandatory non-disbursement period in selected situations to allow time for funds to be verified as collected. Such legislation would provide relief for Closing agent's pressured for 'at the table' disbursement by Realtors, sellers and others who want their funds immediately.