

recommended that FMS adopt the commercial rule of midnight of the next business day, while five responses recommended maintaining the current "reasonable time" standard. Of those suggesting alternatives to the 150 day time frame, four respondents recommended 30 days and one suggested 90 days. One respondent recommended an approach incorporating both a "reasonable time" standard and a date certain after which payment would be final regardless of case-specific problems. This rule adopts the latter approach.

Under the provisions of § 240.5 of NPRM II, Treasury retains the right of a drawee to examine checks presented for payment, to reconcile checks, and, when appropriate, to direct a Federal Reserve Bank to decline payment of any check. Treasury shall have a reasonable amount of time to complete first examination. All payments are provisional until first examination is completed, and, as stated in the definition of provisional credit at § 240.2 of NPRM II, may be reversed by Treasury until the completion of first examination or final payment is deemed made pursuant to § 240.5(d) of NPRM II. As provided in the definition of first examination at § 240.2 of NPRM II, the amount of time necessary to complete first examination will be a function of the procedures deemed appropriate in specific circumstances to determine whether a check presented for payment bears a material defect or alteration or a forged drawer's signature. Under § 240.5(d) of NPRM II, if Treasury has not declined payment within 90 days after the check has been processed for payment by a Federal Reserve Processing Center, Treasury will be deemed to have made final payment on the check.

While FMS understands the desire of the financial community to operate under a single set of rules that are applicable to commercial checks and Treasury checks, adopting a midnight of the next business day standard is not operationally feasible. As stated previously, Treasury is not the only Federal agency to issue Treasury checks. Treasury issues payments for a majority of Executive Branch agencies, but some agencies, including the military departments and the U.S. Marshal's Office, also have statutory authority to issue Treasury checks. Some other agencies have a delegation of authority from the Secretary of the Treasury to issue Treasury checks. It is not possible for Treasury to receive check issue records from all non-Treasury disbursing officials in time for Treasury to take even the most rudimentary steps

to establish the authenticity and integrity of all such Treasury checks before midnight of the next business day. The volume of checks issued (e.g., 362 million checks in fiscal year 2001) and the number of agencies involved necessitate a standard different from that applied to commercial checks.

Further, the "midnight rule" was specifically rejected by the Ninth Circuit Court of Appeals in *Bank of America v. Federal Reserve Bank of San Francisco*, 349 F.2d 565 (9th Cir. 1965), cert. denied, 382 U.S. 984 (1966). In that case, the Court determined that Treasury regulations stating that checks are deemed paid "upon first examination" necessarily implied that "the Treasurer is to have sufficient time within which to conduct first examination." The Court also concluded that first examination included examination for forged indorsements, forged signature of the drawer, raised amounts, and other material defects. Current Treasury regulations codified at Part 240 and these proposed revisions to those regulations ensure that Treasury has sufficient time to make such examinations.

2. *Apportionment of risk.* Since the issuance of NPRM I in 1997, Treasury has continued to improve internal processes, as well as coordination with the various non-Treasury entities that issue Treasury checks, to improve the efficiency of the check payment system. As a result, Treasury is able to complete first examination on most checks in less than 30 days, and has been able to reduce the amount of time necessary to complete first examination in problem cases from 150 days to 90 days. However, Treasury also understands that despite everyone's best efforts, there will be instances where Treasury will be unable to complete first examination within the 90 day time frame, and losses will arise. In NPRM I, Treasury clearly stated that if a material defect or alteration were discovered after final payment had been made, Treasury would reclaim in instances involving forged drawers' signatures, double forgeries (checks bearing both a forged drawer's signature and a forged indorsement), and counterfeit checks. NPRM II takes a different approach. In this proposed rule, Treasury will reclaim after final payment only in those instances where an indorser has breached one of the presentment guarantees listed in § 240.3. As a consequence, this proposed rule allocates losses in specific circumstances as follows:

a. *Checks bearing a forged or unauthorized indorsement.* Treasury will reclaim on a check if it determines,

after final payment, that a check was negotiated over a forged or unauthorized indorsement. In such cases, the basis for Treasury's claim would be a breach of the guarantee of indorsements at 31 CFR 240.3(a).

b. *Checks that have been altered.* Treasury will reclaim on a check if it determines, after final payment, that a check has been materially altered. In such cases, the basis for Treasury's claim would be a breach of the guarantee of alterations at 31 CFR 240.3(b).

c. *Checks bearing a forged drawer's signature.* After final payment, Treasury will not reclaim on a check bearing a forged drawer's signature unless there is evidence that the reclamation debtor had knowledge that the drawer's signature was forged or unauthorized. In such instances, the basis for Treasury's claim would be a breach of the guarantee of drawer's signature at 31 CFR 240.3(c). This provision also applies to a check bearing both a forged drawer's signature and a forged indorsement.

d. *Counterfeit checks.* After final payment, Treasury will not reclaim on a counterfeit check unless the reclamation debtor has failed to make all reasonable efforts to ensure that a check is an authentic Treasury check and not a counterfeit check. Guidance regarding specific attributes, such as the security features on a check, that financial institutions must verify in order to ensure that they have made all reasonable efforts to ensure the authenticity of a Treasury check, will be provided by Treasury or on Treasury's behalf. In instances where Treasury determines that a reclamation debtor has failed to make all such reasonable efforts, the basis for Treasury's claim would be a breach of the guarantee of authenticity at 31 CFR 240.3(d).

In allocating the risk of loss in this manner, Treasury is cognizant of relevant case law in this area. In particular, the holding in *United States v. Chase National Bank*, 252 U.S. 485 (1920), which relied on the English case of *Price v. Neal*, 97 Eng. Rep. 871, 3 Burr. 1354 (1762), was that, after final payment, Treasury generally cannot recover on a Treasury check bearing the forged signature of a drawer, including those situations when such a check also bears a forged indorsement on the back (often referred to as a double forgery). In this proposed rule, Treasury does not alter the allocation of risk for losses involving forged drawers' signatures on authentic Treasury checks. However, this proposed rule does supersede the holding in *Chase National Bank* to the extent that the opinion applies to