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# International Payments and Five Foundations of Wire-Transfer Law

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Funds-transfer law – or wire-transfer law, as it is more commonly called – is new in the United States, and non-existent in many jurisdictions. During the early 1990s American states enacted Article 4A of the Uniform Commercial Code (UCC). It is the principal law in the United States governing wire transfers.<sup>1</sup> In 1992 the United Nations Commission on International Trade Law

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<sup>1</sup> Article 4A does not govern paper-based methods of payments like negotiable instruments or letters of credit (though, of course, payment orders associated with an electronic funds transfer may be issued in writing). The version of Art. 4A cited here is the 1989 Official Text with Comments approved by the American Law Institute and National Conference of Commissioners on Uniform State Laws (NCCUSL). States have been quick to incorporate Art. 4A into their Uniform Commercial Codes, with over forty states enacting the statute in less than three years. Information on state enactment is provided by NCCUSL. As discussed below, Regulation J, which governs Fedwire, essentially incorporates this version of Art. 4A by reference, with some modifications and additions. Regulation J is codified at 12 CFR, part 210 subpart B. Similarly, the New York Clearing House has selected New

(UNCITRAL) published a Model Law on International Credit Transfers (Model Law). It is the main international legal agreement on wire transfers.<sup>2</sup> What animating principles underlie Article 4A and the Model Law? What lessons can countries seeking to draft their own wire-transfer law take from Article 4A and the Model Law?

This article addresses these questions. It examines the legal foundations of large-value credit transfer systems and the importance of certainty, efficiency and fairness in wire-transfer law. A case study is presented to highlight key terminology and concepts. Thereafter, five particularly noteworthy legal rules are discussed in the context of the case study:

- (i) a rule defining the scope of the law;
- (ii) a rule establishing when the rights and obligations of parties to a wire transfer are triggered;
- (iii) a receiver finality rule;
- (iv) a rule assigning liability for interloper fraud; and
- (v) a money-back guarantee rule, coupled with provisions on discharge.

Finally, strategic concerns affecting the drafting of a wire-transfer law are identified. Overall, this article is addressed to the lawyer or policy-maker seeking to identify and understand the key features of wire-transfer law, perhaps with a view to drafting such a law for his or her own jurisdiction.

In the first section the relationship between the legal framework for a large-value credit transfer system and the development of an ideal system is discussed. The second section briefly surveys the five foundations of a legal framework for large-value credit transfer systems. The third section introduces a case study of a wire transfer and employs essential legal terminology. In the fourth section the five foundations of a legal regime governing wire-transfer law are discussed in detail using the essential legal terminology. The fifth section considers general principles of drafting a wire-transfer law in the

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(Cont.)

York's version of Art. 4A as the law applicable to CHIPS. In addition, relevant additional provisions are set forth in Federal Reserve Bank operating circulars and the CHIPS rules. For a discussion of Regulation J and Operating Circular No 8, and of the CHIPS rules, see Ernest T. Patrikis, Thomas C. Baxter, Jr. and Raj Bhala, *Wire Transfers* (1993), part III.

<sup>2</sup> Like Art. 4A, the Model Law governs electronic transfers and not paper-based methods of payment like negotiable instruments or letters of credit. Hereinafter, references are to sections in Art. 4A and certain analogous articles in the Model Law. The Model Law is found at UN GAOR, 47th Sess., Supp. No 17, at Annex 1, p. 48, UN Doc. A/47/17 (1992). For a discussion of the Model Law, see Patrikis, Baxter and Bhala, *op cit* note 1, parts III and V.

special context of developing and transition economies; the countries of the former Soviet Union and Baltic region are considered as examples. Finally, concluding observations are set forth in the sixth section.

## **The Importance of the Governing Legal Regime**

### *Why Care About Wire-Transfer Law?*

Why care about wire-transfer law? After all, wire transfers are not the only cross-border payments mechanism. For instance, transactors could make international payments by means of a draft, note or bill of exchange. However, it is not an overstatement to say that wire transfers are the most significant cross-border payments mechanism. First, because they are used to settle financial market transactions – foreign exchange trade, derivatives transactions, etc – they are the backbone of international financial markets. Secondly, because of the huge amount of funds transferred by wire, they demand special attention.

The first reason can be put in more conceptual terms. A necessary (but not sufficient) condition for a thorough discussion of wire transfers is a treatment of the governing legal regime, such as Article 4A or the Model Law. Whether a wire transfer is a popular means of payment from the view of individual financial market participants, and whether it is conducted in a safe and sound manner from the view of bank regulators, are issues that necessarily involve the law. Wire-transfer law should serve the interests of the institutions that look to large-value credit transfer systems to settle their payment obligations and in particular should facilitate growth in domestic and international transactions. Ill-conceived wire-transfer rules, or a legal void, can retard the growth and development of large-value credit transfer systems. In turn, the underlying financial market transactions which generate many payments obligations may be hampered.

With respect to the second reason, large-value credit transfers are of enormous importance. Over 80 per cent of the dollars transferred in the United States are sent over large-dollar electronic funds-transfer networks. Every day in the United States roughly 2 trillion US dollars are transferred by means of Fedwire and the Clearing House Interbank Payments System (CHIPS). Thus, every few days the equivalent of the entire US gross national product is transferred by Fedwire and CHIPS. Every two to four days the total gross national product of the Group of Ten (G-10) countries is transferred electronically through the appropriate wire-transfer system. Depending on the structure of the laws governing wire transfers, potential users and

providers of wire-transfer services may find these services either more or less attractive.

### *Certainty, Efficiency and Fairness*

With so much money transferred by wire each day, and with the average value of each transfer so high, the potential for large losses is great. Thus, institutions sending and receiving such payments require a clear, comprehensible and sensible legal regime to answer two basic questions: first, how should a wire transfer normally work; and secondly, what happens if a mishap occurs? There is a third public policy issue of particular concern to central bankers, namely systemic risk – how can this risk be minimised and contained?

One way to approach these issues is to consider the theoretical underpinnings of an ideal international payments system. Arguably, the system must have three salient features: it must be certain (ie reliable), efficient (ie high speed, low cost and high security), and fair (ie equitable in its apportionment of liability).<sup>3</sup> In other words, large amounts of funds must be transmitted at low cost and with high security, and the rights and obligations of parties to the wire transfer must be allocated in a fair manner. Accordingly, a legal framework for a wire-transfer system is essential to ensuring that all three features are present in the system.

First, burdensome or unclear legal rules raise the costs of a wire transfer, thereby reducing efficiency. In turn, the system becomes less attractive to potential providers of system services, users of those services, or both. For example, suppose a mutual fund instructs its bank to make a US\$5 million payment to a stockbroker in order to buy shares for the fund. The payment is made through the Bank of Credit and Commerce International (BCCI) but, before the payment transaction is complete, BCCI fails. Does the mutual fund, the stockbroker, the creditors of BCCI, or some other party bear the US\$5 million loss? If the legal framework fails to provide an unequivocal answer, then uncertainty is generated. In reaction to uncertainty, system providers and users must take precautions – that is, insure against risks; hence the cost of providing and using the system will inevitably increase.

Secondly, the lack of rules on authenticity and security reduces reliability. Consequently, the system creates uncertainties and risk for both its providers and users. For example, suppose a US bank that receives a US\$500,000

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<sup>3</sup> See generally Raj Bhala, 'Paying for the Deal: An Analysis of Wire Transfer Law and International Financial Market Interest Groups' (1994) 42 *Kansas Law Review*, p. 667; and Patrikis, Baxter and Bhala, *op cit* note 1, pp. 23–25.

payment instruction from one of its customers discovers – after the payment is made to an offshore bank – that the instruction is unauthorised. What are the rights and obligations of the US bank, its customer and the offshore bank? If the legal framework does not provide a clear answer, then the system will be viewed as unreliable by prospective users and providers of system services.

Thirdly, an over-allocation of duties to system providers or to system users can be unfair. In addition, it may lead to a non-level playing field. For example, where liabilities are skewed toward non-bank users of a large-value credit transfer system, banks may enjoy a monopoly position. When potential users or providers perceive a system to be unfair, they simply will not use or provide, respectively, system services.

## An Overview of the Five Legal Foundations

Thus, there is an integral link between the legal foundations of a wire-transfer system and the extent to which that system is an ideal one, particularly for financial market participants transferring vast sums to one another. How do Article 4A and the Model Law make this link? The essence of Article 4A and the Model Law can be grasped by understanding five legal rules. These rules – what I call the five legal foundations of wire-transfer law – are designed to make the wire-transfer systems to which the rules apply more efficient, reliable and safe.<sup>4</sup>

The five foundations are:

- (i) a *scope rule* to differentiate the parties and payment instructions that are included in the law from those that are not included;
- (ii) a *trigger event* to indicate the moment when the rights and obligations of a party to a wire transfer are manifest;
- (iii) a *receiver finality rule* to establish when credit to an account is irrevocable;
- (iv) a *money-back guarantee* to cover situations where a wire transfer is

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<sup>4</sup> To be sure, these are not the only rules in the US or international wire-transfer laws, and reasonable people may contend that there are other equally or even more essential statutory provisions. The economic and policy justifications for the five legal foundations are beyond the scope of this article. For theoretical discussions of wire-transfer law, see Bhala, *op cit* note 3; and Bhala, 'The Inverted Pyramid of Wire Transfer Law' (1993) 82 *Kentucky Law Journal*, p. 347, reprinted in Joseph J. Norton *et al* (eds), *Cross-Border Electronic Banking* (1995). See also Fairfax Leary, Jr. and Patricia B. Fry, 'A "Systems Approach" to Payment Modes: Moving Toward a New Payments Code' (1984) 16 *Uniform Commercial Code Law Journal*, p. 283.

- not completed, coupled with a *discharge rule* for cases where the transfer is completed; and
- (v) an *anti-fraud rule* to allocate liability for fraudulent payments instructions.

To appreciate these foundations, it is first necessary to master the terminology of wire-transfer law and to use applicable terms in the context of a typical wire transfer.<sup>5</sup> Accordingly, the five critical elements in American and international wire-transfer law are set forth in the appropriate legal terminology and context.

## A Case Study

The following discussion of the five foundations is aided by reference to a case study of a wire transfer. Consider the following hypothetical transaction:<sup>6</sup>

- (i) The Merrill Lynch Dragon Fund is an American mutual fund dedicated to investing in Far East equities. The Dragon Fund buys stock on the Kuala Lumpur Stock Exchange worth US\$100,000 through a Singapore-based brokerage firm named Vickers Ballas Securities. Vickers Ballas arranges for the delivery of the stock to the custodial account of the Dragon Fund, and the Dragon Fund seeks to pay Vickers Ballas for the stock by means of a wire transfer.
- (ii) The Dragon Fund and Vickers Ballas maintain bank accounts at different commercial banks. The Dragon Fund has its account at the Chase Manhattan Bank, while Vickers Ballas uses the Development Bank of Singapore (DBS).

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<sup>5</sup> The terms 'funds transfers' and 'credit transfers' are used interchangeably, as are the terms 'funds-transfer systems' and 'large-value credit transfer systems'. 'Wire transfer' is a common term, though one not used in Art. 4A or the Model Law. A definition of 'funds transfers' is found in UCC Art. 4A s. 104(a), and a 'funds-transfer system' is defined in Art. 4A s. 105(a)(5). 'Credit transfer' is defined in Art. 2(a) of the Model Law, and 'credit' or 'funds-transfer system' is not defined.

<sup>6</sup> A payments obligation to be discharged by a wire transfer can arise from virtually any sort of underlying contractual relationship between the buyer-payer and seller-payee. While the underlying contractual obligation in this hypothetical transaction involves goods, in reality, financial transactions generate the bulk of wire transfers. Most large-value funds-transfer activity is associated with securities and foreign exchange trading. See Bhala, 'The Inverted Pyramid of Wire Transfer Law', *op cit* note 4; and Bank for International Settlements, *Payment Systems in Eleven Developed Countries* (3rd ed, 1989), p. 215.

- (iii) The Dragon Fund instructs Chase Manhattan to pay US\$100,000 to Vickers Ballas.<sup>7</sup> The instruction contains the name and account number of Vickers Ballas, and the name and identifying number of Vickers Ballas' bank.
- (iv) Chase Manhattan complies with the instruction of its customer by further instructing a second bank, Barclays Bank, to pay US\$100,000 to Vickers Ballas. (It is assumed that Chase Manhattan and DBS do not maintain accounts with one another, hence the wire transfer must be routed through correspondent accounts at Barclays Bank.) The second payment instruction again contains the relevant information about Vickers Ballas and the DBS.
- (v) Barclays Bank also complies with the instruction it receives. It further instructs DBS to pay US\$100,000 to Vickers Ballas.
- (vi) DBS complies with the third instruction and pays Vickers Ballas.

This hypothetical transaction is represented in Figure 1. The chronological steps in the transaction are indicated by numbers in parentheses. The terms of Article 4A and the Model Law are used, highlighted and explained in detail below.

Each party, and the actions it undertakes, has a specific legal label in Article 4A and the Model Law. Applying the correct labels is the first step in identifying the five legal foundations of wire-transfer law. Each payment instruction is a '*payment order*' if it meets the requirements of the definition of that term (given in the following section). This term is critical in defining the scope of the law.

The Dragon Fund is the '*originator*' of the wire transfer – that is, 'the sender of the first payment order in a funds transfer'.<sup>8</sup> The bank at which the Dragon Fund maintains an account and to which the first payment order is addressed – Chase Manhattan Bank – is the '*originator's bank*'.<sup>9</sup> Vickers Ballas is the '*beneficiary*' of the originator's payment order.<sup>10</sup> Also, it is the beneficiary of each payment order issued in the wire-transfer chain that implements the originator's order – ie the payment orders issued by the originator's bank and

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<sup>7</sup> Quite possibly, this payment will be made against delivery of the shares – ie the Dragon Fund will not authorise a wire transfer unless and until it receives confirmation that the stock is being or has been transferred to its custodial account.

<sup>8</sup> UCC Art. 4A s. 104(c). See also Model Law, Art. 2(c) (defining 'originator').

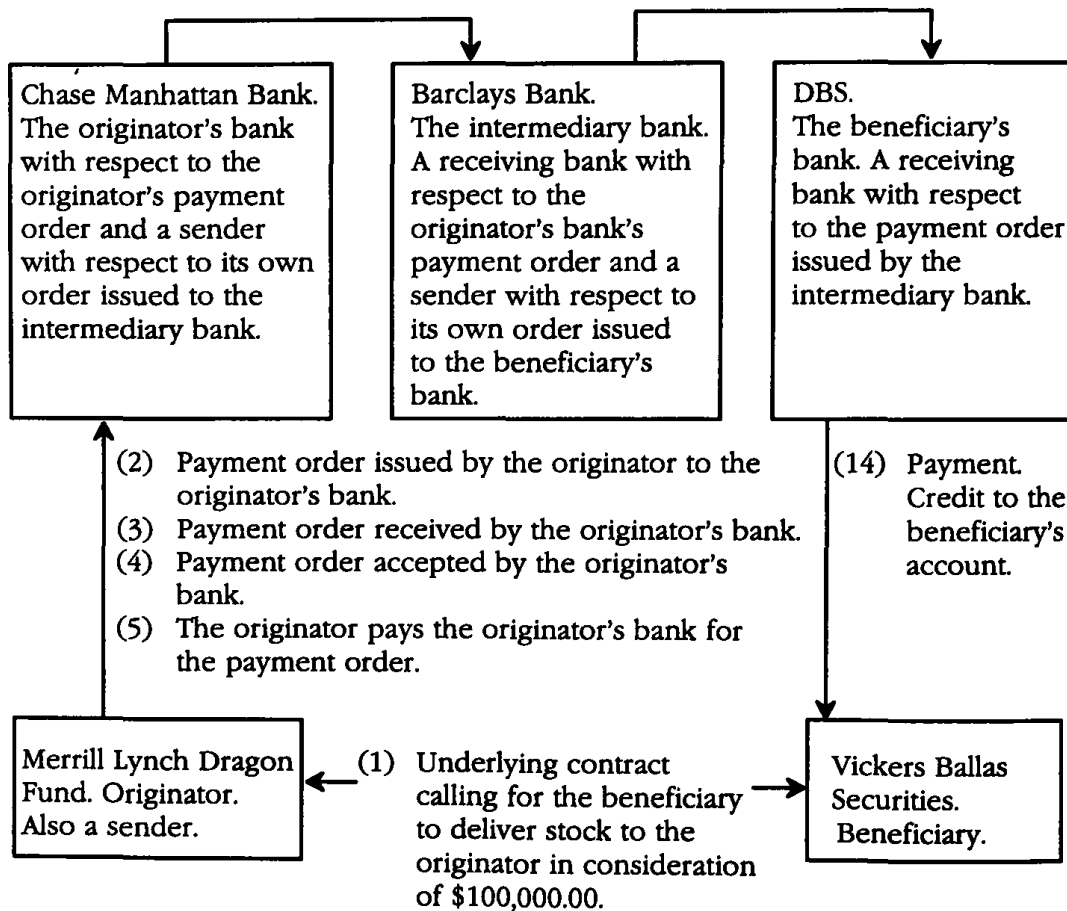
<sup>9</sup> UCC Art. 4A s. 104(d). There is no requirement in this definition, or elsewhere in Art. 4A, that the originator have a pre-existing account relationship with the originator's bank. There is no definition of 'originator's bank' in the Model Law.

<sup>10</sup> UCC Art. 4A s. 103(a)(2). See also Model Law, Art. 2(d) (defining 'beneficiary').



**Figure 1** Hypothetical example of a wire transfer

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|---|---|
| (6) Payment order issued by the originator's bank.                      | (10) Payment order issued by the intermediary bank.                       |
| (7) Payment order received by the intermediary bank.                    | (11) Payment order received by the beneficiary's bank.                    |
| (8) Payment order accepted by the intermediary bank.                    | (12) Payment order accepted by the beneficiary's bank.                    |
| (9) Settlement between the originator's bank and the intermediary bank. | (13) Settlement between the intermediary bank and the beneficiary's bank. |



Adjunct to (12): Obligation of the originator to pay \$100,000 to the beneficiary is discharged when the beneficiary's bank accepts the payment order.

the second bank. The 'beneficiary' is simply 'the person to be paid by the beneficiary's bank'.<sup>11</sup>

The bank at which Vickers Ballas maintains its account and to which funds are credited – DBS – is the '*beneficiary's bank*'.<sup>12</sup> This term is reserved for 'the bank identified in a payment order in which an account of the beneficiary is to be credited pursuant to the order or which otherwise is to make payment to the beneficiary if the order does not provide for payment to an account'.<sup>13</sup> The second bank, Barclays Bank, is the '*intermediary bank*', in that it is 'a receiving bank other than the originator's bank or the beneficiary's bank'.<sup>14</sup>

The terms '*sender*' and '*receiving bank*' are generic: a sender is 'the person giving the instruction to the receiving bank' and the receiving bank is 'the bank to which the sender's instruction is addressed'.<sup>15</sup> The Dragon Fund (the originator), Chase Manhattan Bank (the originator's bank), and Barclays Bank (the intermediary bank) are all senders. The originator's bank, intermediary bank, and beneficiary's bank (Vickers Ballas' bank) are receiving banks.

The '*funds (or wire) transfer*' is the entire 'series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order'.<sup>16</sup> It includes the payment orders issued by the originator's bank and the intermediary bank, because these are 'intended to carry out the originator's payment order'.<sup>17</sup> The wire transfer 'is *completed* by acceptance by the beneficiary's bank of a payment order for the benefit of the beneficiary of the originator's payment order'.<sup>18</sup>

The sale of stock by Vickers Ballas to the Dragon Fund is the underlying contract between the beneficiary and originator of the wire transfer. Under the terms of the contract, the originator has a US\$100,000 payment obligation, and the originator begins the wire transfer for the purpose of *discharging* this obligation.<sup>19</sup>

The concept of discharge is tricky in two senses. First, its legal importance is not always clearly understood. The crucial point is that until the wire transfer is completed, which occurs when the beneficiary's bank accepts a payment

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<sup>11</sup> UCC Art. 4A s. 103(a)(3). See also Model Law, Art. 2(d) (defining 'beneficiary').

<sup>12</sup> UCC Art. 4A s. 103(a)(3). Here, too, there is no requirement for a pre-existing account relationship. There is no definition of a 'beneficiary's bank' in the Model Law.

<sup>13</sup> UCC Art. 4A s. 103(a)(3).

<sup>14</sup> UCC Art. 4A s. 104(b). See also Model Law, Art. 2(g) (defining 'intermediary bank').

<sup>15</sup> UCC Art. 4A s. 103(a)(4)–(5). See also Model Law, Art. 2(f) (defining 'receiving bank').

<sup>16</sup> UCC Art. 4A s. 104(a). See also Model Law, Art. 2(a) (defining 'credit transfer').

<sup>17</sup> UCC Art. 4A s. 104(a).

<sup>18</sup> *Ibid.* See also Model Law, Art. 19(1).

<sup>19</sup> UCC Art. 4A s. 406(b). See also Model Law, Art. 19 footnote.

order for the beneficiary, the originator is legally liable on this obligation – it is not discharged.<sup>20</sup> The originator's obligation to pay the beneficiary based on the contract for stock is not discharged until the beneficiary's bank accepts a payment order for the benefit of the beneficiary. Thereafter, the originator cannot be sued by the beneficiary for breach of contract on the grounds of non-payment.

Secondly, seemingly synonymous uses of the terms 'payment obligation' (or 'payment'), 'settlement obligation' (or 'settlement') and 'discharge' sometimes generate confusion. In the wire-transfer context, the underlying payment obligation refers to the obligation of the originator to pay the beneficiary. This obligation arises from the underlying contractual obligation between those two parties. When the obligation is satisfied, it is said to be legally discharged. Each sender whose payment order is accepted by a receiving bank has a payment obligation to that bank, namely to pay for the accepted order. The terms 'settlement' and 'settlement obligation' refer to an interbank payment obligation that arises from the acceptance of a payment order; that is, they refer to the payment obligation as between a sending and receiving bank. However, these interpretations are based more on customary and trade usage than on specific sections of Article 4A or the Model Law.<sup>21</sup>

Each receiving bank has a decision to make when it receives a payment order: should it *accept* or *reject* the order? The receiving bank is not obliged to accept an order.<sup>22</sup> A receiving bank may reject an order because the sender does not have sufficient funds in its account to pay for the order, or a receiving bank may reject a payment instruction because it states conditions with which the bank is unwilling or unable to comply. A receiving bank other than the beneficiary's bank (ie the originator's bank and intermediary bank) accepts a payment order by executing the order.<sup>23</sup> 'Execution' of a payment

<sup>20</sup> UCC Art. 4A s. 104(a), Art. 4A s. 406(a)–(b). See also Model Law, Art. 19 footnote.

<sup>21</sup> Patrikis, Baxter and Bhala, *op cit* note 1, pp. 72–73. For an argument that trade usages should be recognised as a means of self-regulation in international financial markets, see Raj Bhala, 'Self-Regulation in Global Electronic Markets Through Reinvigorated Trade Usages' (1995) 31 *Idaho Law Review* p. 863.

<sup>22</sup> UCC Art. 4A s. 209 and official comment 3. See also UN Model Law, Arts. 7(2), 8(2), 9, 10(1). The receiving bank is free to enter into an account agreement with its sender-customer specifying that the bank will accept all payment orders issued by that customer. In this instance, the bank cannot reject the order. In addition, a receiving bank is unable to reject a payment order transmitted through Fedwire. This is because one of the ways in which a receiving bank accepts a payment order is by obtaining payment from its sender. UCC Art. 4A s. 209(b)(2), Model Law, Art. 6(b). With a wire transfer through Fedwire, the payment order and payment (ie the instruction and value) move simultaneously from sender to receiving bank. Patrikis, Baxter and Bhala, *op cit* note 1, p. 174.

<sup>23</sup> UCC Art. 4A s. 209(a). A broader definition is set forth in Art. 7(2) of the Model Law.

order means that the bank 'issues a payment order intended to carry out the payment order received by the bank'.<sup>24</sup> Thus, the originator's bank accepts the payment order of the originator by issuing an order that conforms with the instructions set forth in the order of the originator. Similarly, the intermediary bank accepts the payment order of the originator's bank by issuing a conforming order designed to implement the originator's bank's order.

A beneficiary's bank, however, does not accept a payment order by execution.<sup>25</sup> Rather, the beneficiary's bank, if it accepts the order, is required to pay the beneficiary the amount of the order.<sup>26</sup> Typically, it does so by crediting the account of the beneficiary maintained at the beneficiary's bank.

A receiving bank's decision to accept or reject a payment order is partly a credit judgment: if the order is accepted, then the sender must *pay* for the order (eg the originator must pay US\$100,000 to the originator's bank if the bank accepts the originator's order, the originator's bank must pay US\$100,000 to the intermediary bank if the intermediary bank accepts the originator's bank's order, and so forth).<sup>27</sup> The credit issue arises where a sender does not currently have funds in its account with the receiving bank sufficient to pay for the payment order. The receiving bank may, at its discretion, grant the sender an overdraft, but any receiving bank, including a central bank, may charge interest to the sender for the amount and duration of the overdraft.<sup>28</sup>

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<sup>24</sup> UCC Art. 4A s. 301(a). See also UN Model Law, Art. 2(1).

<sup>25</sup> UCC Art. 4A s. 301(a). The Model Law does not clarify this point.

<sup>26</sup> UCC Art. 4A s. 404(a). While this duty is plainly sensible, the liability for failing to perform it is unique in the statute. Failure to pay the beneficiary the amount of an accepted order is the only instance where the statute expressly provides for consequential damages, though the bank has a defence that it had a 'reasonable doubt' as to the entitlement of the beneficiary to payment. With respect to other duties imposed on receiving banks, liability for consequential damages is precluded unless such banks expressly agree to assume this liability in writing with their sender-customers. See UCC Art. 4A s. 305. The liability rules of Art. 4A are not treated in this article. However, they are relevant not only for those involved in the development of wire-transfer law in other countries but also for those giving or seeking practical legal advice. See Note, 'Cancellation of Wire Transfers Under Article 4A of the Uniform Commercial Code: *Delbrueck & Co. v. Manufacturers Hanover Trust Co.* Revisited' (1992) 70 *Texas Law Review*, p. 739; Ernest T. Patrikis, Thomas C. Baxter, Jr. and Raj Bhala, 'Article 4A: The New Law of Funds Transfers and the Role of Counsel' (1991) 23 *UCC LJ* 219; and Thomas C. Baxter, Jr. and Raj Bhala, 'Proper and Improper Execution of Payment Orders' (1990) 45 *Business Lawyer*, p. 1447.

<sup>27</sup> UCC Art. 4A s. 402(b)-(c). See also Model Law, Art. 5(6).

<sup>28</sup> With respect to a Federal Reserve Bank, see, for example, 'Modification of the Payments System Risk Reduction Program; Daylight Overdraft Pricing', 57 Fed. Reg. 47084 (14 October 1992) and 'Modification of the Payments System Risk Reduction Program; Measurement of Daylight Overdrafts', 57 Fed. Reg. 47093 (14 October 1992).

If the bank entitled to payment is a receiving bank other than the beneficiary's bank (ie the originator's bank or an intermediary bank), then the obligation to pay arises upon acceptance but does not mature until the *execution date*; that is, payment is not due until the day on which it is proper for the receiving bank to execute the order.<sup>29</sup> Generally, the execution date is the day the order is received.<sup>30</sup> This is referred to as 'same-day execution', which means that the receiving bank executes the order on the day it is received from the sender. On or before that day, the sender must pay for the order.<sup>31</sup> Payment by a sender to a receiving bank for a payment order issued by the former and accepted by the latter may be made by a number of means. These include receipt of final settlement on the books of a central bank or through a funds-transfer system (which may involve bilateral or multilateral netting), a credit to an account of the receiving bank with the sender, or a debit to an account of the sender with the receiving bank.<sup>32</sup>

If the bank entitled to payment is the beneficiary's bank, then again the obligation to pay arises upon acceptance by that bank.<sup>33</sup> Here, however, the sender (in the hypothetical transaction, the intermediary bank) need not pay the beneficiary's bank until the *payment date*; that is, the date on which the amount of the payment order accepted by the beneficiary's bank is payable to the beneficiary.<sup>34</sup> Typically, this is the date of receipt.<sup>35</sup> The beneficiary's bank can pay the beneficiary by crediting its account.<sup>36</sup> The beneficiary is paid as a matter of law when it 'is notified of the right to withdraw the credit' or funds 'are otherwise made available to the beneficiary', or the bank 'lawfully applies the credit to a debt of the beneficiary'.<sup>37</sup>

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<sup>29</sup> UCC Art. 4A s. 301(b). Receiving banks are free to establish cut-off times for the receipt of payment orders. See UCC Art. 4A s. 106 and Model Law, Art. 2(k). Note that the Model Law defines 'execution period' in lieu of the concepts of 'execution date' and 'payment date'.

<sup>30</sup> *Ibid.* See Model Law, Art. 11(1).

<sup>31</sup> In the hypothetical transaction, assume that the originator issues its payment order on day 1 and the originator's bank receives it on that day. Assuming that the originator does not specifically instruct the originator's bank to execute on a future day, the bank will execute it on day 1. The execution is, therefore, on the same day as the day of receipt (day 1), and payment from the originator to the originator's bank is due on or before that day.

<sup>32</sup> UCC Art. 4A s. 403(a). See also Model Law, Art. 6(b).

<sup>33</sup> See UCC Art. 4A s. 404 and Model Law, Art. 10(1). However, as discussed below, the Model Law leaves the details of the relationship between a beneficiary's bank and a beneficiary to local law.

<sup>34</sup> UCC Art. 4A s. 401.

<sup>35</sup> *Ibid.*

<sup>36</sup> UCC Art. 4A s. 405(a).

<sup>37</sup> *Ibid.*

The above discussion has not expressly highlighted the role of a central bank in a wire transfer. The conventional but incomplete view is that a central bank acts as an intermediary bank. To be sure, a central bank often is an intermediary between two receiving banks. However, it can play any role in a wire transfer: originator, originator's bank, intermediary bank, beneficiary's bank, or beneficiary. Thus, the critical point is that a central bank can be a sender or receiving bank at any point in a wire-transfer chain. The role of a central bank in a wire transfer makes little legal difference unless the applicable wire-transfer law is modified by the regulations of the central bank.<sup>38</sup> However, there is an important practical difference. A central bank cannot go bankrupt, thus there is no credit risk associated with sending a payment order to, or receiving a payment order from, a central bank. If a wire transfer is not completed, then the reason for the non-completion will lie with a party other than the central bank.

## Discussion of the Five Legal Foundations

### *Scope Rule*

What is the scope of application of the law? How does a party seeking to send funds electronically know whether the transmission is a wire transfer governed by applicable wire-transfer law? Who is included and who is excluded? Appropriate answers to these questions foster certainty and efficiency, in part by reducing the likelihood of litigation about the coverage of the law and thereby reducing potential legal costs.

These questions are answered in Article 4A and the Model Law by referring to the definition of 'payment order'. *If an instruction is not a 'payment order', then Article 4A is not applicable.* Under Article 4A, the term 'payment order' means:

... an instruction of a sender to a *receiving bank*, transmitted orally, electronically, or in writing, to pay, or to cause another bank to pay, a *fixed or determinable* amount of money to a beneficiary, if:

- (i) the instruction *does not state a condition* to payment to the beneficiary other than time of payment,

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<sup>38</sup> An example of such rules would be Regulation J of the Board of Governors of the Federal Reserve System. As indicated below, however, Regulation J elects Art. 4A as the governing law and the deviations from the statute are, on balance, minimal.

- (ii) the receiving bank is to be *reimbursed* by debiting an account of, or otherwise receiving payment from, the sender, and
- (iii) the instruction is transmitted by the sender *directly* to the receiving bank or to an agent, funds-transfer system, or communication system for transmittal to the receiving bank.<sup>39</sup> (Emphasis added.)

A similar definition is provided in the Model Law.<sup>40</sup>

There are five salient features of the definition of 'payment order'. First, the instruction must be issued to a 'bank'. While any person can be a 'sender', only a 'bank' can be a 'receiving bank'.<sup>41</sup> A 'bank' is 'a person engaged in the business of banking and includes a savings bank, savings and loan association, credit union, and trust company'.<sup>42</sup> This definition is flexible, applying to a variety of financial institutions that offer account services – regular commercial banks and certain other types of financial institutions that take deposits and make loans. Thus, the scope of application is potentially wide.

Secondly, the amount of the instruction must be 'fixed or determinable'. In most cases the application of this requirement is straightforward. In the hypothetical transaction, the US\$100,000 amount is 'fixed'.

Thirdly, the definition of 'payment order' requires that the instruction contain no condition other than time of payment.<sup>43</sup> If the Dragon Fund's instruction to Chase Manhattan said 'pay US\$100,000 on day 5 if you receive delivery of documents relating to the stock purchased', then the requirement would not be satisfied. Only the statement regarding day 5 is permissible; the statement regarding presentation of documents to the bank is a condition other than time of payment. If both statements are included in the instruction, then it is not a 'payment order' and Article 4A is inapplicable. Under the Model Law, a receiving bank can accept a conditional payment order, strip off the condition, and then execute the unconditional payment order.<sup>44</sup>

The fourth requirement concerns payment for the payment instruction. A receiving bank that receives a payment instruction from its sender must be

<sup>39</sup> UCC Art. 4A s. 103(a)(1).

<sup>40</sup> See Model Law, Art. 2(b).

<sup>41</sup> UCC Art. 4A s. 103(a)(4)–(5). 'Person' is used throughout the definition sections of Art. 4A but is not defined therein. Therefore, the Art. 1 definition would apply (UCC Art. 1 s. 105(d)). Under Art. 1, a "person" includes an individual or an organization' (UCC Art. 1 s. 201(30)). No analogous definition exists in the Model Law.

<sup>42</sup> UCC Art. 4A s. 105(a)(2). The Model Law does not define 'bank'. To the contrary, Art. 1(2) indicates that the Model Law applies 'to other entities that as an ordinary part of their business engage in executing payment orders in the same manner as it applies to banks'.

<sup>43</sup> UCC Art. 4A s. 103(a)(1)(i).

<sup>44</sup> See Model Law, Art. 3.

reimbursed by debiting an account of, or otherwise receiving payment from, the sender.<sup>45</sup> This means that credit transfers are included, but all electronic funds transfers that are debit transfers are excluded.<sup>46</sup> In the hypothetical transaction, if Chase Manhattan Bank is reimbursed for the Dragon Fund's payment order by debiting an account of the Fund, then this requirement is met.

The way in which this result is obtained raises the important distinction between a credit and debit transfer. 'In a credit transfer the instruction to pay is given by the person making payment. In a debit transfer the instruction to pay is given by the person receiving payment.'<sup>47</sup> The classic example of a debit transfer involves a cheque or other negotiable instrument.<sup>48</sup> In a cheque transaction, a debtor (the drawer of the cheque) gives authority to the creditor (the payee of the cheque) to draw on the debtor's account which is maintained at the payer bank (also called the drawee).<sup>49</sup> The authority is given by drawing the cheque and transferring the cheque to the payee. In turn, the payee issues the instruction to pay to the payer bank when it deposits the cheque,<sup>50</sup> that is, the payee (not the drawer) issues the instruction by depositing the cheque in the depository bank (at which the payee maintains an account), and the cheque is presented to the payer bank through the cheque collection process.<sup>51</sup> Assuming the payer bank honours the cheque, it is reimbursed by the debtor, not the person giving the instruction (the payee).<sup>52</sup> 'Article 4A is limited to transactions in which the account to be debited by the receiving bank is that of the person in whose name the instruction is given.'<sup>53</sup> The Model Law is limited in a similar manner.<sup>54</sup> In sum, in a wire transfer the payer (originator) issues the instruction (payment order) to the paying bank (originator's bank) and reimburses that bank. In a cheque transaction the payee issues the instruction (the cheque) and the paying bank (payer bank) is reimbursed by the drawer of the cheque.

Finally, to qualify as a payment order, an instruction must be transmitted

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<sup>45</sup> UCC Art. 4A s. 103(a)(1)(ii). See also Model Law, Art. 2(b)(i).

<sup>46</sup> See UCC Art. 4A s. 103(a)(1)(ii) official comment 4.

<sup>47</sup> *Ibid.* See also UCC Art. 4A Prefatory Note, p. 11.

<sup>48</sup> Negotiable instruments are governed by UCC Arts. 3 and 4. UCC Art. 3 s. 102, Art. 4 s. 102.

<sup>49</sup> UCC Art. 3 s. 102(1)(d) (the 'drawer' is a secondary party on the cheque, whereas the payer bank becomes primarily liable upon accepting the cheque); Art. 3 s. 302 ('payee' may be a holder in due course); and Art. 4 s. 105(b) (definition of 'payor bank').

<sup>50</sup> UCC Art. 3 s. 102(1)(a) (definition of 'issue').

<sup>51</sup> UCC Art. 4 s. 105(a) (definition of 'depository bank').

<sup>52</sup> UCC Art. 4A s. 104 official comment 4.

<sup>53</sup> *Ibid.*

<sup>54</sup> See UN Model Law, Art. 2(b)(i).



directly by the sender to the receiving bank (or its agent, funds-transfer system or communication system for subsequent transmission to the receiving bank).<sup>55</sup> In the hypothetical transaction, each instruction is directly transmitted from sender to receiving bank. This requirement serves to exclude from Article 4A and the Model Law payments made by means of a cheque or credit card, for example.<sup>56</sup>

Assume that the parties know that a wire-transfer law like Article 4A or the Model Law applies to their transfer. Does it apply to the entire transfer, from the originator to the beneficiary? This is the issue of 'end-to-end' coverage. Generally speaking, Article 4A is intended to apply end-to-end.<sup>57</sup> The rules of a funds-transfer system like Fedwire - namely Regulation J of the Board of Governors of the Federal Reserve System - ensure such coverage. For example, if the wire transfer is through Fedwire, then whether remote parties (ie those that are not in privity with a Federal Reserve Bank) are bound by Regulation J depends on whether they had prior notice that (i) Fedwire might be used and (ii) the applicable law governing Fedwire is Regulation J.<sup>58</sup> Privity means that the parties send payment orders directly to or receive orders directly from a Reserve Bank.<sup>59</sup> These requirements presumably avoid the unwarranted extension of Regulation J or the extraterritorial application thereof in inappropriate situations.<sup>60</sup> Regulation J, however, essentially states that Article 4A is the law governing Fedwire.<sup>61</sup> Similarly, the rules of the CHIPS system make clear that Article 4A governs that system.<sup>62</sup>

The Model Law governs a wire transfer where any sender and receiving bank are in different countries.<sup>63</sup> In contrast to Article 4A, however, the Model Law does not purport to provide end-to-end coverage. Rather, it governs all parties in the wire-transfer chain from the originator to the beneficiary's bank. The relationship between the beneficiary's bank and the beneficiary is left to local law.

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<sup>55</sup> UCC Art. 4A s. 103(a)(1)(iii).

<sup>56</sup> UCC Art. 4A s. 103(a)(1) official comment 5.

<sup>57</sup> UCC Prefatory Note, iii, Art. 4A s. 507(c).

<sup>58</sup> 12 CFR § 210.25(b)(2)(v).

<sup>59</sup> 12 CFR § 210.25(b)(2)(ii)-(iii).

<sup>60</sup> See 12 CFR sub-pt B, app. A comment (a) to § 210.25.

<sup>61</sup> See Patrikis, Baxter and Bhala, *op cit* note 1, p. 140.

<sup>62</sup> See *ibid*, p. 191.

<sup>63</sup> Model Law, Art. 1(1).

### *Trigger Event*

At what point are the rights and obligations of a party to a wire transfer triggered? In other words, when does the party gain certain legal entitlements, and when is it legally 'on the hook' to perform certain duties? Appropriate answers to these questions can promote certainty. The answers can also ensure that wire transfers are conducted efficiently, specifically and at high speed.

The answers are provided in Article 4A and the Model Law by the concept of acceptance. *'Rights and obligations under Article 4A arise as the result of "acceptance" of a payment order by the bank to which the order is addressed.'*<sup>64</sup> (Emphasis added.) A similar though more narrowly crafted statement is found in the Model Law.<sup>65</sup> Only when a receiving bank accepts a payment order issued by its sender are the rights and obligations of the receiving bank and sender triggered.

As the hypothetical transaction suggests, acceptance is divided according to the class of receiving bank. A receiving bank other than the beneficiary's bank – in the example, the originator's bank and the intermediary bank (Chase Manhattan Bank and Barclays Bank, respectively) – can accept a payment order only by executing the order. 'Execution' means the issuance of a payment order that conforms with the terms of the order received from the sender.<sup>66</sup>

In contrast, a beneficiary's bank is responsible for crediting the account of the beneficiary (or otherwise lawfully applying funds received on behalf of the beneficiary). There are essentially three acts that constitute 'acceptance' by a beneficiary's bank:

- (i) payment by the beneficiary's bank to the beneficiary;
- (ii) notification from the beneficiary's bank to the beneficiary that a payment order has been received; or
- (iii) receipt of payment by the beneficiary's bank from the sender that issued the payment order to the beneficiary's bank.<sup>67</sup>

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<sup>64</sup> UCC Art. 4A Prefatory Note, p. iv. See also Art. 4A s. 209 (regarding acceptance of a payment order) and official comment 1 thereto ('[a]cceptance of the payment order imposes an obligation on the receiving bank to the sender if the receiving bank is not the beneficiary's bank, or to the beneficiary if the receiving bank is the beneficiary's bank').

<sup>65</sup> See UN Model Law, Art. 5(6).

<sup>66</sup> UCC Art. 4A s. 209(a), Art. 4A s. 301(a). See also Model Law, Art. 2(1) (defining 'execution').

<sup>67</sup> UCC Art. 4A s. 209(b). This list is incomplete because there is a fourth manner of acceptance. A beneficiary's bank can do nothing with the payment order received

Acceptance occurs at the earliest of these times. The first two acts involve the 'downstream' relationship between the beneficiary's bank and its customer, the beneficiary.<sup>68</sup> The third act involves the 'upstream' relationship between the beneficiary's bank and its sender.<sup>69</sup>

What rights and obligations are triggered upon acceptance of a payment order? Again, there is bifurcation. The basic duty of a sender whose payment order is accepted by a receiving bank is to pay the receiving bank for the order. Conversely, the basic right of the receiving bank is to be paid for the accepted order. While this right-duty set is triggered upon acceptance, it does not mature until the execution date.<sup>70</sup> In addition, the sender has a right to have its payment order, upon acceptance, executed at the right time, in the right amount, and to the right place.<sup>71</sup> This is a trinity of rights which, from the receiving bank's perspective, constitutes a trinity of duties.

The right-duty set pertaining to the beneficiary's bank and the beneficiary is straightforward. Upon acceptance of a payment order, the beneficiary's bank has an obligation to pay the order, and the beneficiary has a right to be paid.<sup>72</sup>

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(Cont.)

and waits until the opening of the next funds-transfer business day. In other words, the beneficiary's bank can defer acceptance overnight (and, therefore, defer payment to the beneficiary). The incentive to do this is to 'buy time' to see whether the sender will pay for the order. (Delaying acceptance is not possible if the beneficiary's bank has been paid by its sender, because that payment is by definition a form of acceptance.) UCC Art. 4A s. 209(b)(3) and official comment 5. See also Art. 4A s. 405 official comment 2. Of course, this method of acceptance is unavailable if the wire transfer is through a system like Fedwire, because the payment order and payment are received simultaneously.

<sup>68</sup> Payment by a beneficiary's bank to a beneficiary is governed by UCC Art. 4A s. 405, which is discussed below in the context of the receiver finality rule.

<sup>69</sup> Payment by a sender to a receiving bank is covered in UCC Art. 4A s. 403 and Model Law, Art. 6.

<sup>70</sup> UCC Art. 4A s. 402(c). Note that if the receiving bank is the beneficiary's bank, then the obligation of the sender to pay matures on the payment date, which is the date the order is payable by the beneficiary's bank to the beneficiary. Thus, the beneficiary's bank is afforded the legal protection of being entitled to payment from its sender no later than the time it must pay its customer - ie it need not have paid out before receiving inter-bank settlement. UCC Art. 4A s. 402(b). Under the Model Law, a similar scheme is established. See Model Law, Arts. 8, 11. However, if a receiving bank does not execute a payment order on the day it is received, then it must do so for value as of the date of receipt. Model Law, Art. 11(2). This rule prevents the receiving bank from obtaining 'float' with respect to funds paid for the payment order.

<sup>71</sup> UCC Art. 4A s. 302(a). See also Model Law, Art. 8(2).

<sup>72</sup> UCC Art. 4A s. 404(a). See also Model Law, Art. 10(1) (referring to local law for the details of payment by the beneficiary's bank to the beneficiary).

These mature on the payment date which, typically, is the day the order is received by the beneficiary's bank.<sup>73</sup>

### *Receiver Finality*

When does a beneficiary know that it has received 'good funds'? If Vickers Ballas receives a US\$100,000 credit to its account, is the credit provisional (revocable), on the one hand, or final on the other hand? If the credit is revocable, then Vickers Ballas cannot irrevocably commit the US\$100,000 to other uses (eg paying its bills, buying stock for its own account, and the like). This is because DBS (the beneficiary's bank) might demand that the US\$100,000 be returned if the bank does not finally receive payment from the intermediary bank. An answer to this dilemma is crucial if a wire transfer is to be a certain, efficient (especially high-speed), and fair mode of payment.

Once a beneficiary's bank has paid the beneficiary, it has thereby satisfied the obligation to pay the beneficiary that arises from its acceptance of a payment order on behalf of the beneficiary. The payment is *final*.<sup>74</sup> The payment for the wire transfer cannot be recovered by the beneficiary's bank. This is the receiver finality rule. Even the beneficiary's right to withdraw a credit (ie even if the beneficiary's account has been credited but the beneficiary has not withdrawn the credit) cannot be revoked.

The receiver finality rule is subject to one important exception.<sup>75</sup> Consider a major settlement failure in a funds-transfer system that nets payment obligations on a multilateral (or net-net) basis and has a loss-sharing arrangement among participants in the system to handle a settlement failure by one or more participants.<sup>76</sup> If a beneficiary's bank accepts a payment order but the multilateral netting system fails to complete settlement in spite of the operation of the loss-sharing scheme, then the acceptance is nullified and the beneficiary's bank can recover funds from the beneficiary.<sup>77</sup> In this unwind scenario, the wire transfer is not completed, the originator is not discharged of its

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<sup>73</sup> UCC Art. 4A s. 401.

<sup>74</sup> UCC Art. 4A s. 405(c). As explained above, the Model Law does not contain a receiver finality rule because it does not purport to govern the relationship between the beneficiary's bank and the beneficiary. That relationship is governed by local law.

<sup>75</sup> An additional exception, not treated here, pertains to wire transfers involving automated clearing houses. See UCC Art. 4A s. 405(d).

<sup>76</sup> UCC Art. 4A s. 405(e). The classic example of such a system is CHIPS.

<sup>77</sup> *Ibid.*

underlying obligation to the beneficiary, and each sender is excused from its obligation to pay for its payment order.

This exception to the receiver finality rule supports the development of loss-sharing agreements and other methods to achieve finality on privately operated funds-transfer systems that rely on netting. The unwind exception is a 'last resort escape' from potentially expensive settlement guarantees that remaining (and presumably solvent) participants in the funds-transfer system might be unable to meet. Only by accounting for the potential trade-off between settlement guarantees and finality can the law promote netting systems designed to offer their users finality on a routine basis.

Because of this exception to the receiver finality rule, some observers (eg officials at the Bundesbank and Bank for International Settlements) contend that a real-time gross-settlement (RTGS) funds-transfer system is preferable to a netting system. In an RTGS system there is no worrisome overhang of a possible settlement unwind, yet this possibility plagues a multilateral netting system. Of course, netting serves the purpose of lowering systemic risk by reducing the number and volume of wire transfers. Ultimately, the choice between the systems may depend on country, market and technological conditions.

The receiver finality rule is constrained when the beneficiary's bank (having accepted a payment order) has a 'reasonable doubt concerning the right of the beneficiary to payment'.<sup>78</sup> But the beneficiary's bank risks incurring liability for consequential damages as a result of its nonpayment if the beneficiary demands payment, the bank has notice of 'particular circumstances that will give rise to consequential damages as a result of nonpayment', and it is shown that the bank lacked reasonable doubt.<sup>79</sup> This is the only instance in Article 4A where consequential damages are a remedy provided by the statute, in the absence of a written agreement between parties that calls for consequential damages.<sup>80</sup>

In stark contrast to Article 4A, the Model Law contains no receiver finality rule. As mentioned above, the Model Law does not purport to intrude on the relationship between a beneficiary's bank and the beneficiary. A receiver finality rule is a rule about this relationship, dictating whether and when a credit to a beneficiary's account might be revoked by the beneficiary's bank. Thus, the Model Law provides that the beneficiary's bank must place funds at the disposal of the beneficiary 'in accordance with the payment order *and the*

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<sup>78</sup> UCC Art. 4A s. 404(a).

<sup>79</sup> *Ibid.*

<sup>80</sup> UCC Art. 4A s. 305(c)-(d) (consequential damages for late or improper execution of a payment order, or failure to execute a payment order, are not recoverable unless agreed to expressly in writing by the receiving bank).

*law governing the relationship between the bank and the beneficiary*.<sup>81</sup> (Emphasis added.)

### *Interloper Fraud Rule*

As the recent Australian case of *Swiss Bank Corporation v. State Bank of New South Wales* illustrates, modern day electronic pirates abound.<sup>82</sup> A fraudster – also called an interloper – claiming to be an official of the Dragon Fund could send a payment order to Chase Manhattan Bank instructing that US\$100,000 be paid to an account No 10017 at the Bank of Credit and Commerce International (BCCI) in the Grand Cayman Islands. How is Chase Manhattan Bank to determine whether the payment order is really that of its customer, the Dragon Fund? If Chase Manhattan Bank executes the order and debits the Dragon Fund's account for US\$100,000, is the bank obliged to re-credit the account when it is discovered that the payment order was not authentic? What if the payment order is issued by an employee or agent of the Dragon Fund that has access to its bank account information? Appropriate answers to these questions promote certainty, efficiency in the sense of high security, and fairness.

Article 4A and the Model Law address the interloper fraud problem through the concept of a '*security procedure*' and rules based on the existence or non-existence of such a security procedure.

A security procedure is the generic term for a device or method (whether an electronic message authentication or other computer algorithm, code words, telephone call-back, or the like) for 'verifying that a payment order is that of the customer ...'<sup>83</sup> The Article 4A rules are summarised as follows.

In a large percentage of cases, the payment order of the originator of the funds transfer is transmitted electronically to the originator's bank. In these cases it may not be possible for the bank to know whether the electronic message has been authorized by its customer. To ensure that no unauthorized person is transmitting messages to the bank, the normal practice is to establish security procedures that usually involve the use of codes or identifying words. If the bank accepts a payment order that purports to be that of its customer after verifying its authenticity by complying with a *security procedure agreed to by the customer and the bank*, the customer is bound to pay the order even if it was not authorized.

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<sup>81</sup> Model Law, Art. 10(1).

<sup>82</sup> See unreported judgment, New South Wales Supreme Court, Commercial Division, Action No 50693 of 1989 (Rogers CJ) (interim judgment delivered 9 December 1992, final judgment delivered 30 April 1993).

<sup>83</sup> UCC Art. 4A s. 201. See Model Law, Art. 5(1).

But there is an important limitation on this rule. The bank is entitled to payment in the case of an unauthorized order only if the court finds that the security procedure was a *commercially reasonable* method of providing security against unauthorized payment orders. The customer can also avoid liability if it can prove that the unauthorized order was *not initiated by an employee or other agent* of the customer having access to confidential security information or by a person who obtained that information from a source controlled by the customer ... If the bank accepts an unauthorized payment order without verifying it in compliance with a security procedure, the loss falls on the bank.<sup>84</sup> (Emphasis added.)

This summary also characterises the Model Law interloper fraud rule.<sup>85</sup> Thus, three analytical steps are apparent from the summary: the agreement; commercial reasonability; and the 'not an insider' defence.

First, has a security procedure been established pursuant to an agreement between the sender and receiving bank? If no procedure exists, then interloper fraud issues are resolved under non-Article 4A or non-Model Law principles, specifically, the law of agency; that is, the law that establishes when one person is considered to be acting on behalf of another.<sup>86</sup> The resolution that might be achieved under this law will turn on whether the fraudsperson sent the payment order with the authority (whether actual or apparent) of the purported sender. Thus, if no security procedure exists between the Dragon Fund and Chase Manhattan Bank, then whether the payment order issued by the fraudsperson was authorised by the Dragon Fund will be determined under applicable agency law principles.

A security procedure, in theory, is not unilaterally imposed by one party or the other, but rather results from negotiations culminating in a written account agreement. To be sure, many customers are likely to have a standard-form contract specifying a particular procedure presented to them by their banks. Assuming that a security procedure has been agreed to between the bank and its customer, the next step is to consider whether that procedure is 'commercially reasonable'.

'Commercial reasonability' is a question of law, not fact. The judge's discretion is limited by Article 4A, which sets out criteria for evaluating whether a security procedure is commercially reasonable in a case at bar: 'the wishes of the customer expressed to the bank, the circumstances of the customer known to the bank, including the size, type and frequency of payment orders normally issued by the customer to the bank, alternative security procedures offered to the customer, and security procedures in

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<sup>84</sup> Article 4A Prefatory Note, p. vii. The rules are set forth at Art. 4A ss. 201 to 204.

<sup>85</sup> See Model Law, Art. 5.

<sup>86</sup> UCC Art. 4A s. 202(a).

general use by customers and receiving banks similarly situated.’<sup>87</sup> No similar limitation exists in the Model Law.

To avoid liability, the originator’s bank in the hypothetical transaction must prove that the security procedure it agreed to with its customer is commercially reasonable. In addition, the bank must show that it accepted the payment order in ‘good faith’ and in compliance with the procedure.<sup>88</sup> Acting in good faith and following the security procedure are issues of fact and, therefore, matters for a trier of fact such as a jury.

In the hypothetical wire transfer, suppose the originator argues that the US\$100,000 payment order issued in its name and accepted by the originator’s bank was unauthorised, and the ensuing US\$100,000 debit to its account should be reversed. Suppose also that Chase Manhattan Bank proves to a judge that the security procedure in operation between it and the Dragon Fund by which the payment order was verified was commercially reasonable. Suppose further that the bank also proves to the trier of fact that it acted in good faith in accepting the order and in compliance with the procedure. Has the purported originator, the innocent customer of the bank, lost the case?

Not necessarily, because of the ‘not an insider’ defence. The suspect payment order may have been issued by a person who was not an employee or agent of the Dragon Fund, and who did not gain access to the Fund’s bank account information through someone controlled by the Fund. In other words, the fraudsperson may not have been an ‘insider’ of the Dragon Fund or someone close to an insider. If the ‘innocent’ Dragon Fund proves these facts, then Chase Manhattan Bank cannot retain payment for the payment order.

Note that the burden of proof has shifted: Chase Manhattan Bank has the burden on the matters of a security procedure agreement, commercial reasonability, and good faith and compliance; but the customer purporting to be a victim of fraud has the burden of the ‘not an insider’ defence.<sup>89</sup> Note also that the ‘not an insider’ defence is difficult to maintain successfully. A large number of fraud, and even attempted fraud, cases appear to involve insiders.

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<sup>87</sup> UCC Art. 4A s. 202(c). Note that a security procedure can be deemed commercially reasonable, and this presents bank counsel with a useful negotiating tactic. See Patrikis, Baxter and Bhala, ‘Article 4A: The New Law of Funds Transfers and the Role of Counsel’, *op cit* note 26, pp. 235–236.

<sup>88</sup> UCC Art. 4A s. 202(b). ‘Good faith’ is defined in Art. 4A s. 105(a)(6) as ‘honesty in fact and the observance of reasonable commercial standards of fair dealing’. There is no analogous definition in the Model Law.

<sup>89</sup> UCC Art. 4A s. 202, Art. 4A s. 203.



There is no comparative negligence analysis or sharing of liability in this legal scheme. The purported sender/innocent customer (the Dragon Fund) bears the full US\$100,000 loss (in that its account is not re-credited) if (i) the bank proves that it acted in good faith and complied with a commercially reasonable security procedure and (ii) the customer cannot meet the innocent customer defence requirements.<sup>90</sup>

### *Money-back Guarantee and Discharge*

In the hypothetical wire transfer, what rights does each sender (the originator, originator's bank and intermediary bank) have if the wire transfer is not completed? (A wire transfer is complete when the beneficiary's bank accepts a payment order for the benefit of the beneficiary of the originator's order.)<sup>91</sup> For example, is the Dragon Fund entitled to a refund of US\$100,000, or must it commence litigation against some downstream party to recover the funds? What rights do Chase Manhattan Bank and Barclays Bank have in the event of non-completion? Does completion have an effect on the underlying contractual obligation of the Dragon Fund to pay US\$100,000 to Vickers Ballas? Appropriate answers to these questions promote certainty, efficiency in the form of low litigation costs, and fairness.

A money-back guarantee rule ensures that the originator of a wire transfer, and each subsequent sender of a payment order in the wire-transfer chain, obtains its money back in the event the transfer is not completed. As indicated above, a wire transfer is said to be completed when the *beneficiary's bank accepts* a payment order on behalf of the beneficiary. If the transfer is not completed, then each sender of a payment order in the wire-transfer chain is *entitled to a refund* of the principal amount of the payment order, plus any accrued interest.<sup>92</sup> If the transfer is completed, then the originator's underlying contractual obligation to the beneficiary is *discharged*.<sup>93</sup>

In the hypothetical wire transfer, as soon as DBS accepts the payment order

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<sup>90</sup> The concept of an 'electronic signature' is a potential security procedure. However, the precise meaning of this concept is unclear. On the one hand, it could involve a means to identify the originator of a funds transfer – in effect, a personal identification code. On the other hand, it could mean not only such a code, but also a method of telling where the originator is located, the computer used to send a payment order, etc – in effect, a tracing device. Whatever the meaning, the critical legal issue is commercial reasonability.

<sup>91</sup> Article 4A s. 104(a). See Model Law, Arts. 14(1), 19(1).

<sup>92</sup> UCC Art. 4A s. 402(c)–(d). See also Model Law, Art. 14(1).

<sup>93</sup> UCC Art. 4A s. 406(b). See also Model Law, Art. 19 footnote.

issued by Barclays Bank, the transfer is complete and the Dragon Fund is discharged of its underlying obligation to pay US\$100,000 to Vickers Ballas. In the event of non-completion, each sender – the Dragon Fund, Chase Manhattan Bank and Barclays Bank – is entitled to a refund of any amount it paid for its payment order, plus interest.<sup>94</sup>

The money-back guarantee may not be varied by an agreement between the sender and receiving bank.<sup>95</sup> However, the rule is subject to the exception that a sender that selects a particular intermediary bank through which to route a wire transfer bears the risk of loss associated with the failure of that bank.<sup>96</sup>

Suppose the Dragon Fund instructs its bank to route the US\$100,000 transfer through BCCI instead of Barclays Bank, and Chase Manhattan Bank complies with this instruction and debits its customer's account. Assume that BCCI is closed by banking supervisors. The closure occurs after BCCI accepts the payment order issued by Chase Manhattan Bank and is paid for the order by that bank, but before the wire transfer is completed (ie before DBS accepts BCCI's order). The effective result of these facts is that the funds are 'stuck' at BCCI. Then, the originator is not entitled to a re-credit of US\$100,000. Chase Manhattan Bank can keep the US\$100,000, and the Dragon Fund is subrogated to the right of its bank to claim against the receiver or trustee of BCCI's assets. (That is, the Dragon Fund's ability to retrieve the US\$100,000 depends on the right of its bank to claim against the receiver.) In sum, the party (here, the originator) who designates the failed intermediary bank should and does bear the risk of adverse consequences of that choice.

### *A Note on Bank Failure*

The consequences of bank failure on account holders depend in part on the time the failure occurs and on which bank in the wire-transfer chain fails.

- (i) *Failure of an intermediary bank before completion.* In the above example, BCCI fails before the wire transfer is complete. Therefore,

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<sup>94</sup> The rate of interest is determined in accordance with UCC Art. 4A s. 506. Unless otherwise agreed, it is the Fed Funds rate. The Model Law calls for interest to be paid at the customary interbank rate (such as the Fed Funds rate or LIBOR) for the banking community for the funds or money involved. See Model Law, Art. 2(m).

<sup>95</sup> UCC Art. 4A s. 402(f). See also Model Law, Art. 14(2). Note, however, that the Model Law carves out an exception that allows the money-back guarantee to be varied when a 'prudent' originator's bank would not have accepted a particular payment order because of a 'significant' risk in the wire transfer. The scope of this exception is unclear.

<sup>96</sup> UCC Art. 4A s. 402(d). See also Model Law, Art. 14(3).

the risk of loss is assumed by the party that designated the use of the intermediary bank.

- (ii) *Failure of an intermediary bank after completion.* If BCCI fails after the transfer is complete, then the beneficiary's bank must have accepted a payment order from BCCI, and the originator must have been discharged, before the failure. This is because of the definition of 'completion' and the discharge rule.<sup>97</sup> Under Article 4A (but not the Model Law), payment by the beneficiary's bank to the beneficiary is final because of the receiver finality rule.<sup>98</sup> Whether the beneficiary's bank was paid by BCCI for the order it received and accepted from BCCI before the beneficiary's bank paid the beneficiary depends on the facts of the case. If the beneficiary's bank accepts BCCI's order by paying the beneficiary before receiving settlement from BCCI, then the beneficiary's bank assumes the risk of loss from a BCCI failure.<sup>99</sup>
- (iii) *Failure of the originator's bank before acceptance.* The above discussion prompts the question of what happens if BCCI remains solvent, but the originator's bank or the beneficiary's bank fails. Consider first the case where the originator's bank fails before accepting the originator's payment order. Plainly, the wire transfer is not complete and the originator's obligation to pay US\$100,000 to the beneficiary is not discharged. Because the originator's bank failed before acceptance, the duty of the originator to pay the originator's bank for its order never matured; hence the originator is not liable for the order it issued.<sup>100</sup> It is entitled to a refund of any money it might have paid to the originator's bank for its payment order.
- (iv) *Failure of the originator's bank after acceptance.* If the originator's bank fails after accepting the order, then the originator is obliged to pay for its order.<sup>101</sup> Assuming a same-day execution scenario, the

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<sup>97</sup> UCC Art. 4A s. 104(a), Art. 4A s. 406, respectively. See also Model Law, Art. 19(1) and footnote, respectively.

<sup>98</sup> UCC Art. 4A s. 405(c).

<sup>99</sup> Under UCC Art. 4A s. 209(b)(1) (clause (i)), one manner in which the beneficiary's bank can accept a payment order is by paying the beneficiary in accordance with Art. 4A s. 405(a) or (b). Article 4A s. 405(a) concerns a credit to the beneficiary's account, and Art. 4A s. 405(b) concerns payment by means other than a credit as determined by 'principles of law that determine when an obligation is satisfied'. The point is that the beneficiary's bank can pay the beneficiary before the bank has received settlement from its sender.

<sup>100</sup> UCC Art. 4A s. 402(c). See also Model Law, Art. 5(6).

<sup>101</sup> *Ibid.*

originator's bank will have accepted the originator's payment order by issuing a conforming order - ie by executing the originator's order on the day it received the originator's order.<sup>102</sup> If BCCI accepts the order of the originator's bank, then the originator's bank is liable to pay for its order.<sup>103</sup> Whether this liability is affected by applicable Federal bank regulatory provisions is beyond the scope of this presentation, but the issue raises potentially intriguing legal and policy issues.<sup>104</sup>

For example, the originator is not discharged until the beneficiary's bank accepts an order from BCCI, but suppose BCCI is unwilling to accept the order issued by the originator's bank until the originator's bank provides settlement for its order. In this instance, BCCI presumably is unwilling to assume the risk that the originator's bank fails after BCCI accepts the order but before BCCI has been paid for the order. The originator will then bear that risk, because it may have paid the originator's bank for its payment order but not have been discharged of its underlying payment obligation to the beneficiary. If the originator's bank fails before discharge occurs, then the originator is liable to the beneficiary for US\$100,000 on the underlying contract and must claim against the originator's bank (or its receiver or liquidator) under the money-back guarantee (or perhaps other applicable law).<sup>105</sup> This might be justified on the ground that the originator is the party that selected the use of the originator's bank by maintaining an account at, and issuing a payment order to, that bank.

- (v) *Failure of the beneficiary's bank.* Consider the scenario in which the beneficiary's bank fails. If this occurs after acceptance (and, therefore, completion), then the originator is discharged of its obligation.<sup>106</sup> The beneficiary bears the risk of loss and must make a claim against the failed bank (or its receiver or liquidator). Again, this might be justifiable because the beneficiary is the party that designated to the originator in its underlying contract with the originator that payment should be made at the beneficiary's bank. If

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<sup>102</sup> UCC Art. 4A s. 209(a), Art. 4A s. 301. See also Model Law, Arts. 8(2), 11.

<sup>103</sup> UCC Art. 4A s. 402(b). See also Model Law, Art. 5(6).

<sup>104</sup> This scenario is perhaps more likely given the prompt corrective action rules implemented pursuant to the Federal Deposit Insurance Corporation Improvement Act 1991, Pub. L. No 102-242, section 131 (1991). See 12 CFR, parts 208, 263.

<sup>105</sup> UCC Art. 4A s. 402(c). See also Model Law, Art. 14.

<sup>106</sup> UCC Art. 4A s. 406. See also Model Law, Art. 19 footnote.

failure occurs before acceptance, then the wire transfer is not complete. The originator and each subsequent sender are entitled to the money-back guarantee.<sup>107</sup> Presumably the originator will pay the beneficiary through a wire transfer directed to a different beneficiary's bank (or through an alternative payments mechanism).

## Drafting Principles

### *Interest Groups*

Law, including payments-system law, is not handed down from God. Rather, law results from a long and complicated interaction of interest groups that advance their economic, political and social agendas. Article 4A and the Model Law are examples of this interaction. Accordingly, neither Article 4A nor the Model Law appeared in the law books quickly. The drafters negotiated for years, working and re-working concepts and specific legal language. It would be foolish to suggest that the work of every drafter reflected the same or even similar theories as those held by every other drafter. On the contrary, different drafters had different theories and they negotiated, argued, and ultimately compromised with one another.

However, it is possible to group the drafters of Article 4A into three broad interest groups: system users, system providers and system supervisors. The delegates to UNCITRAL that drafted the Model Law also tended to reflect these constituencies. The users of large-value credit-transfer systems – typically corporate customers and some (usually smaller) financial institutions – had consumer interests in mind. Their aim was to ensure that stringent liabilities were imposed on system providers. Hence they sought clear rules on misdirected payment orders, and to hold banks liable for consequential as well as actual damages under certain circumstances. Often, the arguments of users were cast in terms of fairness.

Conversely, system providers – generally, large banks and owners of particular systems – sought to minimise their liabilities. They struggled to avoid the imposition of consequential damages, and to ensure that stringent rules governing authenticity and security procedures were drafted. Typically, their arguments were cast in terms of efficiency and reliability.

Finally, system supervisors – central banks and finance ministries – sought to minimise systemic risks. Accordingly, they strongly advocated the receiver

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<sup>107</sup> UCC Art. 4A s. 402(c). See also Model Law, Art. 14(1).

finality and discharge rules. They did not consistently side with users or providers. Indeed, often they played the role of mediator between users and providers, while at the same time keeping a watchful eye on their own interests. They would employ the language of fairness, efficiency or reliability depending on the needs of the problem at hand.

When drafting a wire-transfer law, it may be useful to think in terms of users, providers and supervisors as three distinct interest groups whose concerns must be addressed. However, it is not necessarily desirable to encourage this tripartite division of interest groups during the drafting process. Many less developed and newly industrialised countries must draft legal frameworks for large-value funds-transfer systems in different environments from the one in which Article 4A and the Model Law were created. Thinking in terms of consumer, bank and supervisory interests may not necessarily reflect these different environments.

Instead, it may be particularly fruitful to consider what questions are most pressing. For example, to what extent is the general commercial law framework well articulated and well developed? In some instances, the answer is that only a skeletal framework exists. Are bankruptcy rules in place to handle bank and customer insolvencies? In some cases, only nascent rules exist, and in other instances no such rules have been implemented. To what extent is fraud present in commercial transactions? Sadly, in some cases fraud is relatively commonplace.

The special environment in developing and newly industrialising countries suggests five fundamental drafting principles.

### *The Rule of Law*

First, as a threshold matter the importance of the rule of law must be established firmly. The payments-system law should be manifest at the highest level of the hierarchy of rules in a particular country. If, in a country's legal system, a statute has greater force and effect than a regulation, and in turn a regulation has greater force and effect than an administrative order, then the law governing wire transfers should take the form of a statute. This form should afford greater protection against political or bureaucratic meddling in the payments system. Of course, in certain countries – for instance, Vietnam – passing a statute is a more cumbersome process than issuing a regulation. Nonetheless, the rule of law is fundamental to the certain, efficient and fair operation of a funds-transfer system, thus procedural hurdles in passing laws must be overcome.

### *Accountability*

Secondly, institutions involved in wire transfers should be held accountable for their own behaviour. Such parties should not expect assistance from the government in the event of mishaps or financial difficulties. The utmost importance must be accorded rules of law, not relationships among parties or between a party and the government. In general, a wire-transfer law must be part of a larger legal environment that is founded on individual financial accountability, not (as in former communist countries) central planning and control. In this regard, the participation of the central bank in the funds-transfer system should not be overemphasised. There is no necessary reason why it must own and operate a system. Indeed, private party action and responsibility ought to be encouraged in countries in transition toward a market economy.

### *Integration with Other Bodies of Law*

Thirdly, wire-transfer law cannot develop in a vacuum. This law must be seen as part of the broad commercial and bankruptcy framework and not developed in a piecemeal fashion. Accordingly, the rules governing large-value credit transfers must be consistent with those established for contracts, negotiable instruments, letters of credit, secured transactions and insolvencies. Thus, for example, the concepts of 'commercial reasonability' or 'good faith' must be used consistently throughout the framework. The economic incentives created by the different parts of the framework must also be consistent. Commercial law is a seamless web, and thus there must be a holistic integrity to the law.

### *Fraud Prevention*

Fourthly, particular emphasis must be given to fraud prevention. Accordingly, appropriate safeguards must be implemented that create incentives for all parties to a large-value credit transfer to exercise at least reasonable care. More generally, the legal framework must be seen as a primary guarantor of the integrity of the payments system. Nothing undermines that integrity faster than fraud. However, in drafting rules on fraud prevention, an inevitable tension between security and efficiency must be managed. On the one hand, requiring receiving banks and their sender customers to exercise great diligence in preventing fraud raises the level of security. On the other hand, the greater the burden on receiving banks and senders to act as policemen against fraud, the

higher the monetary cost of a wire transfer, and the longer it may take to process a transfer. There is no simple recipe for managing this tension; rather, the appropriate solution will depend on the country in question.

### *Supporting the Financial Markets*

Fifthly, the legal framework for wire transfers should accommodate the anticipated growth and development of the economy and its constituent sectors. In the US and other post-industrial societies, the primary motivation for engaging in such transfers is not to settle payments obligations arising from the sale of goods. As the above hypothetical transaction suggests, the bulk of wire-transfer activity is generated by financial transactions – the buying and selling of foreign exchange, short-term money-market instruments, and various types of investment securities. Accordingly, in developing a legal framework for large-value credit-transfers systems, the future needs of the financial community must be anticipated and addressed.<sup>108</sup>

### **Summary**

The legal foundations of American large-value credit-transfer systems, Fedwire and CHIPS, are set forth in Article 4A. The same legal foundations are found in the Model Law. Among the many provisions in these legal texts, at least five are particularly noteworthy:

- (i) a rule defining the scope of the law;
- (ii) a rule establishing when the rights and obligations of parties to a wire transfer are triggered;
- (iii) a receiver finality rule (in Article 4A, but not the Model Law);
- (iv) a rule assigning liability for interloper fraud; and
- (v) a money-back guarantee rule, coupled with provisions on discharge.

The rules are articulated through precise terminology identifying each party to a wire transfer and the actions that each party undertakes.

Must the five rules exist in any wire-transfer statute? To what extent can one generalise from the Article 4A or Model Law experience? These questions deserve two levels of analysis. First, comparative legal research on the laws governing large-value credit-transfer systems in other jurisdictions is needed to

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<sup>108</sup> See Bhala, 'The Inverted Pyramid of Wire Transfer Law', *op cit* note 4.



identify the foundations of those laws. In other words, those laws need to be distilled. Secondly, theoretical debate, involving economic rationales and public policy goals, is required to determine the justifications for alternative statutory foundations.

These analyses have yet to be performed, but one point of caution is appropriate: commercial law, including wire-transfer law, is not immutable. It serves parties and their transactions, but because both of these change over time, individual needs and systemic concerns vary as well. Accordingly, the legal foundations for wire transfers should be viewed as dynamic.