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Towards a Payments System Law for Developing and Transition Economies

Raj Bhala

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Raj Bhala
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FOREWORD

Today, there is a growing recognition that at particular stages of financial sector development the conversion of the traditional manually-processed payment system into an electronic fund transfer system supports sound financial market development through improved certainty and timeliness of payments. When a party transforms, through electronic means, its claim against a bank into another party’s claim against a bank, the product of wire transfer processing is a distinctly legal concept. Thus, one of the common tasks of the World Bank in helping develop wire transfer systems in client countries is to provide technical advice on setting up the legal framework governing payment transactions.

The paper by Professor Raj Bhala is prepared to serve this purpose. It was originally presented at the World Bank Seminar on "Payment Systems in Financial Sector Development" in April 1995. This seminar was initiated by the Financial Sector Development Department of the World Bank and organized in conjunction with the Federal Reserve Bank of Richmond. Given the positive response to this paper, and the ensuing debate it provoked, we decided to publish this paper to a wider audience.

We are sure this paper will prove to be of great interest to those who specialize in payment systems issues, as well as those with a broader interest in financial matters during transition and development.

Gary L. Perlin
Director
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ABSTRACT

This paper examines the legal foundations of large-value credit transfer systems and the importance of certainty, efficiency, and fairness in funds 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: (1) a rule defining the scope of the law; (2) a rule establishing when the rights and obligations of parties to a funds transfer are triggered; (3) a receiver finality rule; (4) a rule assigning liability for interloper fraud; and (5) a money-back guarantee rule, coupled with provisions on discharge. Finally, strategic concerns affecting the drafting of a funds transfer law are identified.
ACKNOWLEDGEMENT

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INTRODUCTION

This paper explains the interactions among the main pillars of law which should govern large-value credit transfer systems. It does so by focusing on the essence of the American legal regime governing large-value credit transfer systems. The same essential principles discussed herein are found in the new international legal regime governing these systems. Accordingly, the paper will be useful to readers who are concerned with the development of funds transfer laws in other countries.

The paper consists of four remaining parts. In Part I, the relationship between the legal framework for a large-value credit transfer system and the development of an ideal system is discussed. Part II briefly surveys the five foundations of a legal framework for large-value credit transfer systems. Part III introduces a case study of a funds transfer and employs essential legal terminology. In Part IV, the five foundations of a legal regime governing funds transfer law are discussed in detail using the essential legal terminology. Part V considers general principles of drafting a funds transfer law in the 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 Part VI.
I. THE IMPORTANCE OF THE GOVERNING LEGAL REGIME

A necessary (but not sufficient) condition for a thorough discussion of large-value credit transfers is a treatment of U.C.C. Article 4A. Whether these transfers are popular means of payment from the view of individual transactors, and whether they are conducted in a safe and sound manner from the view of bank supervisors, are issues that necessarily involve the law. Funds transfer law should serve the interests of the commercial parties who look to large-value credit transfer systems to settle their payment obligations and in particular should facilitate growth in domestic and international transactions. As discussed below, ill-conceived funds transfer rules, or a legal void, can retard the growth and development of large-value credit transfer systems. In turn, the underlying transactions which generate payments obligations may be hampered.

Large-value credit transfers are of enormous importance. For example, over 80 percent of the dollars transferred in the United States are sent over large-dollar electronic funds transfer networks. Every day in the United States, roughly two trillion U.S. dollars are transferred by means of Fedwire and the Clearing House Interbank Payments System (CHIPS). Depending on the structure of the laws governing funds transfers, potential users and providers of funds transfer services may find these services either more or less attractive.

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, commercial parties making and receiving such payments require a clear, comprehensible, and sensible legal regime to answer two basic questions. First, how should a funds transfer normally work? Second, 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 minimized and contained?

One way to approach these issues is to consider the theoretical underpinnings of an ideal payments system. Arguably, an ideal payments system must have three salient features: it must be certain (i.e., reliable), efficient (i.e., high speed, low cost, and high security), and fair (i.e., equitable in its apportionment of liability). That is, large amounts of funds must be transmitted at low cost and with high security, and the rights and obligations of parties to the funds transfer must be allocated in a fair manner. A legal framework for a large-value credit 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 funds 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 an automobile company instructs its bank to make a $5 million payment to a steel supplier. The payment is made through the Bank of Credit and Commerce International (BCCI), but before the payment transaction is complete BCCI fails. Does the automobile company, the steel company, the creditors of BCCI, or some other party bear the $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 inevitably will increase.

Second, 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 U.S. bank that receives a $500,000 payment instruction from one of its customers discovers – after the payment is made to an offshore bank – that the instruction is unauthorized. What are the rights and obligations of the U.S. 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.

Third, 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 funds 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.

In sum, there is an integral link between (1) the legal foundations of a large-value credit transfer system and (2) extent to which that system is an ideal one. The essence of the American and United Nations legal regimes governing large-value credit transfer systems can be grasped by understanding five legal rules. These rules – the five legal foundations – are designed to make the systems to which the rules apply more efficient, reliable, and safe. To be sure, these are not the only rules in the U.S. or international funds transfer laws, and reasonable people may contend that there are other equally or even more essential statutory provisions. But, distilling the law to five rules assuredly yields much of the essence of the law.
II. AN OVERVIEW OF THE FIVE LEGAL FOUNDATIONS

To appreciate the rules, it is first necessary to master the terminology of funds transfer law and to use applicable terms in the context of a typical funds transfer. (The terms "funds transfers" and "credit transfers" are used interchangeably, as are the terms "funds transfer systems" and "large-value credit transfer systems." Accordingly, the five critical elements in the American and international funds transfer laws are set forth in the appropriate legal terminology and context.

The economic and policy justifications for the five legal rules are beyond the scope of this presentation. Similarly, there is no attempt to argue or prove that the rules discussed herein are the exclusive legal pillars of funds transfer law. By setting forth the important provisions in American funds transfer law, the presentation will serve as a point of departure for the future work and study of the lawyer, banker, or scholar.

The five rules are set forth in Article 4A of the Uniform Commercial Code (U.C.C.), the principal law in the United States governing funds transfers, and the United

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2 A definition of "funds transfers" is found in U.C.C. Section 4A-104(a), and a "funds transfer system" is defined in Section 4A-105(a)(5).


5 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 Article 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 Article 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, (continued...
Nations Model Law on International Credit Transfers (U.N. Model Law), the main international legal agreement on funds transfer rules. They are:

1. a **scope rule** to differentiate the parties and payment instructions that are included in the law from those that are not included;

2. a **trigger event** to indicate the moment when the rights and obligations of a party to a funds transfer are manifest;

3. a **receiver finality rule** to establish when credit to an account is irrevocable;

4. a **money-back guarantee** to cover situations where a funds transfer is not completed, coupled with a discharge rule for cases where the transfer is completed; and,

5. an **anti-fraud rule** to allocate liability for fraudulent payments instructions.

(...continued)

which governs Fedwire, essentially incorporates this version of Article 4A by reference, with some modifications and additions.

Regulation J is codified at 12 C.F.R. Part 210 subpart B (1992). Similarly, the New York Clearing House has selected New York's version of Article 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 part III (1993).

Like Article 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 U.C.C. Article 4A and certain analogous provisions in the Model Law.
III. A CASE STUDY

A discussion of the five key rules of U.C.C. Article 4A is aided by reference to a case study of a funds transfer. Consider the following hypothetical:

1. An automobile manufacturer buys steel worth $100,000 from a steel company to make vehicles. The steel company delivers the steel to the automobile manufacturer, and the manufacturer now seeks to pay the company for the steel by funds transfer.

2. The manufacturer and steel company hold their accounts at different banks.

3. The manufacturer instructs its bank to pay $100,000 to the steel company. The instruction contains the name and account number of the steel company and the name and identifying number of the steel company's bank.

4. The automobile manufacturer's bank complies with the instruction of its customer by further instructing a second bank to pay $100,000 to the steel company. This second instruction again contains the relevant information about the steel company and its bank.

5. The second bank also complies with the instruction it received. It further instructs the bank at which the steel company has an account to pay $100,000 to the steel company.

6. The steel company's bank complies with the third instruction and pays the company.

This hypothetical transaction is represented in the following diagram. The chronological steps in the transaction are indicated by numbers in parentheses. The defined terms of U.C.C. Article 4A are used, highlighted, and explained in detail below.

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2 A payments obligation to be discharged by a funds transfer can arise from virtually any sort of underlying contractual relationship between the buyer-payor and seller-payee. While the underlying contractual obligation in this hypothetical involves goods, in reality financial transactions generate the bulk of funds transfers. Most large-value funds transfer activity is associated with securities and foreign exchange trading. See Raj Bhala, The Inverted Pyramid of Wire Transfer Law, 82 KENTUCKY LAW JOURNAL 347 (winter 1993-94) and BANK FOR INTERNATIONAL SETTLEMENTS, PAYMENT SYSTEMS IN ELEVEN DEVELOPED COUNTRIES 215 (3rd ed. 1989).
Each of these parties, and the actions each undertakes, has a specific legal label in U.C.C. Article 4A. Applying the correct labels is the first step in the process of distilling Article 4A to its essential ingredients. Each payment instruction is a "payment order" if it meets the requirements of the definition of that term. This term is critical in defining the scope of the law.

The automobile manufacturer is the "originator" of the funds transfer, that is, "the sender of the first payment order in a funds transfer." 9 The bank at which the automobile manufacturer maintains an account and to which the first payment order is addressed is the "originator’s bank." 9 The steel company is the "beneficiary" of the originator’s payment order. 10 Also, it is the beneficiary of each payment order issued in the funds transfer chain that implements the originator’s order, i.e., the payment order issued by the originator’s bank and the second bank. The "beneficiary" is simply "the person to be paid by the beneficiary’s bank." 10 The bank at which the steel company maintains its account and to which funds are credited is the "beneficiary’s bank." 11 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." 11 The second bank is the "intermediary bank" in that it is "a receiving bank other than the originator’s bank or the beneficiary’s bank." 12

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9 U.C.C. Section 4A-104(c).

10 U.C.C. Section 4A-104(d). There is no requirement in this definition, or elsewhere in Article 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.

11 U.C.C. Section 4A-103(a)(2).

12 U.C.C. Section 4A-103(a)(3).

13 U.C.C. Section 4A-103(a)(3). Here too, there is no requirement of a pre-existing account relationship. There is no definition of a "beneficiary’s bank" in the Model Law.

14 U.C.C. Section 4A-103(a)(3).

Diagram: Hypothetical example of a funds transfer

(6) Payment order issued by the originator's bank

(7) Payment order received by the intermediary bank

(8) Payment order accepted by the intermediary bank

(9) Settlement between the originator's bank and the intermediary bank

(10) Payment order issued by the intermediary bank

(11) Payment order received by the beneficiary's bank

(12) Payment order accepted by the beneficiary's bank

(13) Settlement between the intermediary bank and the beneficiary's bank

Automobile manufacturer's bank
The originator's bank

A receiving bank with respect to the originator's payment order and a sender with respect to its own order issued to the intermediary bank.

Second Bank
The intermediary bank

A receiving bank with respect to the originator's bank's payment order and a sender with respect to its own order issued to the beneficiary's bank.

Steel company's bank
The beneficiary's bank

A receiving bank with respect to the payment order issued by the intermediary bank.

(1) Underlying contract calling for the beneficiary to deliver steel to the originator in consideration of $100,000.

(2) Payment order issued by the originator to the originator's bank.

(3) Payment order received by the originator's bank.

(4) Payment order accepted by the originator's bank.

(5) The originator pays the originator's bank for the payment order.

(14) Payment. Credit to the beneficiary's account.

Automobile manufacturer
Originator
Also a sender

Steel company
Beneficiary

Adjoint 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 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."15 The automobile manufacturer (the originator), the bank of the automobile manufacturer (the originator's bank), and the second bank (the intermediary bank) are all senders. The originator's bank, intermediary bank, and beneficiary's bank (the steel company's bank) are receiving banks.

The "funds 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."16 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."17 The funds 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."18

The sale of steel by the steel company to the automobile manufacturer is the underlying contract between the beneficiary and originator of the funds transfer. Under the terms of the contract, the originator has a $100,000 payment obligation, and the originator begins the funds transfer for the purpose of discharging this obligation.19

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 funds transfer is completed, which occurs when the beneficiary's bank accepts a payment order for the beneficiary, the originator is legally liable on this obligation – it is not discharged.20 The originator's obligation to pay the beneficiary based on the contract for steel 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.

Second, seemingly synonymous uses of the terms "payment obligation" (or "payment"), "settlement obligation" (or "settlement") and "discharge" sometimes generate confusion. In the funds transfer context, the underlying payment obligation refers to the

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16 U.C.C. Section 4A-104(a).

17 Id.

18 Id.


20 U.C.C. Sections 4A-104(a) and 4A-406(a)-(b).
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 specific sections of U.C.C. Article 4A.21

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 obligated to accept an order.22 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 (i.e., the originator's bank and intermediary bank) accepts a payment order by executing the order.23 "Execution" of a payment order means that the bank "issues a payment order intended to carry out the payment order received by the bank."24 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.25 Rather, the beneficiary's bank, if it accepts the order, is required to pay the

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22/ U.C.C. Section 4A-209 and official comment 3. See U.N. Model Law, Articles 7(2), 8(2), 9 and 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 obtaining payment from its sender. U.C.C. Section 4A-209(b)(2). With a funds transfer through Fedwire, the payment order and payment (i.e., the instruction and value) move simultaneously from sender to originator. ERNEST T. PATRIKIS, THOMAS C. BAXTER, AND RAJ BHALA, WIRE TRANSFERS 174 (1993).

23/ U.C.C. Section 4A-209(a).

24/ U.C.C. Section 4A-301(a). See U.N. Model Article 2(1).

25/ U.C.C. Section 4A-301(a). The U.N. Model Law does not clarify this point.
beneficiary the amount of the order. 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 (e.g., the originator must pay $100,000 to the originator's bank if the bank accepts the originator's order, the originator's bank must pay $100,000 to the intermediary bank if the intermediary bank accepts the originator's bank's order, and so forth.). 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, in 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.

If the bank entitled to payment is a receiving bank other than the beneficiary's bank (i.e., 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. Generally, the execution date is the day the order is received. This is referred to as "same-day execution," which means that the receiving bank executes the order on the day it is received.

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26 U.C.C. Section 4A-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 defense 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 U.C.C. Section 4A-305. The liability rules of U.C.C. Article 4A are not treated in this chapter. However, they are relevant not only for those involved in the development of funds 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: Dellbrueck & Co. v. Manufacturers Hanover Trust Co. Revisited, 70 Texas Law Review 739 (1992); Ernest T. Patrikis, Thomas C. Baxter, Jr., and Raj Bhala, Article 4A: The New Law of Funds Transfers and the Role of Counsel, 23 Uniform Commercial Code Law Journal 219 (1991); and Thomas C. Baxter, Jr. and Raj Bhala, Proper and Improper Execution of Payment Orders, 45 Business Lawyer 1447 (1990).


28 U.C.C. Section 4A-301(b). Receiving banks are free to establish cut-off times for the receipt of payment orders. See U.C.C. Section 4A-106 and U.N. Model Law Article 2(k). Note that the Model Law defines "execution period" in lieu of the concepts of "execution date" and "payment date."

29 Id. See U.N. Model Law Article 11(1).
from the sender. On or before that day, the sender must pay for the order. 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.

If the bank entitled to payment is the beneficiary’s bank, then again the obligation to pay arises upon acceptance by that bank. Here, however, the sender (in the hypothetical, 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. Typically, it is the date of receipt. The beneficiary’s bank can pay the beneficiary by crediting its account. 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. The above discussion has not expressly highlighted the role of a central bank in a funds transfer. The conventional but incomplete view is that a central bank is the intermediary bank. To be sure, a central bank often is the intermediary between two commercial banks (the originator’s and beneficiary’s bank), the upstream originator, and the downstream beneficiary. However, a central bank can play any role in a funds 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 funds transfer chain.

Insertion of the central bank at any point in the funds transfer would not alter the case study as a legal matter unless funds transfer rules set forth in U.C.C. Article 4A (or

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\[1\] 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.

\[2\] U.C.C. Section 4A-403(a).

\[3\] U.C.C. Section 4A-401.

\[4\] Id.

\[5\] U.C.C. Section 4A-405(a).

\[6\] Id.
the U.N. Model Law) are modified by the rules of the central bank. 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 the funds transfer is not completed, then the reason for the non-completion will lie with a party other than the central bank.

37 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 Article 4A as the governing law and the deviations from the statute are, on balance, minimal.
IV. 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 funds transfer governed by applicable funds 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 thus reducing potential legal costs.

These questions are answered in U.C.C. Article 4A by referring to the definition of "payment order." If an instruction is not a "payment order," then Article 4A is not applicable. 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,

(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 for transmittal to the receiving bank.  

There are five salient features of this definition. First, the instruction must be issued to a "bank." While any person can be a "sender," only a "bank" can be a "receiving bank." 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." This definition is

\textsuperscript{139} U.C.C. Section 4A-103(a)(1) (emphasis supplied). See U.N. Model Law Article 2(b).

\textsuperscript{139} U.C.C. Section 4A-103(a)(4)-(5). "Person" is used throughout the definition sections of U.C.C. Article 4A but not defined therein. Therefore, the U.C.C. Article 1 definition would apply. U.C.C. Section 1-105(d). Under Article 1, a "person" includes an individual or an organization." U.C.C. Section 1-201(30).

\textsuperscript{139} U.C.C. Section 4A-105(a)(2).
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.

Second, the amount of the instruction must be "fixed or determinable." In most cases, the application of this requirement is straightforward. In the hypothetical, the $100,000 amount is "fixed."

Third, the definition of "payment order" requires that the instruction contain no condition other than time of payment. If the automobile manufacturer's instruction to its bank said "pay $100,000 on day 10 if you receive delivery of shipping documents pertaining to the purchased steel," then the requirement would not be satisfied. Only the statement regarding day 10 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 U.C.C. Article 4A is inapplicable.

The fourth requirement concerns payment for the payment instruction. A receiving bank that receives a payment instruction from its sender must be reimbursed by debiting an account of, or otherwise receiving payment from, the sender. This means that credit transfers are included, but all electronic funds transfers that are debit transfers are excluded. In the hypothetical, if the originator's bank is reimbursed for the automobile company's payment order by debiting an account of the company, 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." The classic example of a debit transfer involves a check or other negotiable instrument. In a check transaction, a debtor (the drawer of the check) gives authority to the creditor (the payee of the check) to draw on the debtor's account which is

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41/ U.C.C. Section 4A-103(a)(1)(i).
42/ U.C.C. Section 4A-103(a)(1)(ii).
44/ Id. See also U.C.C. Article 4A Prefatory Note, p. 11.
45/ Negotiable instruments are governed by U.C.C. Articles 3 and 4. U.C.C. Sections 3-102 and 4-102.
maintained at the payor bank (also called the drawee). The authority is given by drawing the check and transferring the check to the payee. In turn, the payee issues the instruction to pay to the payor bank when it deposits the check. That is, the payee (not the drawer) issues the instruction by depositing the check in the depositary bank (at which the payee maintains an account), and the check is presented to the payor bank through the check collection process. Assuming the payor bank honors the check, it is reimbursed by the debtor, not the person giving the instruction (the payee). "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." In sum, in a funds transfer the payor (originator) issues the instruction (payment order) to the paying bank (originator's bank) and reimburses that bank. In a check transaction the payee issues the instruction (the check) and the paying bank (payor bank) is reimbursed by the drawer of the check.

Finally, to qualify as a payment order, an instruction must be transmitted directly by the sender to the receiving bank (or its agent, funds transfer system, or communication system for subsequent transmission to the receiving bank). In the hypothetical, each instruction is directly transmitted from sender to receiving bank. This requirement serves to exclude from U.C.C. Article 4A payments made by means of a check or credit card, for example.

Assume that the parties know that U.C.C. Article 4A 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, U.C.C. Article 4A is intended to apply end-to-end. 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 funds transfer is through Fedwire, then whether remote parties (i.e., those that are not in

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46/ U.C.C. Sections 3-102(1)(d) (the "drawer" is a secondary party on the check, whereas the payor bank becomes primarily liable upon accepting the check); 3-302 ("payee" may be a holder in due course), and 4-105(b) (definition of "payor bank").

47/ U.C.C. Section 3-102(1)(a) (definition of "issue").

48/ U.C.C. Section 4-105(a) (definition of "depositary bank").

49/ U.C.C. Section 4A-104 official comment 4.

50/ U.C.C. Section 4A-104 official comment 4.

51/ U.C.C. Section 4A-103(a)(1)(i)(ii).

52/ U.C.C. Section 4A-103(a)(1) official comment 5.

53/ U.C.C. Prefatory Note, iii and Section 4A-507(c).
privity with a Federal Reserve Bank) are bound by Regulation J depends on whether they had prior notice that (1) Fedwire might be used and (2) the applicable law governing Fedwire is Regulation J. Privity means that the parties send payment orders directly to or receive orders directly from a Reserve Bank. These requirements presumably avoid the unwarranted extension of Regulation J or the extraterritorial application thereof in inappropriate situations. Regulation J, however, essentially states that U.C.C. Article 4A is the law governing Fedwire. Similarly, the rules of the CHIPS system make clear that Article 4A governs that system.

Trigger event

At what point are the rights and obligations of a party to a funds 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 also can ensure that funds transfers are conducted efficiently, specifically, in a high speed manner.

The answers are provided in U.C.C. Article 4A 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." 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 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 (the automobile manufacturer's bank and the second 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.

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58 See id. at 191.
59 U.C.C. Article 4A Prefatory Note p. iv (emphasis supplied). See also Section 4A-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."). See U.N. Model Law Article 5(6).
received from the sender.60/

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: (1) payment by the beneficiary's bank to the beneficiary; (2) notification from the beneficiary's bank to the beneficiary that a payment order has been received; or (3) receipt of payment by the beneficiary's bank from the sender that issued the payment order to the beneficiary's bank.61/ 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.62/ The third act involves the "upstream" relationship between the beneficiary's bank and its sender.63/

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.64/ 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.65/ This is a trinity of rights which, from the receiving bank's perspective, constitute a trinity of duties.

60/ U.C.C. Sections 4A-209(a) and 4A-301(a).
61/ U.C.C. Section 4A-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 and wait 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.) U.C.C. Section 4A-209(b)(3) and official comment 5. See also Section 4A-405 official comment 2. Of course, this method of acceptance is unavailable if the funds transfer is through a system like Fedwire, because the payment order and payment are received simultaneously.
62/ Payment by a beneficiary's bank to a beneficiary is governed by U.C.C. Section 4A-405, which is discussed below in the context of the receiver finality rule.
63/ Payment by a sender to a receiving bank is covered in U.C.C. Section 4A-403.
64/ U.C.C. Section 4A-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, i.e., it need not have paid out before receiving inter-bank settlement. U.C.C. Section 4A-402(b).
65/ U.C.C. Section 4A-302(a).
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.\textsuperscript{66} These mature on the payment date, which typically is the day the order is received by the beneficiary's bank.\textsuperscript{67}

**Receiver finality**

When does a beneficiary know that it has received "good funds"? If the steel company receives a $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 the steel company cannot irrevocably commit the $100,000 to other uses (e.g., paying its bills, paying dividends, investing in new projects, and the like). This is because the steel company's bank (the beneficiary's bank) might demand that the $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 funds 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.\textsuperscript{68} The payment for the funds transfer cannot be recovered by the beneficiary's bank. This is the receiver finality rule. Even the beneficiary's right to withdraw a credit (i.e., 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.\textsuperscript{69} 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.\textsuperscript{70} 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

\textsuperscript{66} U.C.C. Section 4A-404(a).

\textsuperscript{67} U.C.C. Section 4A-401.

\textsuperscript{68} U.C.C. Section 4A-405(c). The U.N. 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.

\textsuperscript{69} An additional exception, not treated here, pertains to funds transfers involving automated clearing houses. See U.C.C. Section 4A-405(d).

\textsuperscript{70} U.C.C. Section 4A-405(e). The classic example of such a system is CHIPS.
beneficiary’s bank can recover funds from the beneficiary. In this unwind scenario, the funds transfer is not completed, the originator is not discharged on its 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 (e.g., 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 a 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 funds 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." 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. This is the only instance in U.C.C. Article 4A where consequential damages are a remedy provided by the statute, absent a written agreement between parties that calls for consequential damages.

Interloper fraud rule

Modern day electronic pirates abound. A fraudsperson (also called an interloper) claiming to be an official of the automobile manufacturer could send a payment

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21/ Id.
22/ U.C.C. Section 4A-404(a).
23/ Id.
24/ U.C.C. Section 4A-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).
order to the automobile manufacturer's bank instructing that $100,000 be paid to an account #10017 at the BCCI in the Grand Cayman Islands. How is the automobile manufacturer's bank to determine whether the payment order is really that of its customer, the automobile manufacturer? If the bank executes the order and debits the automobile manufacturer's account for $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 automobile manufacturer that has access to its bank account information? Appropriate answers to these questions promote certainty, efficiency in the sense of high security, and fairness.

U.C.C. Article 4A addresses 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...." The U.C.C. Article 4A rules are summarized 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. 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,

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the loss falls on the bank.76/

Three analytical steps are apparent from the summary: the agreement; commercial reasonability; and the "not an insider" defense.

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-U.C.C. Article 4A principles, specifically, the law of agency, that is, the law that establishes when one person is considered to be acting on behalf of another.77/ 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 automobile manufacturer and its bank, then whether the payment order issued by the fraudsperson was authorized by the automobile manufacturer 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 U.C.C. 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 general use by customers and receiving banks similarly situated."78/

To avoid liability, the originator's bank in the hypothetical 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. 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 funds transfer, suppose the originator argues that the 
$100,000 issued in its name and accepted by the originator's bank was unauthorized, and 
the ensuing $100,000 debit to its account should be reversed. Suppose also that the 
automobile manufacturer's bank proves to a judge that the security procedure in operation 
between it and the automobile manufacturer 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" defense. The suspect payment 
order may have been issued by a person who was not an employee or agent of the 
automobile manufacturer, and who did not gain access to the manufacturer's bank account 
information through someone controlled by the manufacturer. In other words, the 
fraudsperson may not have been an "insider" of the automobile manufacturer or someone 
close to an insider. If the "innocent" automobile manufacturer proves these facts, then the 
automobile manufacturer's bank cannot retain payment for the payment order. Note that the 
burden of proof has shifted: the automobile manufacturer's 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" defense. Note also that the "not an insider" defense is difficult to maintain 
successfully. A large number of fraud, and even attempted fraud, cases appear to involve 
insiders.

There is no comparative negligence analysis or sharing of liability in this legal 
scheme. The purported sender/innocent customer (the automobile manufacturer) bears the 
full $100,000 loss (in that its account is not re-credited) if (1) the bank proves that it acted in 
good faith and complied with a commercially reasonable security procedure and (2) the 
customer cannot meet the innocent customer defense requirements.

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28 U.C.C. Section 4A-202(b). "Good faith" is defined in Section 4A-105(a)(6) as "honesty in fact and the observance 
of reasonable commercial standards of fair dealing."

30 U.C.C. Sections 4A-202 and 4A-203.

31 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 she used to send a payment order, etc. – in 
effect, a tracing device. Whatever the meaning, the critical legal issue is commercial reasonability.
Money-back guarantee and discharge

In the hypothetical funds transfer, what rights does each sender (the originator, originator's bank, and intermediary bank) have if the funds transfer is not completed? (A funds transfer is complete when the beneficiary's bank accepts a payment order for the benefit of the beneficiary of the originator's order.82) For example, is the automobile manufacturer entitled to a refund of $100,000, or must it commence litigation against some downstream party to recover the funds? What rights do the automobile manufacturer's bank and the second bank have in the event of non-completion? Does completion have an effect on the underlying contractual obligation of the automobile manufacturer to pay $100,000 to the steel company? 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 funds transfer, and each subsequent sender of a payment order in the funds transfer chain, obtains its money back in the event the transfer is not completed. A funds transfer is said to be completed when the beneficiary's bank accepts a payment order on behalf of the beneficiary.83 If the transfer is not completed, then each sender of a payment order in the funds transfer chain is entitled to a refund of the principal amount of the payment order, plus any accrued interest.84 If the transfer is completed, then the originator's underlying contractual obligation to the beneficiary is discharged.85

In the hypothetical funds transfer, as soon as the steel company's bank accepts the payment order issued by the second bank, the funds transfer is complete and the automobile manufacturer is discharged on its underlying obligation to pay $100,000 to the steel company. In the event of non-completion, each sender -- the automobile manufacturer, the automobile manufacturer's bank, and the second bank -- is entitled to a refund of any amount it paid for its payment order, plus interest.86

The money-back guarantee may not be varied by an agreement between the

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82 U.C.C. Section 4A-104(a). See U.N. Model Law Articles 14(1) and 19(1).
83 U.C.C. Section 4A-104(a).
84 U.C.C. Section 4A-402(c)-(d).
85 U.C.C. Section 4A-406(b).
86 The rate of interest is determined in accordance with U.C.C. Section 4A-506. Unless otherwise agreed, it is the Federal funds rate.
sender and receiving bank. However, the rule is subject to the exception that a sender that selects a particular intermediary bank through which to route a funds transfer bears the risk of loss associated with the failure of that bank.

Suppose the automobile manufacturer instructed its bank to route the $100,000 transfer through BCCI instead of the second bank, and the automobile manufacturer's 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 the automobile manufacturer's bank and is paid for the order by that bank, but before the funds transfer is completed (i.e., before the steel company's bank 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 $100,000. The automobile manufacturer's bank can keep the $100,000, and the automobile manufacturer is subrogated to the right of its bank to claim against the receiver or trustee of BCCI's assets. (That is, the automobile manufacturer's ability to retrieve the $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 funds transfer chain fails.

- **Failure of an intermediary bank before completion**

  In the above example, BCCI fails before the funds transfer is complete, therefore, the risk of loss is assumed by the party that designated the use of the intermediary bank.

- **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. Payment by the beneficiary's bank to the beneficiary is final because of the receiver

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87/ U.C.C. Section 4A-402(f).
88/ U.C.C. Section 4A-402(d).
89/ U.C.C. Sections 4A-104(a) and 4A-406, respectively.
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.

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 funds transfer is not complete and the originator’s obligation to pay $100,000 to the beneficiary is not discharged. Under U.C.C. Article 4A, 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. It is entitled to a refund of any money it might have paid to the originator’s bank for its payment order.

Failure of the originator’s bank after acceptance

If the originator’s bank fails after accepting the order, then the originator is obligated to pay for its order. Assuming a same-day execution scenario, the originator’s bank will have accepted the originator’s payment order by issuing a conforming order, i.e., by executing the originator’s order, on the day it received the originator’s order. Under U.C.C. Article 4A, if BCCI accepts the order of the originator’s bank, then the originator’s bank is liable to pay for its order. Whether this liability is affected by applicable Federal bank regulatory provisions is beyond the scope of this presentation, but the issue raises

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90/ U.C.C. Section 4A-405(c).

91/ Under U.C.C. Section 4A-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 Section 4A-405(a) or (b). Section 4A-405(a) concerns a credit to the beneficiary’s account, and Section 4A-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.

92/ U.C.C. Section 4A-402(c).

93/ Id.

94/ U.C.C. Sections 4A-209(a) and 4A-301.

95/ U.C.C. Article 4A-402(b).
potentially intriguing legal and policy issues.96

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 on 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 $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).97 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.

• Failure of the beneficiary’s bank

Consider the scenario in which the beneficiary’s bank fails. If this occurs after acceptance, then the originator is discharged on its obligation.98 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 failure occurs before acceptance, then the funds transfer is not complete. The originator (and each subsequent sender) are entitled to the money-back guarantee.99 Presumably, the originator will pay the beneficiary through a funds transfer directed to a different beneficiary’s bank (or through an alternative payments mechanism).

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97 U.C.C. Section 4A-402(c).
98 U.C.C. Section 4A-406.
99 U.C.C. Section 4A-402(c).
V. 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. U.C.C. Article 4A and the U.N. 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. To 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 U.C.C. Article 4A into three broad interest groups: system users, system providers, and system supervisors. The delegates to the United Nations Commission on International Trade Law (UNCITRAL) that drafted the U.N. 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 minimize their liabilities. They struggled to avoid the imposition of consequential damages, and 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 minimize systemic risks. Accordingly, they strongly advocated the receiver 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 funds 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. The countries of the former Soviet Union, and the Baltic countries, must draft legal frameworks for large-value funds transfer system in different environments from the one in which U.C.C. Article 4A and the U.N. 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 rule of law**

The special environment in developing and transition economies — present, for example, in the countries of the former Soviet Union, and the Baltic countries — suggests five fundamental drafting principles. 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 funds 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**

Second, institutions involved in funds transfers should be held accountable for their own behavior. 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 funds transfer law must be part of a larger legal environment that is founded on individual financial accountability, not central planning and control. In this regard, the participation of the central bank in the funds transfer system should not be overemphasized. There is no necessary reason why it must own and operate a system. Indeed, private party action and responsibility ought to be encouraged, not only in transition and developing economies, but also in developed market economies.
Integration with other bodies of law

Third, funds 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

Fourth, 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 funds 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

Fifth, the legal framework for large-value funds transfers should accommodate the anticipated growth and development of the economy and its constituent sectors. In the U.S. 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. In this sense, the case study discussed above concerning the automobile manufacturer and steel company is antiquated. In truth, the bulk of credit 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.109

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VI. SUMMARY

The legal foundations of the large-value credit transfer systems in the United States, Fedwire and CHIPS, are set forth in U.C.C. Article 4A. The same legal foundations are found in the U.N. Model Law. Among the many provisions in these legal texts, at least five are particularly noteworthy: (1) a rule defining the scope of the law; (2) a rule establishing when the rights and obligations of parties to a funds transfer are triggered; (3) a receiver finality rule; (4) a rule assigning liability for interloper fraud; and (5) a money-back guarantee rule, coupled with provisions on discharge. The rules are articulated through precise terminology identifying each party to a funds transfer and the actions that each party undertakes.

Must the five rules exist in any funds transfer statute? To what extent can one generalize from the Article 4A or U.N. 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 identify the foundations of those laws. In other words, those laws need to be distilled. Second, theoretical debate, involving economic rationales and public policy goals, is required to determine the justifications for alternative statutory foundations.

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