Payment System Issues - UCC Article 4A: Regulations J, S, and D

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By Alvin C. Harrell

("Funds Transfers") in 1989 there was no clear-cut framework of legal rules governing wholesale wire transfers in the United States. At this writing, Article 4A has been enacted in every American state except South Carolina, an exceptional enactment record that reflects the near universal approval accorded this statute. In addition, the liberal choice of law rule at section 4A-507, the incorporation of Article 4A with slight modification into Federal Reserve Board Regulation J, and the adoption of Article 4A into the rules of several funds transfer systems, mean that Article 4A is often applicable to wire transfers, even in jurisdictions that have not yet enacted it. This is an unparalleled record of success, reflecting the importance of Article 4A in diminishing the legal impediments to funds transfers.

Article 4A is limited to "wholesale" funds transfers and does not apply to consumer electronic funds transfers, including debit and credit card transactions, where there is already extensive federal law coverage. Article 4A is limited to funds transfers effectuated through the banking system and does not apply to transfers via nonbank entities such as Western Union.

II. Article 4A Definitions and Fundamental Concepts

The concept of a "payment order" is a central focus of Article 4A. "Payment order" is defined as an instruction by a "sender" (transmitted orally, electronically, or in writing) to a bank to pay money to a "beneficiary" within the limitations at section 4A-103(a)(1). "Sender" is the person giving such an instruction (the initial "sender" is called the "originator"); and the "beneficiary" is the person to be paid. A payment order is initiated when an originator issues such an order to a bank. The receiving bank then accepts the order by "executing" it in

1. Art. 4A-203, 8 UCC § 2-303.
2. 8 UCC § 2-203.
3. 8 UCC § 2-303.
4. 8 UCC § 2-303.
5. 8 UCC § 2-303.
6. 8 UCC § 2-303.
favour of another receiving bank. This process is repeated until the order is sent to, and accepted by, the beneficiary's bank.

Acceptance of a payment order involves the liability of the receiving bank to comply with the order. Acceptance occurs when a receiving bank executes the payment order by sending payment information in the case of the customer's bank, by paying the beneficiary, by notifying the beneficiary. But payment has been received, or receipt of payment by the beneficiary bank.

Use of proper terminology is crucial when discussing the order. The "originator" initiates the funds transfer by giving a "payment order" to the "originator's bank", which accepts the order for "executing it", thereby becoming a "sender". The "receiving bank" then likewise "accepts" the order by "executing it" in favor of another "receiving bank". Ultimately, it is executed in favor of the beneficiary's bank, which "accepts" the order by paying the beneficiary or by notifying the beneficiary (that payment has been received). All intermediary banks (those between the originator's and the beneficiary's banks) are both a "receiving bank" and a "sender", as they accept the order and "execute it". The essential basis for the obligations of each bank is the underlying contract (the payment order) and the bank's acceptance of that contract pursuant to the rules of Article 4A.

III. Liability for Errors and Unauthorized Orders

The authority of the originator and each sender to initiate or execute the payment order is governed by agency principles. Even if the order was not so authorized, if the bank has in place a "commercially reasonable security procedure" that had been accepted by the customer, and the bank has complied with that procedure in good faith and in accordance with any instructions, the order is treated as having been authorized by the customer. A bank handling a payment order is not liable for consequential damages due to delay or other error, unless the bank agreed to assume this risk.

Section 4A.201 defines "Security procedure" as follows:

1. (i) the security procedure is a commercially reasonable method of providing security against unauthorized payment orders, and

2. (ii) the bank proves that it accepted the payment order in good faith and in accordance with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer.

The term "commercially reasonable" is not defined, but section 4A.202(c) provides that the circumstances of the customer (as known to the bank), alternative security procedures offered, and security procedures in general use by customers and receiving banks similarly situated are factors to be used in determining this "question of law". If the customer declines to use a commercially reasonable security procedure that is offered by the bank, and instead opts for a more convenient or less expensive procedure, the customer assumes the risk of a failure of the system.

IV. Obligations of a Bank Accepting a Payment Order

Other Article 4A provisions govern erroneous orders, erroneous execution, duplicate orders, misappropriated beneficiary, improperly executed orders, and other similar problems. Sections 4A.202 through 4A.205 set out certain requirements of a bank upon acceptance of a payment order. Generally, if a receiving bank (other than the beneficiary's bank) accepts a payment order, the bank is obligated to issue a payment order on the execution date, following the sender's instructions as to "intermediary bank or funds-transfer system to be used in carrying out the funds transfer", or the means by which payment orders are to be transmitted in the funds transfer. Under section 4A.202(b), the implementation of the security procedure is effective for a receiving bank regardless of whether or not the payment order is authorized, only if:

(i) the security procedure is a commercially reasonable method of providing security against unauthorized payment orders, and

(ii) the bank proves that it accepted the payment order in good faith and in accordance with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer.

V. Transmitting the Payment Order

The means of transmitting the payment order depends upon the sender's instruction, and is stated payment date in the sender's instruction obligates the receiving bank to transmit its payment order "at a time and by a means reasonably necessary to allow payment to the beneficiary on the payment date or as soon thereafter as is feasible." This and other provisions of Article 4A Part 2 and 3 should be closely reviewed in order that financial institutions shall be familiar with the statutory obligations of a receiving bank with regard to the execution of payment orders.

VI. Fees and Settlement

Fees and provisional settlement are important issues to be addressed in the bank customer agreement. Section 4A.402(d) provides that charges and expenses cannot be deducted nor instructions given for such deduction unless the receiving bank is "instructed to do so" by the "sender". The basic rule under Article 4A is that the beneficiary's bank cannot make provisional payment, so the bank (if it accepts an order) takes any credit risk if settlement is not made. Section 4A.405(d) provides that immediate provision of payment or a beneficiary by its bank is at the bank's option, and does not include any requirement that the beneficiary, the beneficiary's bank, and the originator's bank agree to the rule allowing such provisional credit: (2) the rule provides that notice of the provisional nature of the payment is given both to the beneficiary and the originator before the funds transfer is initiated; and (3) the beneficiary's bank did not receive payment of the order it is accepted.

Finally, it should be noted that the Department of Treasury has finalized enhanced recordkeeping requirements relating to final (and provisional) and additional information requirements of non-cashier account holders.

VII. Payment

Article A. Payment in General

Article 4A Part 4 governs payment of the order. The "payment date" is the day on which the amount of the order becomes payable to the beneficiary by the beneficiary's bank. This date is determined by the instructions of the sender, but cannot be earlier than the due date of the order by the beneficiary's bank. In the absence of instructions, the payment date is the date the order is received by the beneficiary's bank.

Each sender has an obligation to pay the receiving bank if the order is accepted by the receiving bank. If the receiving bank is the beneficiary's bank, acceptance of the order obliges the sender to pay on the payment date. In other cases acceptance by the receiving bank obliges the sender to pay on the execution date of the sender's order.

If the payment order is not accepted or completed, the receiving bank is entitled to refund the payment, with interest, to the extent the sender is not obligated to pay. However, if the receiving bank is unable to refund such payment (due to insolvency or other suspension of payments or due to applicable law) and the sender designated that bank, the risk of such loss is on the sender.

All of the rules noted above are subject to the provisions of 4A-203 (for erroneous execution and the right to reimbursement for any excess paid), as well as sections 4A-205 (erroneous payment orders) and 4A-207 (misappropriation of payment orders) from payment to and receipt of a refund as noted above cannot be waived by agreement.
B. Payment and Discharge Between Banks

Article 4A provides rules to govern the finality of payments between banks, similar in some ways to the rules governing final payment under Article 4C. The sender's obligation to pay the receiving bank may be discharged by:

1. making final settlement (through a Federal Reserve Bank); or
2. crediting an account of the receiving bank with the amount of payment, by the end of the day that the receiving bank learns that the credit is withdrawable; or
3. the receiving bank debiting any account of the sender with the receiving bank (to the extent the debit is covered by a withdrawable credit balance).

If the sender and receiving bank are members of a funds transfer system that provides for netting mutual obligations, payment will occur when final settlement is received pursuant to the rules of that system. Netting is also allowed, by means of setoff, between banks transmitting off-balance payment instructions among themselves pursuant to a netting agreement, issues regarding finality of payment not otherwise covered by these rules will be decided according to otherwise applicable law.

C. Obligation of Beneficiary's Bank to Pay to Beneficiary

The beneficiary's bank may accept the payment order by paying or notifying the beneficiary. If the beneficiary's bank accepts a payment order, it is obligated to pay that amount to the beneficiary. This payment will be due on the payment date unless the order is accepted after the close of the funds transfer business day, in which case payment is due on the following funds transfer business day.

If the beneficiary's bank refuses to pay after demand by the beneficiary and notice of specific circumstances that may give rise to consequential damages and their magnitude in the event of nonpayment, the beneficiary may recover consequential damages unless the bank had a reasonable cause to doubt the beneficiary's right to payment.

There are four rules governing the obligation of the beneficiary's bank to give notice to the beneficiary of the payment order:

1. If the payment order instructs payment to an account, the beneficiary's bank is obligated to notify the beneficiary of receipt of the order before mid-night of the funds transfer business day following the payment date.
2. If the payment order does not instruct payment to an account, notice to the beneficiary is required only if the order so provides.
3. Notice may be given by first class mail or any other reasonable means.
4. If the beneficiary's bank fails to provide the required notice, it must pay interest to the beneficiary at the rate prescribed in Article 4A(a).

The beneficiary's right to payment and the statutory rules governing damages cannot govern the beneficiary's right to funds transfer rule. The beneficiary's right to receive notice (as described above) may be modified by agreement or funds transfer rule if the beneficiary is given prior notice.

D. Payment to the Beneficiary

Article 4A provides rules governing the time, method, and finality of payment by the beneficiary's bank to the beneficiary. If the beneficiary's bank credits the beneficiary's account, payment occurs:

1. If the payment order instructs payment to an account, the beneficiary's bank is obligated to notify the beneficiary of receipt of the order before mid-night of the funds transfer business day following the payment date.
2. If the payment order does not instruct payment to an account, notice to the beneficiary is required only if the order so provides.
3. Notice may be given by first class mail or any other reasonable means.
4. If the beneficiary's bank fails to provide the required notice, it must pay interest to the beneficiary at the rate prescribed in Article 4A(a).

E. Payment and Discharge

The time and extent of payment as between the originator and the beneficiary may be important as regards discharge of the originator's underlying obligation to the beneficiary. Generally, between the originator and beneficiary payment occurs when (1) the payment order is accepted by the beneficiary's bank and (2) in an amount equal to the order accepted by the beneficiary's bank.

These rules are subject to other Article 4A provisions governing cancellation or amendment of a payment order, provisional settlement pursuant to a funds transfer system agreement, and failure of a funds transfer system to complete settlement pursuant to its rules.

If the payment is made to satisfy an obligation, the obligation is discharged as if he payment were made in money, unless: (1) this method of payment is prohibited by contract; (2) within a reasonable time after receiving notice of the order the originator notified the originator of his or her refusal to accept payment by such means; (3) the funds were not withdrawn or applied to the credit of the beneficiary; and (4) the beneficiary would suffer a loss that could reasonably have been avoided by payment in accordance with the contract.

In the absence of discharge the originator is subrogated to the rights of the beneficiary against the beneficiary's bank. The rights of the originator and beneficiary under this section can be modified by an agreement between those parties.

VIII. Miscellaneous Article 4A Issues

A. Variation by Agreement or Funds-Transfer Rule

Section 4A-501 provides that unless otherwise provided the rules of Article 4A may be varied by agreement of the parties. If any such variation is made, safety and soundness should be the paramount consideration.

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C. The Bank-Customer Relation

The primary source of laws governing the relationship between a banking institution and its deposit customers is UCC Article 4.15 Once the beneficiary's bank has accepted a payment order and paid the beneficiary by crediting the beneficiary's account, any of the issues relating to that account will be governed by Article 4. Similarly, issues relating to the account of the originator at the originator's bank may be governed by Article 4.15

Under section 4-A04, if any receiving bank has received any payment order, and/or other items payable from the sender's account, the bank may charge the sender's account with the orders and/or items in any sequence the bank desires.12 This is subject to variation by agreement of the parties.12 In tracing credits and withdrawals out of an account, Article 4-A04 contemplates that the bank credited them is the same funds withdrawn or otherwise applied.12 If a receiving bank has received payment from a customer as sender of a payment order accepted by the bank, and the customer received notice from the bank of payment that identifies the order, the customer cannot seek to recover the payment, unless notice of the customer's objections is given to the bank within one year after the customer received notice of the order from the bank.15 This is the nature of a statute of repose, to place a time limit on the customer's ability to object to an executed payment order.15

D. Rule of Interest

If a receiving bank is required to pay interest with respect to a payment order, 2 execution of the payment order is necessary to satisfy the customer's request.15 By agreement between the parties, by funds-transfer system rule (if applicable), or by modifying the applicable law, the number of days for which interest is payable.15 If a receiving bank is required to refund the amount of an accepted payment order, due to no fault of its own, the interest payable is reduced by a percentage equal to the reserve requirement for deposits at the bank.15

E. Choice of Law

The liberal choice of law rule in Article 4-A is one reason that the nationwide implementation of Article 4-A was not delayed by the few states that initially did not adopt. The choice of law rule at section 4-A-507(b) allows the parties to a payment order to select any jurisdiction as the source of the applicable law, regardless of whether that choice bears a reasonable relationship to the transaction.15 This allows parties, in a jurisdiction that has not yet enacted Article 4-A, to contract for application of the law of a state that has enacted Article 4-A, and to enforce that choice in any state where constitutional limitations on jurisdiction can be met. Since many major funds-transfer systems have incorporated Article 4-A into their system agreements, and the Federal Reserve Board likewise has incorporated rules based on Article 4-A (into Regulation Z, Article 2-A (or something like it)) is applicable to most payment orders in the United States regardless of an individual state's law.15 The reason for this approach is the need for a single choice of law rule to govern transactions crossing jurisdiction lines, since any payment order accepted across interstate or even international borders, and may involve a number of jurisdictions, is essential that there be a clear consensus as to the governing law. Section 4-A-507(b) is designed to facilitate and codify that consensus.15

More importantly, section 4-A-507(c) permits a funds-transfer system to select the law applicable to a payment order processed through the system, and provides that such a selection will be binding on participating banks and the originator, other sender, or a receiving bank with notice.15 If more than one funds-transfer system is utilized and there is a conflict between the choices made by the two systems, the issue will be governed by the law of that choice that bears the most significant relationship to that issue.15

Absent an effective choice, Article 4-A provides a hierarchy of statutory choice of law rules, generally referencing the law of the jurisdiction where the respective bank is located.15

IX. Summary and Conclusions—UCC Article 4-A

Article 4-A provides an efficient, comprehensive set of rules to govern funds transfers that can total billions of dollars over short periods of time. Prior to Article 4-A, there was no orderly body of law governing such transactions, and participants in this modern and efficient system of funds transfers were subject to considerable legal risk and uncertainty.

Article 4-A preserves the principle of party autonomy, allowing the parties to a funds transfer to create a legal environment that is most suitable to their needs. It also provides clear-cut choice of law rules suitable to multi-jurisdictional funds transfers. It creates a uniform legal foundation for funds transfers, and provides specific rules governing common issues that are unique to such transactions.15 Article 4-A also demonstrates the viability of and continuing need for uniform and modern uniform law processes, and the importance of state law in preserving and modernizing rational commercial laws for the 21st century.

X. Regulation J Subpart A Collection of Checks Through Federal Reserve Banks

Regulation J was promulgated by the Board of Governors of the Federal Reserve System to govern the collection of checks and other items through Federal Reserve Banks.16 Subpart A provides uniform standards to be followed by Federal Reserve Banks when handling such items, and is also binding on all banks interested in such items. In addition, Subpart B governs funds transfers through Fedwire.16

Subpart A applies to any "item" handled by a Federal Reserve Bank. "Item" means any negotiable or non-negotiable instrument for the payment of money, including checks and other drafts as well as other bonds and investment securities that are handled through the bank collection system.15

By sending an item to a Federal Reserve Bank, either directly or through an intermediate banking facility, the sender authorizes the Federal Reserve Bank (or intermediate bank) to handle the item pursuant to Subpart A, and warrants its authority to give this as an banking day without any notice or consent of the sender warrants that the sender is (or is acting on behalf of the person who is entitled to enforce the instrument and that it has been subject to no loss or expense sustained (including litigation expenses) as a result of handling the item. These warranties are consistent with the 1990 revisions to the uniform text of UCC Article 4.15

Federal Reserve Bank handling such items is the agent or subagent of the owner of the item. The Federal Reserve Bank has a duty of ordinary care and good faith and certain other duties as provided in Regulation CC. However, Regulation J supersedes the UCC, other state law, and Regulation CC to the extent of any incompatibility.15 The bank on which an item is drawn ("the paying bank") becomes accountable for the amount of a cash item received directly or through another Federal Reserve Bank, at the close of the banking bank's banking day on which it receives the item, (1) returns the item beyond the close of the banking day without paying the item. However, such payment may be subsequently rescinded if the item is dishonored and returned within the midnight deadline or other deadline provided by Regulation CC, in Article 4 of the applicable UCC, or applicable Federal Reserve Bank operating circulations.15 These deadlines may be shortened, but not extended, by clearinghouse rules. As noted, Regulation J supersedes Article 4 of any other regulation to the extent of any incompatibility.
bank also may return the item in accordance with Regulation J section 1010.6(a) and applicable operating circulars. A paying bank that receives a check not honored by a Federal Reserve Bank, and determines not to pay such check, may return the check to its Federal Reserve Bank pursuant to Regulation J, Subpart C, the UCC, and applicable operating circulars. In such case the warranty and other provisions of Regulation J are applicable.

In the event a Federal Reserve Bank handles as item and does not receive payment for that item, the Federal Reserve Bank may recover by chargeback or otherwise collect the amount of such item from any bank from which the item was received, whether or not the item can be returned to such bank. The Federal Reserve Bank has a security interest in such bank's assets, to secure its claims, and this security interest relates back to the time the claim arose for priority purposes.

The times limits imposed under Regulation J may be extended due to disasters or other circumstances beyond the control of the bank.

A paying bank that receives presentment from a Federal Reserve Bank and owes settlement to the Federal Reserve Bank may not set off other claims against such presentment. Such set off is allowed as against private-sector banks.

Regulation J Subpart B — Fedwire

Regulation J Subpart B applies to funds transfers through Fedwire. It has the effect of federal law and is not a funds transfer system rule as defined in UCC Article 4A, although it incorporates the provisions of Article 4A in Appendix B of the Subpart. In the event of a conflict between Subpart B and Article 4A, Subpart B governs.

Subpart B applies to all parties to a funds transfer through Fedwire, including the Federal Reserve Banks sending or receiving the payment order, senders and receiving banks that send an order to or receive payment from a Federal Reserve Bank, beneficiaries of such orders, and any other party to a funds transfer that is carried out through Fedwire. Subpart B applies to such a funds transfer even if a portion of the funds transfer is governed by the Electronic Fund Transfer Act, although the portion governed by the EFTA is not governed by Subpart B. Similarly, if any portion of the funds transfer is governed by Regulation C, for example with regard to the availability of funds, then Subpart B does not apply to that extent.

Each Federal Reserve Bank issues operating circulars to govern the details of Fedwire transfers, including such things as cut-off hours, funds transfer business days, security procedures, format and media requirements for payment orders, identification of payment orders, and charges for fund transfer services. Banks must monitor such circulars for compliance with these rules.

The terminology used in Subpart B generally complies with that of UCC Article 4A, with some exceptions. For example, "payment order" has the same meaning as in Article 4A, except that it does not include automated clearing house (ACH) or wire transfers or communications initiated in an operating circular as not being a payment order. A Federal Reserve Bank may rely on the beneficiary or intermediary bank or beneficiary bank identifying number in the payment order, even if incorrect, and is not required to verify this number or detect any error, so long as it does not know of such error. Therefore banks must exercise care to assure that any such numbers assigned are correct.

By maintaining or using an account with a Federal Reserve Bank, a bank authorizes the Federal Reserve Bank to obtain payment for payment orders sent by the bank, by charging the bank's account. The bank does not have a right to alter or draft this account, and the bank must maintain such an account. The Federal Reserve Bank is designated in the payment order. A bank may not send to a Federal Reserve Bank a payment order instructing use of a funds transfer system other than Fedwire, unless the Federal Reserve Bank agrees in writing. A bank may not set off a Federal Reserve Bank a payment order instructing execution on a funds transfer business day after the day of receipt by the Federal Reserve Bank, unless the Federal Reserve Bank agrees in writing.

A Federal Reserve Bank will not be liable for damages to any party except as provided under UCC Article 4A, and (notwithstanding the above) will not be liable to any sender, receiving bank, beneficiary or other Federal Reserve Bank for consequential damages under Article 4A section 4A-305.122


As noted, Subpart B incorporates the provisions of Article 4A of the UCC. The rights and obligations between the sender of a payment order and the receiving bank are governed by the law of the jurisdiction in which the bank is located. The rights and obligations between the beneficiary's bank and the beneficiary are governed by the law of the jurisdiction in which the beneficiary's bank is located. The issue of what payment is made pursuant to a funds transfer by the originator to the beneficiary is governed by the law of the jurisdiction in which the beneficiary's bank is located.

If the parties have made an agreement selecting the law of a particular jurisdiction to govern rights and obligations between each other, the law of that jurisdiction governs those rights and obligations, whether or not the payment order or the funds transfer bears a reasonable relationship to that jurisdiction.

A funds-transfer system rule may select the law of a particular jurisdiction to govern (i) rights and obligations between participants in banks with respect to payment orders transmitted or processed through the system, or (ii) the rights and obligations of, or all parties to a funds transfer any part of which is carried out by means of the system. A choice of law rule pursuant to clause (ii) is binding in the originator, the originator's senders, or a receiving bank having notice that the funds-transfer system might be used in the funds transfer and of the choice of law by the system when the originator, other sender, or receiving bank issued or accepted a payment order. The beneficiary of a funds transfer is bound by the choice of law. If, when the funds transfer is initiated, the beneficiary has notice that the funds-transfer system might be used in the funds transfer, the system is governed by the law of the system. The law of a jurisdiction selected pursuant to this subsection may govern, whether or not that law bears a reasonable relationship to the matter in issue.117

XIII. Wire Transfer Monitoring Rules

On December 21, 1994 the Financial Crimes Enforcement Network (FinCEN), of the Department of the Treasury and the Board of Governors of the Federal Reserve System approved certain record keeping requirements. FinCEN, 118

1. The originator's name and address.
2. The amount of the payment order.
3. The date.
4. Payment instructions received with the payment order, including identification of the beneficiary's bank, and the beneficiary's name and address or account number.
5. Other payment instructions, such as the purpose of the fund transfer and any directions to the beneficiary's bank regarding notification of the beneficiary of receipt of the payment order.

(Note: Payment instructions from the originator must be retained, whether oral or written.)
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