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Recommended Citation
Available at: https://digitalcommons.lmu.edu/llr/vol28/iss1/18
THE UCC DRAFTING PROCESS AND SIX QUESTIONS ABOUT ARTICLE 4A: IS THERE A NEED FOR REVISIONS TO THE UNIFORM FUNDS TRANSFERS LAW?

Paul S. Turner*

Article 4A of the Uniform Commercial Code (UCC) governs the rights and liabilities of the parties to commercial wire transfers. It was approved by its sponsors in 1989 and immediately filled a great void. In only five years, UCC Article 4A has been enacted in forty-nine states and the District of Columbia and incorporated into the regulations of the Federal Reserve Bank system. This essay will consider what the process of Article 4A's creation can teach us about the process of drafting the UCC generally and whether revisions to Article 4A are needed.

I. UCC ARTICLE 4A AND THE UCC DRAFTING PROCESS

Elsewhere in this issue and as a part of this Symposium, Carlyle C. Ring, Jr., discusses the UCC drafting process in general and describes in detail the process by which Article 4A was conceived and, after sixteen drafting committee meetings and fifty-seven days of debate and dialogue, completed. Mr. Ring is a past president of the national conference that sponsors all uniform laws and was a co-chair of the drafting committee that wrote Article 4A. In another article that is also a part of this Symposium, Donald J. Rapson discusses the

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* Mr. Turner, a member of the California and New York bars, served as editor of the Model Funds Transfer Services Agreement of the ABA Section of Business Law and was an adviser to the drafting committees that produced revised UCC Articles 3, 4, 4A, and 5. He was formerly Assistant General Counsel of Occidental Petroleum Corporation. He is currently a consultant for that company and others.

1. Revisions to the UCC are sponsored jointly by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI).

2. Carlyle C. Ring, Jr., The UCC Process—Consensus and Balance, 28 Loy. L.A. L. Rev. 289 (1994). South Carolina is the only state that has not enacted Article 4A. Article 4A has been introduced in South Carolina and Puerto Rico.


4. Ring, supra note 2 at 298.
process of writing and revising UCC articles. Mr. Rapson was the American Law Institute representative on the UCC Article 4A Drafting Committee.

Mr. Ring's article considers whether federal enactment of uniform legislation is preferable to state-by-state enactment of uniform legislation. If I may rephrase and summarize Mr. Ring's not unexpected answer regarding Article 4A: "Certainly not!" Mr. Ring has every reason to be proud of his accomplishments in the promulgation of uniform state legislation and understandably advocates that system.

By contrast, Mr. Rapson's article considers whether the "public interest" is appropriately represented in the UCC drafting process and suggests procedural changes in the process. Mr. Rapson and Mr. Ring disagree on certain issues, and they exchange views in their articles. What can we learn from the Article 4A drafting process concerning the issues discussed in these articles?

First, we can learn that the process works. Article 4A is very much alive and well. The unparalleled swiftness of its enactment in forty-nine states attests not only to the need for the legislation, but also to its broad acceptance and the general public perception of its fundamental fairness to both banks and bank customers.

The broad and rapid acceptance of Article 4A does not demonstrate, however, that state enactment of uniform legislation is preferable to federal enactment. How the product of legislation sponsored and regulated by the Federal Reserve Board might have been received is unclear. Nor is it practicable to speculate on the relative merits of such hypothetical legislation as compared to Article 4A. On the other hand, the broad acceptance of Article 4A demonstrates that the process is capable of producing sound and highly regarded legislation.

Second, my own experience in the Article 4A drafting process taught me something about the public interest issue discussed by Mr. Rapson and Mr. Ring. My involvement, as a corporate law department lawyer, began in the very late stages of the drafting process, in response to a call asking for my help. The caller explained that more corporate lawyers were needed in the drafting process because "there are hordes of bankers at the drafting meetings, but only three of us represent corporate customers. They do things by vote, and we typically lose fifty to three." I soon found, however, that the caller was

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greatly exaggerating matters and that the public interest problem was more complicated than a "them against us" numbers game.

Article 4A is quite complex and set against a background of highly specialized and complex banking laws and regulations. The issues presented in Article 4A and Articles 3, 4, and 5 are far from the typical corporation's concerns. Expertise in these areas would seem an exotic specialty to most corporate lawyers.

Under these circumstances, it is not normally practicable for a corporate law department lawyer to acquire the requisite expertise. Thus, a typical corporate lawyer is unlikely to understand all of a UCC article's complexities to the degree that a practitioner who attends drafting sessions on behalf of the banking community may understand them. This is true not only in the context of Article 4A, but also in the context of Articles 3, 4, and 5, and I suspect, of the other UCC articles as well. Thus I believe that a part of the public interest concern voiced by Mr. Rapson derives from the differences in the practice of those who represent banks and those who represent corporate payment systems users. Because of these differences, the interests of corporate users are less likely to be effectively articulated.

Another part of the public interest concern discussed by Mr. Rapson derives from the "adversarial" nature of the UCC drafting process. At the meetings of the Article 4A Drafting Committee, representatives of the banking community advocated the bank's point of view, and representatives of the corporate community advocated the corporate customer's point of view. As indicated, the corporate representatives were not, generally, the equals of their banking counterparts. The corporate representatives were also greatly outnumbered.

For the process to work well under these circumstances, the members of the drafting committee must elevate themselves above the interests and perspectives of their employers and any particular interest group. Their ability to do so in Article 4A demonstrates that, in this respect, the process works very well. As to the participants in the

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6. See id. at 258.
7. I do not express any views with respect to the drafting process that has completed revisions to Article 5. (A final revised draft Article 5 was approved by NCCUSL during its July 29 - August 5, 1994 annual meeting and is scheduled for approval by the ALI in 1995.) Mr. Rapson suggests that UCC drafting committees are subject to interest group pressures under the glare of "open" meetings. Id. at 252. Since a banking interest group expressed strong opposition to an earlier version of the revised Article 5 and was very active in the Article 5 process, Mr. Rapson wonders whether such pressures might have influenced decisions of the drafting committee in connection with certain provisions of the revised Article
process who were not drafting committee members, I believe that Mr. Ring's statement regarding some of the policy choices of the Article 5 participants applies generally to the Article 4A participants, that most of them honestly believed that the choices they advocated were in the public interest.8

In fact, the drafters of Article 4A did a wonderful job, creating the uniform legislation out of whole cloth. The legislation is of necessity, however, elaborate and rather complex. Inevitably, as time has passed and thought has been given to the complexities of Article 4A, some ambiguities and uncertainties have emerged. I will consider these ambiguities and uncertainties in the remainder of this Essay. I will first review certain liability rules of Article 4A and then pose and try to answer six questions. In the process, I will consider whether there is a need for revisions to Article 4A.9

II. LIABILITY FOR LOSSES RESULTING FROM FRAUD UNDER UCC ARTICLE 4A

Since four of our questions relate to losses resulting from fraud, I begin with a discussion of the Article 4A rules allocating liability for fraud losses between the bank and the customer. Understanding these rules is a bit like watching a ping-pong game. There is first a general rule for authorized and unauthorized orders of the customer. This is followed by contrary rules constituting a broad exception to the general rule when the customer's order has been verified in com-

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5 of which he is critical. Id. at 267. Thanks in no small part to Mr. Rapson himself, see infra note 38, the specter of an interest group opposing the adoption of Article 4A was not a factor in the Article 4A process. The drafting process that produced the revised Article 5 is beyond the scope of this Essay.

8. Of course, it may be that some of those who appear to be putting the concerns of their interest group above the public interest are melding the two in their minds; that is, they genuinely believe that "what's good for my interest group is good for the country."

9. To the extent that revisions to Article 4A are necessary, the difficulty of enacting such revisions on a state-by-state basis would illustrate one of the arguments for federal, as opposed to state-by-state, enactment of uniform legislation generally. For a good discussion of the relative merits of federal versus state enactment of wire transfer legislation, see David B. Goldstein, Federal Versus State Adoption of Article 4A, 45 Bus. Law. 1513 (1990). Mr. Goldstein favored federal enactment in theory but advocates enactment of Article 4A by states because Article 4A is an improvement over existing state law. Id. at 1513. There is some current thinking that the days of massive UCC revisions, article-by-article, every 40 or so years, will give way to modest revisions by amendment or even by commentary issued by the Permanent Editorial Board (PEB) for the UCC. The problem discussed in Question No. 6 of this Essay is certainly one that could be resolved by the PEB. Other problems discussed in this Essay could perhaps also be resolved in that manner, but some can probably only be resolved by legislative amendment.
pliance with a security procedure, and then by three exceptions to the contrary rules for verified orders. The rules discussed below are contained in sections 4A-201 through 4A-204.

A. Authorized and Unauthorized Payment Orders

The general rule is that the customer is liable for all authorized payment orders issued in the customer's name. A "payment order" under Article 4A is an instruction to a receiving bank to make a payment or to cause another bank to make a payment. Authorized payment orders include not only those orders issued by persons who are actually authorized by board resolution or due delegation of authority, but also include orders issued by persons who are only apparently authorized to issue payment orders. In the latter case, the order is deemed to have been "authorized" for purposes of Article 4A if the customer would be bound by the payment order under agency principles.

Conversely, the bank is liable under the general rule when the payment order is not authorized. The primary concern in this discussion is with unauthorized payment orders—that is, with payment orders that result in funds-transfer losses caused by fraud.

B. Orders Verified in Compliance with a Security Procedure

Under a broad exception to the general rule that the bank is liable for unauthorized payment orders, different rules apply when the bank and the customer have agreed that they will use a security procedure. A "security procedure" is a method of verifying the authenticity of the customer's payment orders.

10. U.C.C. 4A § 4A-103(a)(1) (1990). The instruction may be transmitted orally, electronically, or in writing; must be for the payment of a fixed or determinable amount of money; and must be unconditional except as to the time of payment. The instruction is not a payment order unless the receiving bank is to be reimbursed by the sender and is transmitted directly by the sender. A typical funds transfer consists of at least two payment orders: one from the customer to its bank, and a second from the customer's bank to the bank used by the recipient of the payment (the recipient is called the "beneficiary" in Article 4A). The use of intermediary banks increases the number of payment orders in a funds transfer. Id. § 4A-103(b).

11. Id. § 4A-202(a).

12. Id. § 4A-204(a)(i).

13. A security procedure, as defined in § 4A-201, is a procedure established by agreement between the bank and the customer for the purpose of verifying that a payment order or other communication is that of the customer. The § 4A-201 definition also includes procedures for detecting errors in the transmission or content of payment orders, but security procedures for the detection of errors are irrelevant to this discussion.
When the parties have agreed upon the security procedure, liability for losses resulting from an unauthorized payment order is shifted from the bank to the customer if (i) the security procedure is "commercially reasonable"; and (ii) the bank proves that it accepted the payment order (a) in compliance with both the security procedure and with the customer's instructions restricting the acceptance of payment orders, and (b) in "good faith." Conversely, when these elements are not present in a fraudulent funds transfer, the bank is liable for the losses unless the bank can show that the order was authorized under agency principles.

There are three exceptions to the rules described in the preceding paragraph. One exception allows the parties to agree that the bank will not be liable even though the customer has chosen a security procedure that may not be commercially reasonable. The second exception shifts liability from the customer back to the bank when the customer can prove that the fraud was perpetrated by an "interloper." The third exception allows the parties to vary the liability rules to the detriment of the bank. These exceptions are discussed below.

1. Exception when customer deliberately chooses a security procedure that may not be commercially reasonable

The first exception is an exception to the rule that the security procedure must be commercially reasonable for the bank to avoid liability for an unauthorized transfer by complying with that procedure.

"Commercial reasonableness" is a question of law depending on the customer's wishes, circumstances, and other factors. The Article 4A drafters foresaw that some customers would believe that any security procedure that was good enough to be commercially reasonable would not be worth its cost. To allow freedom of contract to the parties in that situation, the Article 4A drafters provided that a security procedure is "deemed" to be commercially reasonable if (i) the customer chose the procedure after the bank offered, and the customer refused, a commercially reasonable procedure and (ii) the customer expressly agreed in writing to be bound by payment orders accepted by the bank in compliance with the chosen procedure, whether or not the orders were authorized.
Under these circumstances, the bank can avoid liability under this first exception by complying with the chosen security procedure even though the procedure is not commercially reasonable.

2. Exception for interloper fraud

The second exception is an exception to the broad rule shifting liability for unauthorized transfers to the customer when the bank has verified the order in compliance with a commercially reasonable security procedure.

Article 4A distinguishes among the possible perpetrators of fraud. The perpetrator might be a person associated with the customer, perhaps an employee with access to the customer’s transmitting facilities and knowledge of the security procedures. On the other hand, the perpetrator might be an “interloper,” a person having no association with the customer. The interloper might be a person associated with the bank, perhaps an employee in the bank’s wire room, or a person not associated with either the bank or the customer. An interloper not associated with either of the parties is often described as a “third-party interloper.”

When the customer can prove that the perpetrator is an interloper, the second exception shifts liability back to the bank, regardless of whether the perpetrator is an interloper associated with the bank or a third-party interloper.

The customer need not, however, identify the perpetrator to avoid liability under this exception. The customer must instead prove the negative proposition that the perpetrator was not (i) a person entrusted with duties to act for the customer relating to payment orders or the security procedure, or (ii) a person who obtained access to the customer’s transmitting facilities or to information facilitating a breach of the security procedure from a source controlled by the customer. When the customer can meet this burden of proof, liability for the unauthorized transfer shifts back to the bank, notwithstanding that the bank has verified the payment order in compliance with a commercially reasonable security procedure.

3. Exception for variation by agreement in favor of the customer

Under the first exception to the rules for verified orders, Article 4A allows freedom of contract in the case of a cost-conscious customer that opts for a security procedure that may be less than com-

18. *Id. § 4A-203(a)(2).*
mercially reasonable. The customer's express agreement to be liable for unauthorized payment orders verified in compliance with its chosen procedure is enforceable by the bank. Under no other circumstances do the Article 4A liability rules for unauthorized funds transfers allow the parties the freedom to vary the rules in favor of the bank.¹⁹

Under the third exception, however, the parties have complete freedom to vary the rules in favor of the customer.²⁰ By express written agreement, the bank may waive its right to enforce unauthorized payment orders against the customer.²¹ For example, a bank could agree to share the liability for unauthorized funds transfers equally with the customer even when the bank has verified the payment order in accordance with a commercially reasonable security procedure.

I have just stated that the liability rules discussed above may be varied by agreement in favor of the bank only under the first exception to the rules. Thus, it is clear that a customer may not waive its right to hold the bank liable for an unauthorized funds transfer (i) when the bank has failed to comply with a commercially reasonable security procedure, or (ii) when the customer can prove interloper fraud.

Or is it clear?

III. SIX QUESTIONS ABOUT ARTICLE 4A

A. Question No. 1: Can the Statute of Repose Be Shortened by Agreement?

The "statute of repose" in section 4A-505 precludes a customer from asserting an objection to a payment order issued in the customer's name unless the customer notifies the bank of the objection within one year after notice of the order was received by the customer.²²

Section 4A-501 provides that the rules of Article 4A may be varied by agreement except as otherwise provided in Article 4A.²³ Since Article 4A does not prohibit variation of section 4A-505 by agreement, it would seem at first glance that the one-year period under the statute of repose may be shortened. But, is this true when shortening

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¹⁹. Id. §§ 4A-202(f), 4A-203(a)(1), 4A-204(b).
²⁰. Id. §§ 4A-204(b), 4A-202(b), 4A-501(a).
²¹. Id. § 4A-203(a)(1).
²². Id. § 4A-505.
²³. Id. § 4A-501(a).
the period results in a conflict with a nonvariable provision of Article 4A?

For example, assume that a funds transfer agreement requires Customer to report unauthorized wire transfers within thirty days of receipt of notice of the transfer. Suppose that fraud is perpetrated, resulting in loss due to an unauthorized transfer. Customer reports the transfer thirty-one days after receipt of notice of it. Suppose also that Bank had failed to verify the authenticity of the payment order in accordance with the security procedure or that the perpetrator was an interloper. Is the thirty-one-day reporting requirement enforceable as a permissible variation of the statute of repose? Or, is it unenforceable as an impermissible variation of the nonvariable liability rules for losses resulting from fraud under Article 4A described in Section II above?24

Shortening the one-year period could also conflict with the "money-back guarantee," another provision that may not be varied by agreement.25 The money-back guarantee imposes liability on the bank for losses resulting from an incompletion of the funds transfer. When such losses occur and the customer has violated a contractual obligation to report the loss within a period shorter than the one-year period under the statute of repose, the reporting obligation and the nonvariable money-back guarantee would conflict.

The one-year period in section 4A-505 is not a lengthy one per se. The rationale of a contractual requirement to report unauthorized transfers, however, is that prompt reporting may allow the parties to identify the perpetrator and possibly recover the funds. In that context, the one-year period is virtually meaningless. Perhaps an appropriate adjustment to the needs of banks and customers would be to permit the parties to shorten the one-year period and to make a minimum shortened period not variable by agreement.

On the other hand, perhaps a reasonable shortened period for some customers would nevertheless be of such length that, by the time

24. The conflict between the apparently variable statute of repose and the nonvariable §§ 4A-201 through 4A-204 was first made known publicly by Richard M. Gottlieb, in Complementing and Varying Article 4A, in UCC ARTICLE 4A, A PRACTICAL GUIDE FOR BANKERS AND BANK COUNSEL 89 (1991). That chapter also discussed the ability of the bank to disclaim liability for its own errors, the issue posed in Question No. 5 of this Essay. I have discussed these issues with Mr. Gottlieb and William B. Davenport of Jenner & Block and am grateful to both of them for their contributions to my thinking about these and other aspects of Article 4A. I am also grateful to Mr. Davenport for his review of and helpful comments upon draft versions of this Essay.

25. U.C.C. § 4A-402(c), (d), (f).
the customer reported an unauthorized transfer, identification of the perpetrator or recovery of the funds would be unlikely. In that event, the rationale for reducing the one-year period might not apply.

These considerations need further deliberation, but whatever the resolution, the conflicts between these variable and nonvariable provisions of Article 4A should be resolved.26

B. Question No. 2: May a Customer That Chooses a Security Procedure That May Not Be Commercially Reasonable Waive Its Right to Shift Liability to the Bank When the Customer Can Prove That Fraud Was Perpetrated by an Interloper?

As noted, the drafters of Article 4A allow the bank and customer freedom of contract when the cost-conscious customer opts for a procedure that may be less than commercially reasonable. The procedure chosen by the customer is "deemed" to be reasonable if the customer expressly agrees to be bound by payment orders accepted by the bank in compliance with the chosen procedure.27 Customer's express agreement might look like the following:

Customer's Acknowledgment. Customer acknowledges that it was offered and it refused the security procedure described in Exhibit A-1, and that it chose the security procedure described in Exhibit A-2 (the "Security Procedure"), and expressly agrees to be bound by any payment order, whether or not authorized, issued in Customer's name and accepted by Bank in compliance with the Security Procedure.

26. The § 4A-505 statute of repose is not a statute of limitations; that is, the one-year period is not a period beyond which any party in a funds transfer is barred from filing an action in court. With respect to a lawsuit based on an objection by a customer to a payment order issued in the customer's name, § 4A-505 would preclude the objection in or out of court, of course, and would function very much like a statute of limitations. The section would not bar the customer from suing the bank on other grounds, however, and would not bar suits brought by the bank in funds transfers. Article 4A does not contain a statute of limitations, although perhaps it should. The statute of limitations, dealing with the handling of paper items such as checks, is three years pursuant to § 4-111. However, § 4-406 imposes a statutory obligation on the customer to report forged signatures on checks within a reasonable period of time. A customer that does not comply with that obligation is precluded from asserting a forged check drawer's signature under § 4-406. Section 4A-204 analogously imposes an obligation on the customer to report unauthorized payment orders within a "reasonable time not exceeding 90 days" after the customer is notified of the order. Yet the penalty to the customer for breach of that obligation is only loss of interest, not liability for the unauthorized payment order. Id. §§ 4A-204, 4A-505, 4-406.

27. Id. § 4A-202(c).
Assume that Customer has executed an agreement containing the above acknowledgment, an unauthorized transfer has occurred, and Bank has complied with the procedure that Customer has chosen. Assume also that Customer can prove that Bank president and an employee in Bank’s wire room are the perpetrators. The following debate might ensue.

**Bank:** You are liable under the “Customer’s Acknowledgment” provision in our agreement, Customer. Read it! You agreed to be bound by payment orders verified in compliance with the procedure you chose, whether or not the payment order was authorized.

**Customer:** No, you are liable, Bank. I admit I signed the agreement, but I did that pursuant to section 4A-202(c), which merely provides that under these circumstances the security procedure is deemed commercially reasonable. Commercial reasonableness is not at issue here because the interloping perpetrators are employees of Bank. My right to avoid liability in interloper cases may not be varied by agreement.

**Bank:** Not true. Section 4A-202(f) states that your right to avoid liability in interloper cases may not be varied by agreement “except as provided in this section.” My right under section 4A-202(c) to enforce payment orders verified in compliance with the second-rate security procedure you chose is “in this section.”

**Customer:** Hmmmmm. Well, my right to a refund when there is interloper fraud is in section 4A-204(a). That right can’t be varied by agreement under section 4A-204(b), and there is no exception to that right under section 4A-204. Anyhow, you can’t seriously be arguing that the law makes me liable when the principal perpetrator is the president of Bank! For goodness’ sake, have you no shame?

**Bank:** The provisions of Article 4A at issue here, sections 4A-202(c) and 4A-203(a)(2), apply when the identity of the perpetrator is unknown but Customer can prove that the perpetrator was a third party interloper.

We certainly can argue without shame that if the perpetrator is unidentified but is a third party interloper not associated with the bank, the bank should not be liable for the fraud. We think that the customer should be liable in that case because the customer chose the
less than commercially reasonable security procedure, just as we did in this case.

How would a court decide this case? It seems probable that the court would apply public policy reasoning and hold in favor of the customer when the perpetrators were employees of the bank. It is perhaps somewhat less probable, but not improbable, that the court would reach the same result if the perpetrator was a third party interloper. In any event, it is quite clear that the customer could have avoided liability under these circumstances if the agreement had been properly qualified. For example, the customer should have requested the following proviso at the end of the “Customer’s Acknowledgment” provision stated above:

provided that Customer does not agree to be bound by any such payment order when Bank would otherwise not be entitled to enforce the payment order under UCC section 4A-203.

The proviso would be enforceable against Bank.28

The bank, of course, might object to the proviso. The bank might even seek to clarify the statutory ambiguity in its own favor. It might ask the customer to agree to be bound by unauthorized payment orders verified in compliance with the chosen procedure even when the customer can prove that the payment order had been caused by an interloper and thus would not otherwise be enforceable by the bank against the customer. This clarification could take the form of the following sentence added at the end of the “Customer’s Acknowledgment” provision quoted above:

Revision: The foregoing agreement by Customer shall apply even though Customer can prove that the payment order was not caused by a person associated with Customer as specified in UCC section 4A-203(a)(2). Provided that Bank complies with the security procedure, Customer hereby waives its right to assert that Bank is not entitled to enforce or retain payment of an unauthorized payment order under section 4A-203(a)(2).

This agreement makes clear the intent of the parties but could nevertheless produce a debate similar to the hypothetical debate above and might or might not be enforceable. Article 4A is ambiguous on this point.

28. Id. § 4A-203(a)(1).
One resolution of the ambiguity would be to provide in a revised version of section 4A-202 that the customer prevails over the bank when the agreement is unqualified or is otherwise silent on the issue, or when the agreement is qualified in favor of the customer as illustrated in the proviso above. To the extent, however, that the customer's waiver of its right to avoid liability when it can prove that the perpetrator is an interloper is express and distinct, the customer's agreement would be enforceable against the customer. The form of agreement quoted in the paragraph above might be an example of such an express agreement.

C. Question No. 3: What Does the Bank Have to Show in Order to Prove That It Accepted an Unauthorized Payment Order in "Good Faith"?

I have reviewed the rule that relieves the bank of liability for unauthorized payment orders when the bank can prove that it accepted the order in compliance with a commercially reasonable security procedure and in good faith.29 "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 This definition is based on the definition of good faith in Article 2. A general discussion of the obligation of contracting parties to exercise good faith is contained in the Restatement (Second) of Contracts31 and in a discussion of the good faith obligation in the PEB.32

Neither discussion is very helpful in the context of funds transfers. Both suggest that the courts will look to the "reasonable and justified expectations" of the customer. What might such expectations be in the context of wire transfers? Neither the black letter law nor the official comments to Article 4A offer any guidance.

The drafters probably intended the requirement that the bank prove good faith to be meaningful and not merely perfunctory.33 On the other hand, it seems improbable that they intended the burden of

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29. Id. § 4A-202(b).
30. Id. § 4A-105(a)(6).
33. See, e.g., Chapter 3 of UCC ARTICLE 4A, A PRACTICAL GUIDE FOR BANKERS AND BANK COUNSEL, supra note 24, at 40, in which Thomas E. Montgomery of Bank of America suggests that courts will "expect bank personnel to be well trained and alert and to act responsibly when handling funds transfer[s]." Compare, however, official comment 4 to UCC § 3-103, which distinguishes the concepts of good faith and care.
the bank to prove good faith to be as substantial a burden as the bur-

D. Question No. 4: Are the Rules on Unauthorized Funds
Transfers Unfair to Customers?

The reader who has made it to Question No. 4 will have acquired
a fair understanding of the Article 4A rules allocating liability in cases
of unauthorized funds transfers. Congratulations are in order. Most
attorneys, at least most of those who do not represent banks, are not
familiar with these rules. In my experience, most attorneys who rep-
resent customers and are familiar with the rules believe that the rules
are unfair to customers. Are they right?

The particular rule that attorneys for customers dislike is the pro-
vision that generally absolves the bank when the bank, acting in good
faith, has verified the authenticity of the customer's payment order in
compliance with a commercially reasonable security procedure.35

Since it is to be expected in a typical case that the security pro-
cedure will be a commercially reasonable one and that the bank will
comply with the procedure and accept the payment order in good
faith, the elements of the rule are expected to be present in a "garden
variety" fraudulent funds transfer case. The drafters of Article 4A
might have decided to make the blameless bank and blameless cus-
tomer share the loss equally under these circumstances. However, the
drafters were determined to impose the whole liability on either one
or the other of the parties.36 Given that determination, the choice
made by the drafters to impose threshold liability on the customer
seems justifiable for the following reasons.

34. See, e.g., the definition of "ordinary care" in UCC § 3-103(a)(7), under which a
bank is not necessarily required to examine checks by sight.
36. The drafters felt it their duty as legislators to choose which of the parties should
bear the loss under the circumstances and believed that to provide for a sharing of the loss
between the parties would be to shirk that duty.
First, there is a beneficial purpose underlying the statutory scheme. Since the banks will generally be liable when the agreed upon security procedure is not commercially reasonable, the rules motivate banks to be certain that their procedures are commercially reasonable and thus encourage the use of effective procedures to prevent fraud. This approach is rational and generally beneficial, although it does not itself bear on the issue of fairness.

Second, to impose the risk of loss on the bank could make the process more expensive for the funds transfer payment system as a whole and thus more expensive for other customers participating in the system. While this rationale does not dispositively settle the issue of fairness to customers, it represents a respectable basis for choosing to impose liability on the customer, especially in the absence of any countervailing rationale for choosing to impose liability on the bank.

Third, the rule imposes liability on the customer only at the threshold and is subject to the exception for interloper fraud. The exception for interloper fraud affords some balance in the statutory scheme. As noted above, the customer can shift liability to the bank in any case when it can prove that the perpetrator is an interloper.

Thus, while the rules impose liability on the customer at the threshold when the bank has complied with the security procedure and the identity of the perpetrator is unknown, liability is shifted to the bank under the interloper provisions in two instances: (i) when the identity is known and the perpetrator is an interloper; and (ii) when the identity is unknown but the customer can nevertheless meet the burden of proving that the perpetrator is an interloper.

When the identity of the interloping perpetrator is known, the bank will bear the loss. When the identity is unknown, the customer might or might not have difficulty proving interloper fraud, depending on the facts and possibly, on future judicial interpretations of section 4A-203. In any event, I believe that the threshold rule is balanced to a meaningful degree by the interloper exception to the rules for verified payment orders.38

37. See supra text accompanying note 18.
38. The balance was achieved only at the very end of the drafting process by the Article 4A Drafting Committee. The drafts considered prior to the last meeting of the committee would have made the customer unable to shift liability to the bank except when the customer could prove that the perpetrator was a person associated with the bank or a person with responsibility for the bank's security procedures. A last-minute change suggested by Mr. Rapson enabled the customer to shift liability when the customer could prove that the perpetrator was not a person associated, as specified in § 4A-203(a)(2), with the customer. While it is usually more difficult to prove a negative proposition than a positive
Fourth, the rule may be varied to the customer's benefit by agreement. In a particular funds transfer agreement, a bank may agree to share the liability for unauthorized transfers equally or on some other basis with the customer when the identity of the perpetrator is unknown. Banks are not likely to enter into such agreements routinely, of course, but they may well do so on an ad hoc basis for important customers or under other circumstances.

The critics of the liability allocation rules have a point. It is unfair to impose liability for a fraudulent funds transfer loss on the customer simply because the bank has complied with a commercially reasonable security procedure and accepted the payment order in good faith. On the other hand, had the drafters instead chosen to impose liability on the Bank under these circumstances, the result would be equally unfair to the bank. For the reasons discussed above, I believe that the rules as a whole are sound and that no substantive changes are necessary.

E. Question No. 5: Can a Bank Disclaim Liability for Its Own Errors?

Under section 4A-303, the bank is liable for resulting losses when it (i) executes a payment order in an amount greater than the customer's order, (ii) issues a duplicate order after executing the customer's order, or (iii) executes the customer's order by issuing a payment order to the wrong beneficiary.

Section 4A-501 provides that the rules of Article 4A may be varied by agreement of the parties except as otherwise provided in Article 4A. Since Article 4A does not prohibit variation of section 4A-303 by agreement, it would seem at first glance that the section is variable and that the bank can disclaim liability for its errors.

There are reasons to believe, however, that the drafters of Article 4A intended that section 4A-303 not be variable. The statutory scheme of Article 4A allocates such liability between the banks and their customers as the drafters thought fair, and numerous provisions one, customers can more easily prove facts related to their own personnel and operations than those of the bank. The effect of the change was to shift liability to the bank when the customer could prove that the fraud was perpetrated by a third-party interloper as opposed to only an interloper associated with the bank. The change was accorded grudging acceptance by many of the representatives of corporate customers, enough of them, in any event, to deter their organized opposition to the enactment of Article 4A.

39. U.C.C. § 4A-203(a)(1). As noted during the discussion in Part II of the Article 4A rules allocating liability for unauthorized funds transfers, such rules may be varied to the detriment of the bank but not to the detriment of the customer.
are made not variable by agreement. It seems at least doubtful that the drafters would have intentionally permitted a bank to disclaim liability for its own errors.

Moreover, the official comments suggest that the rules regarding errors are "similar"\(^{40}\) and "identical in effect"\(^{41}\) to the rules relating to unauthorized payment orders, which generally may not be varied to the detriment of the customer. These comments support an interpretation that the bank cannot disclaim liability for its own errors.\(^{42}\) The only problem with that interpretation, of course, is the absence in Article 4A of an explicit prohibition on variation by agreement of the provisions of section 4A-303. The problem should be resolved.

The statutory scheme and official comments suggest that the drafters intended that the bank not be permitted to disclaim liability for its own errors. I believe that section 4A-303 should be revised accordingly.

F. Question No. 6: Does the Bank's Obligation to Compensate the Customer for Failure to Execute or for Late or Improper Execution of the Customer's Payment Orders Apply to Book Transfers?

Occasionally the customer and the person whom the customer wishes to pay—the "beneficiary" in Article 4A terminology—use the same bank. When only one bank is involved, the wire transfer is a fairly simple matter. Upon receipt of the customer's payment order, the bank debits the customer's account and credits the beneficiary's account. This kind of transfer is called a "book transfer."

Section 4A-301(a) defines the term "execute."\(^{43}\) The first sentence states that the customer's payment order is executed when the bank issues its own payment order intended to carry out the customer's payment order.\(^{44}\) It is clear that the drafters of section 4A-301(a) were thinking of typical funds transfers in which the customer

\(^{40}\) See U.C.C. § 4A-505 cmt.

\(^{41}\) See id. § 4A-304 cmt.

\(^{42}\) Of course, if the bank issues a payment order to the wrong person, the funds transfer will not have been completed. As a result, the customer is excused from its obligation to pay for the transfer or entitled to a refund of its payment under the "money-back guarantee" provisions of § 4A-402, which are not variable. It has been suggested that the interplay of §§ 4A-303 and 4A-402 supports the interpretation that the bank may not disclaim liability for its own errors. See Gottlieb, supra note 24, at 98-103.

\(^{43}\) U.C.C. § 4A-301(a).

\(^{44}\) A "payment order" is an instruction to a receiving bank to pay or to cause another bank to pay the beneficiary. U.C.C. § 4A-103(a)(1). A typical funds transfer consists of a series of at least two such instructions, but a book transfer involves only the one instruction
and the beneficiary use different banks. The drafters went on to state in the second sentence of section 4A-301(a) that "[a] payment order received by the beneficiary’s bank can be accepted but cannot be executed." Starting with that sentence, it is possible to construe other provisions of Article 4A in a way that was not intended.

The bank in a book transfer is the beneficiary’s bank as well as the customer’s bank. If a beneficiary’s bank cannot execute a payment order as seemingly provided in section 4A-301(a), it is arguable that the term execute does not encompass the bank’s act of accepting the customer’s payment order in a book transfer. If the bank accepting the order in a book transfer does not execute the order as defined in section 4A-301(a), then the terms execute and “execution” arguably do not apply to the bank’s acceptance of payment orders in book transfers for purposes of the other provisions of Article 4A that use the terms execute and execution.

These other provisions of Article 4A include sections 4A-305 and 4A-210(b). These provisions obligate the bank to compensate the customer when execution by the bank results in delay in payment to the beneficiary, when execution results in noncompletion of the transfer or issuance of a payment order that does not comply with the customer’s payment order, when the bank fails to execute a payment order it was expressly obligated to execute, and when it fails to execute an order without giving notice to the sender.

The argument may be carried to its logical conclusion by asserting that since the terms execute and execution as defined in Article 4A do not encompass the bank’s actions in a book transfer, the bank is not obligated to pay compensation to the customer under sections 4A-305 and 4A-210(b) when the funds transfer is a book transfer.

This construction of sections 4A-305 and 4A-210 is contrary to the clear intention of the Article 4A drafters and should be discouraged. Any customer that nevertheless remains concerned about this issue can make clear in its Funds Transfer Agreement that the term execute—both as used in the Funds Transfer Agreement and for purposes of the application of Article 4A to the parties generally—in-

from the customer to the bank. See supra note 10. Book transfers are also called “on us” transfers by banks.

45. U.C.C. § 4A-301(a).
46. Id. § 4A-305(a).
47. Id. § 4A-305(b).
48. Id. § 4A-305(d).
49. Id. § 4A-210(b).
cludes the bank's acceptance of the customer's payment order in book transfers.

When Article 4A is revised, section 4A-301(a) should be rewritten to make clear that the bank's acceptance of the customer's payment order in a book transfer constitutes the execution of the order.

IV. Conclusion

In Part I of this Essay, I discussed lessons we might learn from the process by which Article 4A was drafted. The fact that this Essay compiles ambiguities in the legislation teaches us something else: Legislative drafting is never perfect. Many of us have already acknowledged this lesson, but it is helpful for us to be reminded. Given the enormous complexity and scope of the Article 4A undertaking, the fact that I have thought only of the problems discussed above should be seen as a tribute to the superb performance of the drafters of Article 4A. It is by no means a criticism of their performance for me to make the prediction that, as time passes, others will think of more.