Permanent Editorial Board for the Uniform Commercial Code

PEB COMMENTARY NO. 16
SECTIONS 4A-502(d) and 4A-503

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PREFACE TO PEB COMMENTARY

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> "A *PEB Commentary* should come within one or more of the following specific purposes, which should be made apparent at the inception of the Commentary: (1) to resolve an ambiguity in the UCC by restating more clearly what the PEB considers to be the legal rule; (2) to state a preferred resolution of an issue on which judicial opinion or scholarly writing diverges; (3) to elaborate on the application of the UCC where the statute and/or the Official Comment leaves doubt as to inclusion or exclusion of, or application to, particular circumstances or transactions; (4) consistent with UCC § 1-102(2)(b),[*] to apply the principles of the UCC to new or changed circumstances; (5) to clarify or elaborate upon the operation of the UCC as it relates to other statutes (such as the Bankruptcy Code and various federal and state consumer protection statutes) and general principles of law and equity pursuant to UCC § 1-103;[†] or (6) to otherwise improve the operation of the UCC."

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[*] Current UCC § 1-103(a)(2).
[†] Current UCC § 1-103(b).

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INTRODUCTION

A funds transfer is a series of payment orders starting with an originator's order to the originator's bank to cause a sum certain amount of money to be paid to a beneficiary. The series of payment orders culminates with a beneficiary bank crediting the account of a beneficiary for that sum certain. U.C.C. § 4A-104(a) (definition of funds transfer). The series of payment orders is a mechanism used to make a transfer of value through the debiting and crediting of bank accounts from the originator to the beneficiary. The funds transfer often involves one or more intermediary banks that receive a payment order from the originator's bank or another bank. The receiving intermediary bank then issues its own payment order to another intermediary bank or the beneficiary's bank. Several cases have raised the issue of whether a creditor of the beneficiary may serve creditor process on an intermediary bank and thus "capture" the value transfer while it is in process.

Article 4A provides that the creditor of the beneficiary may not serve creditor process on any bank other than the beneficiary's bank. U.C.C. § 4A-502(d). Official Comment 4 to § 4A-502 further explains the concept, and does so in relation to a creditor of either the beneficiary or the originator:

> A creditor of the originator can levy on the account of the originator in the originator's bank before the funds transfer is initiated . . . [but] cannot reach any other funds *because no property of the originator is being transferred*. A creditor of the beneficiary cannot levy on property of the originator and until the funds transfer is completed by acceptance by the beneficiary's bank of a payment order for the benefit of the beneficiary, *the beneficiary has no property interest in the funds transfer which the beneficiary's creditor can reach* (emphasis supplied).

Official Comment to § 4A-503 further explains both § 4A-502(d) and § 4A-503 are designed to prevent interruption of a funds transfer after it has been set in motion and that, in particular, intermediary banks are protected.

A funds transfer is a series of payment orders that create contractual obligations only as to the sender and receiver of each payment order. Those contractual obligations are not the property of either the originator or the beneficiary. In a simple funds transfer, the originator instructs its bank, the originator's bank, to debit the originator's account and order the beneficiary's bank to credit the beneficiary. Those instructions are payment orders. U.C.C. § 4A-103 (definition of "payment order," "beneficiary," and "beneficiary's bank"; § 4A-104 (definition of "funds transfer," "originator," and "originator's bank"). See also Regulation J, 12 C.F.R. § 210.26 (governing payment orders issued to or by a federal reserve bank). The originator is the "sender" of the payment order and the originator's bank is the "receiving bank." U.C.C. § 4A-103 (definitions of "sender" and "receiving bank"). If the originator's bank accepts the originator's payment order, the originator owes an obligation to the originator's bank to pay the amount of the payment or-

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der. U.C.C. § 4A-402(b). The originator's bank owes an obligation to the originator to execute the accepted payment order according to the instructions of the originator. U.C.C. § 4A-302.

In execution of the originator's payment order, the originator's bank may send its own payment order to the beneficiary's bank, but more commonly it will send its payment order to an intermediary bank. U.C.C. § 4A-104 (definition of "intermediary bank"). The originator's bank is the sender of its payment order and the intermediary bank is the receiving bank of that second payment order. Upon acceptance of that second payment order, the intermediary bank owes an obligation to the originator's bank, not the originator, to execute its own payment order that replicates *the originator's bank's payment order* (emphasis supplied). U.C.C. § 4A-302 (obligation in execution owed by receiving bank to its sender). The originator's bank, not the originator, owes payment of the originator bank's payment order to the intermediary bank. U.C.C. § 4A-402(b) (sender owes obligation to pay the amount of an accepted payment order to its receiving bank). In the event the originator is not able to pay the amount of its payment order to the originator's bank, but the originator's bank's payment order has been accepted by the intermediary bank, the originator's bank still owes a payment obligation to the intermediary bank. The intermediary bank has no right of recovery against the originator, but only has a right of recovery against the originator's bank (its sender) for payment of the payment order.

Further, the intermediary bank will then issue its own payment order to the beneficiary's bank for the beneficiary's bank to credit the account of the beneficiary when the beneficiary's bank accepts that payment order. Accordingly, the intermediary bank owes an obligation to pay for that order to the beneficiary bank, not the beneficiary. U.C.C. § 4A-402(b). Upon the beneficiary bank's acceptance of the payment order, it is the beneficiary's bank that owes an obligation to pay the beneficiary, usually by crediting an account of the beneficiary. U.C.C. § 4A-404. See also Regulation J §§ 210.28, 210.29, 210.30, 210.31, and 210.32.

In summation, under the Article 4A structure, the issuance and acceptance of payment orders create rights and obligations only as between the sender of the payment order and its receiving bank (e.g., between originator and originator's bank as to the originator's payment order), between the originator's bank and an intermediary bank as to the originator's bank's payment order, between the intermediary bank and the beneficiary bank as to the intermediary bank's payment order, and finally as between the beneficiary bank that has accepted a payment order and the beneficiary. Accepted and executed payment orders thus create contractual obligations that result in a series of credits and debits to bank accounts. They do not involve a transfer of property of the originator to the beneficiary. A receiving bank owes its contractual obligation to its sender to execute the payment order and the sender owes its contractual obligation to pay the amount of the payment order to its receiving bank. The intermediary bank has no contractual obligation to the originator or to the beneficiary, and neither the originator nor the beneficiary has any contractual obligation to or rights flowing from the intermediary bank. Thus, credits in an intermediary bank are credits in favor of the originator's bank, *and are not property of either the originator or the beneficiary* (emphasis supplied).

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DISCUSSION

In a series of cases applying Admiralty Rule B regarding attachment, the federal courts in New York have held that the intermediary bank in a funds transfer is holding "property" of the originator or beneficiary and have thus allowed creditor process on an intermediary bank in an effort to collect a debt owed by either the originator or the beneficiary (as the case may be).[1] See, e.g., Winter Storm Shipping, Ltd. v. TPI, 310 F.3d 263 (2d Cir. 2002), cert. denied, 539 U.S. 927 (2003); Aqua Stoli Shipping Ltd. v. Gardner Smith Pty Ltd., 460 F.3d 434 (2d Cir. 2006); Consub Delaware LLC v. Schahin Engenharia Limitada and Standard Chartered Bank, 534 F.3d 104 (2d Cir. 2008); Navalmar (U.K.) Ltd. v. Welspun Gujarat Stahl Rohren, Ltd., 485 F. Supp. 2d 399 (S.D.N.Y. 2007); Compania Sudamericana de Vapores S.A. v. Sinochem Tianjin Co., 2007 WL 1002265 (S.D.N.Y. 2007); but see Seamar Shipping Corp. v. Kremikovtzi Trade Ltd., 461 F. Supp. 2d 222 (S.D.N.Y. 2006).

These decisions stem from the opinion of the court in *Winter Storm* that the value held by the intermediary bank is property of the originator. Under Article 4A, which is also adopted federal law in Regulation J for funds transfers through a federal reserve bank, the originator does not have any claim against the intermediary bank for return of the value in the event the funds transfer is not completed. Rather, the only party with a claim against the intermediary bank is the sender to that bank, which is typically the originator's bank. In an uncompleted funds transfer, it is the originator's bank that must refund the value to the originator. U.C.C. § 4A-402(d). The intermediary bank owes its refund obligation to its sender, the originator's bank, not to the originator. The originator's bank must refund to the originator even if it cannot recover from the intermediary bank.[2] The beneficiary likewise has no claim to any payment from the intermediary bank. The beneficiary's only claim to the funds is against its bank, the beneficiary bank, and then only when the beneficiary bank has accepted the payment order. U.C.C. § 4A-404. The intermediary bank thus holds no property of either the originator or the beneficiary. Since Admiralty Rule B does not define what is "property" of a party, normally courts look to other law on that issue.

Other law is sufficient to define the parties' rights in a funds transfer. Article 4A is uniform law, enacted in every state in the United States, and Regulation J, which adopts in large part

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[1] Federal Rules of Civil Procedure, Supplemental Rules for Certain Admiralty and Maritime Claims, Admiralty Rule B(1)(a) permits attachment of "the defendant's tangible or intangible personal property" in the hands of named garnishees and thus allows garnishment of such property held by a bank.

[2] A simple example illustrates how these courts conflated privity-based contract claims between two parties to create property rights in a third party. Assume A owes B an obligation, B owes C an obligation, and C owes D an obligation. Under garnishment law, D cannot garnish A to satisfy the obligation C owes D. A holds no property of C (A owes B). Now substitute the Article 4A terms to this simple example. A is the intermediary bank who has received payment of a payment order issued by B, the originator's bank, and C is the originator. D is the garnishing creditor. The court in *Winter Storm* and its progeny have in essence allowed D (the originator's creditor) to garnish A (the intermediary bank) to collect on the debt C (the originator) owes to D.

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Article 4A's provisions, is uniform in applying to all funds transfers through the federal reserve system. Both define uniformly the rights of parties in a funds transfer. The *Consub* court reasoned that leaving the functional usefulness of Rule B attachments to the vagaries of the laws of 50 states would create a measure of anarchy, but did not take into account that Article 4A is uniform law in all U.S. jurisdictions and is adopted federal law.[3] Neither did the court explain how

[3] The courts following *Winter Storm* have not followed the applicable law directly on point regarding property rights, but have also not followed applicable precedent predating Article 4A. The court in Reibor International Limited v. Cargo Carriers (Kacz-Co.) Ltd., 759 F.2d 262 (2d Cir. 1985), considered whether the CHIPS credit involved was property subject to attachment under the Admiralty Rules. The court said that federal law generally governs questions as to the validity of Rule B attachments, but the Admiralty Rules themselves offered little guidance and so the court agreed with the district court that state law more directly in point should be turned to. This is entirely consistent with respect to other contexts where federal law relies on state law to determine whether property is involved, such as in bankruptcy. See, e.g., Butner v. United States, 440 U.S. 48 (1979). Also the Court in *Grain Traders, Inc. v. Citibank, N.A.*, 160 F.3d 97 (2d Cir. 1998), recognized the applicability of U.C.C. Article 4A when it held that law prevents an originator of a funds transfer from suing an intermediary bank. Id. at 102. *Grain Traders* remains good law in the Second Circuit and its logic applies to suits by beneficiaries as well.

Further, looking for a federal precedent concerning the "susceptibility of funds involved in an EFT to attachment under Admiralty Rule B," *Winter Storm* turned to *United States v. Daccarett*, 6 F.3d 37 (2d Cir. 1993), a forfeiture case involving the drug trafficking and money laundering activities of a Colombian drug cartel. 310 F.3d at 276-77 ("The case is instructive in the admiralty field because the attachments of funds in *Daccarett* were accomplished pursuant to the Admiralty Rules, incorporated by reference into the forfeiture statute.") Reasoning from *Daccarett's* holding that "'an EFT while it takes the form of a bank credit at an intermediary bank is clearly a seizable *res* under the forfeiture statutes,'" id. at 276 (quoting *Daccarett*, 6 F.3d at 55), *Winter Storm* concluded that the "inclusive language of [Rule B] and the EFT analysis in *Daccarett* combine to fashion a rule in this Circuit that EFT funds in the hands of an intermediary bank may be attached pursuant to [Rule B]." 310 F.3d at 276. *Consub* endorsed *Winter Storm's* reliance on *Daccarett*, with minimal independent analysis. See 543 F.3d at 110-11. It should be noted that Rule B remains unchanged for all relevant intents and purposes since *Winter Storm* was decided in 2002 even though, effective December 1, 2006, the rules embodying the practice of maritime attachment in civil forfeiture actions and other in rem proceedings have been renamed the Supplemental Rules for Admiralty or Maritime Claims and Asset Forfeiture Actions (the "Supplemental Rules"). The revised Supplemental Rules added, inter alia, the reference to "Asset Forfeiture Actions," and Rule G, governing forfeiture actions in rem arising from a federal statute, "to bring together the central procedures that govern civil forfeiture actions." Supplemental Rule G, Advisory Committee's Note. The point is that *Daccarett* never decided whether either an originator or a beneficiary of the funds transfer had a *property interest* in the amount involved in a funds transfer received by an intermediary bank. It did not need to do so because in a forfeiture case funds can be seized even if they do not constitute property of the defendant. The *Daccarett* court, as appropriate in a forfeiture case, identified the amount of the

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Rule B provides any basis for determining whether anyone had any "property" rights in the value held at the intermediary bank.[4]

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funds as "traceable" to an illicit activity and therefore subject to attachment under 21 U.S.C. § 881(a). This is a critical difference.

Moreover, as a remedy quasi in rem, the validity of a Rule B attachment depends entirely on the determination that the res at issue is property of the judgment debtor at the moment it is attached. See J. Lauritzen A/S v. Dashwood Shipping, Ltd., 65 F.3d 139, 141 (9th Cir. 1995) (Rule B attachment characterized as quasi in rem jurisdiction "because jurisdiction is derived solely from the attachment of the property of the defendant"). Forfeiture, on the other hand, is a remedy in rem, based as it is on the legal fiction that "'property used in violation of law [is] itself the wrongdoer that must be held to account for the harms it [has] caused.'" United States v. 92 Buena Vista Avenue, 507 U.S. 111, 125 (1993). This is a critical distinction between actions proceeding under Supplemental Rule C—now Rule G—and those brought under Rule B; it is not a "distinction[] without a difference," as *Winter Storm* found. 310 F.3d at 278.

Accordingly, unless there is superseding federal law, such as a drug forfeiture law or a regulation of the Treasury Department's Office of Foreign Assets Control ("OFAC"), Article 4A must be honored. Rule B is not such a superseding law.

[4] The *Consub* court believed that the *Winter Storm* rule was not shown to be unworkable. Note that U.C.C. Article 4A is substantially premised on the ability to net obligations because of the large sums involved. U.C.C. § 4A-403. If a particular creditor can seize funds and frustrate that plan, the resultant systemic risk may provide the demonstration that the *Winter Storm* approach and its progeny are unworkable.

Even absent that scenario, the Winter Storm approach is proving to be practically unworkable. The result of the *Winter Storm* approach has been a staggering number of maritime writs that New York banks are required to process on a daily basis. For example, from October 1, 2008 to January 31, 2009, maritime plaintiffs filed 962 lawsuits seeking to attach more than $1.35 billion. These lawsuits constituted 33 percent of all lawsuits filed in the Southern District of New York during that period, and the resulting maritime writs only add to the burden of 800 to 900 prior writs already served daily on the District's banks. The numbers have tapered off only slightly during the past months; from February 1, 2009 to April 30, 2009, maritime plaintiffs filed 498 lawsuits seeking to attach a total of $720 million. The explosion of maritime writs served on the banks has been logistically overwhelming.

Of even more significance, however, this explosion of writs creates an additional threat to the U.S. dollar as the world's primary reserve currency and New York's standing as a center of international banking and finance. Confronted with this situation, companies around the world may well consider restructuring their transactions to provide for payments in euros, sterling, yen, or some other currency to avoid using U.S. dollars cleared through intermediary banks in the United States, or clear transactions through one of the proliferating off-shore dollar clearing networks. Because the only contact with the United States in most of these transactions is the use of an intermediary bank in the United States to clear U.S. dollars, the U.S. litigation apparatus can be avoided entirely by the relatively simple expedient of using a different currency. As a result,

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CONCLUSION

In uniform law under Article 4A and under Regulation J, neither the originator nor the beneficiary of a funds transfer has any property claim to the value held by an intermediary bank in a funds transfer. Thus, neither a creditor of an originator nor the creditor of a beneficiary may successfully issue creditor process[5] to an intermediary bank as the intermediary bank is not holding property of either the originator or the beneficiary. To the extent that the cases cited earlier indicate to the contrary, that reasoning is disapproved and should not be followed.

Winter Storm and its progeny have had a far greater, and damaging, potential impact on U.S. and foreign banks located in New York than might have been anticipated.

An additional significant problem for banks is that the only practical way in which they can accommodate post-*Winter Storm* attachments is by frequent amendments to their software filters used to identify transactions involving entities and other persons whose financial transactions are blocked under OFAC regulations. OFAC administers U.S. economic sanctions programs arising under the Trading with the Enemy Act, 50 U.S.C. app. § 5, the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701-1706, and other statutes. OFAC regularly issues bulletins that add or delete entities or persons from its lists, and banks must update their screening software to reflect these changes. This year, OFAC has updated its lists 19 times through May 6, 2009 (83 business days). By contrast, new maritime attachment orders were filed nearly every business day. The process of constantly amending the software filters to deal with this flood of maritime attachments has greatly increased the burden on the banks, requiring them to take down their OFAC filters almost every day, vastly increasing the chance that the OFAC database will be corrupted by the manipulation, and substantially increasing the number of "hits," including numerous false positives that these filters now generate, creating real risks of inefficiency and error.

In addition, permitting a beneficiary's creditor to attach a funds-transfer credit, ordinarily held only momentarily in New York, would exacerbate the considerable due-process concerns inherent in restraining a funds transfer. The defendants in maritime cases invariably are foreign corporations with few or no contacts with the United States. In many of the cases the defendant does not appear to have significant contacts, if any, with New York. Indeed, for a maritime defendant's property to be prima facie subject to a Rule B attachment, the plaintiff is required to attest, pursuant to Rule B(1)(b), that the defendant could not be found within the District. See STX Panocean (UK) Co., Ltd. v. Glory Wealth Shipping Pte Ltd., 560 F.3d 127, 130-31 (2d Cir. 2009). Moreover, the funds transfers at issue are often meant to effect payment from a third party's non-U.S. account to the defendant's non-U.S. account, or vice versa. The New York garnishee banks in most cases are involved as intermediary banks only because the payment was denominated in U.S. dollars.

[5] "Creditor process" means levy, attachment, garnishment, notice of lien, sequestration, or similar process issued by or on behalf of a creditor or other claimant with respect to an account. As to "account," see "authorized account" defined in U.C.C. § 4A-105(a)(1).

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