

ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

**COMMITTEE ON COMMERCIAL LAW
AND UNIFORM STATE LAWS**

COMMENTS ON PEB COMMENTARY NO. ____
SECTIONS 4A-502 AND 4A-503

Introduction.

The Permanent Editorial Board for the Uniform Commercial Code (“PEB”) has proposed for public comment a commentary (“Commentary”) on sections 4A-502(d) and 4A-503 of the Uniform Commercial Code (“U.C.C.”). Section 4A-502(d) deals with creditor process served on a receiving bank, and section 4A-503 deals with injunctions or restraining orders with respect to funds transfers. The Commentary responds to a series of cases in the U.S. Court of Appeals for the Second Circuit and the U.S. District Court for the Southern District of New York holding that “funds involved in electronic funds transfer (‘EFT’) between banks are subject to attachment under Rule B(1) of the Supplemental Rules for Certain Admiralty and Maritime Claims.”¹ *Winter Storm Shipping, Ltd. v. TPI.*, 310 F.3d 263, 265 (2d Cir. 2002); *see also Aqua Stoli Shipping Ltd. v. Gardner Smith Pty Ltd.*, 460 F.3d 434 (2d Cir. 2006); *Consub Delaware LLC v. Schahin Engenharia Limitada*, 543 F.3d 104 (2d Cir. 2008).

The Commentary explains the law regarding funds transfers in some detail, emphasizing that the obligations that each party to a funds transfer owes are owed only to those parties in privity with it and that because of that legal structure parties have no obligation to pay any other party. Because of this requirement for privity, neither the originator nor the beneficiary of a funds transfer has any right to payment from an intermediary bank and the intermediary bank holds no property of the originator or beneficiary. *See* U.C.C. § 4A-502 cmt. 4. Because the intermediary bank does not hold property of the originator or beneficiary, it is not a proper garnishee for debts owed by the originator or beneficiary. Thus, in the PEB’s view, the reasoning of the Second Circuit in the Rule B cases “is disapproved and should not be followed.”

¹ Since December 1, 2006, the “Supplemental Rules for Admiralty or Maritime Claims and Asset Forfeiture Actions.”

The Second Circuit's decisions in this area have generated debate, with the maritime bar generally supportive and banks and their counsel generally critical. The Committee on Commercial Law and Uniform State Laws of the Association of the Bar of the City of New York ("Committee") believes that, while the PEB ought not to take sides in controversies, it is entirely appropriate for the PEB to make its views known when the courts render decisions that clearly misinterpret applicable sections of the U.C.C. In the Committee's view, the Second Circuit's decisions regarding the application of Rule B to funds-transfer payment orders received by intermediary banks clearly misinterpret the property interests that arise during a funds transfer with the result that the court has concluded that there is a conflict between Rule B (federal law) and Article 4A (state law) when in fact no such conflict exists.

The Committee believes the PEB's action comes at an opportune time, given developments in the U.S. District Court for the Southern District of New York occasioned by the efforts of the judges of that court to cope with the historically high number of maritime attachment orders brought about by the Second Circuit's decisions and by the efforts of the U.S. Attorney for the Southern District of New York to expand the illogic of the *Winter Storm* to nonmaritime cases under the Federal Debt Collection Procedures Act.² The Committee agrees with the analysis set out in the Commentary and believes that it should be issued by the PEB. Nevertheless, we believe that the Commentary could be improved by a more pointed analysis of the basic error made by the Second Circuit and by taking into account some more recent developments in the Southern District.

Discussion.

PROPERTY RIGHTS IN A FUNDS TRANSFER. Rule B does not grant any party substantive rights; it is merely a procedural rule that provides a mechanism for a plaintiff with a valid maritime claim to obtain a writ to attach or garnish property that belongs to the defendant, with the defendant's right to the property determined by applicable law. *See*

² 28 U.S.C. §§ 3000-3308. *See Export-Import Bank of U.S. v. Asia Pulp & Paper Co.*, No. 03-08554 (DCP) (JCF), 2009 WL 1033389 (S.D.N.Y. Apr. 17, 2009).

Sonito Shipping Co. Ltd. v. Sun United Maritime Ltd., 478 F. Supp. 2d 532 (S.D.N.Y. 2007). As with any other attachment or garnishment action, the plaintiff steps into the shoes of the defendant and gets whatever rights the defendant has to the property—nothing more, nothing less.

Winter Storm and its progeny make a basic mistake regarding funds transfers: they mistake the terminology—basically a metaphor that does not describe what actually happens—with the reality. See Howard Darmstadter, *Dark Thoughts in a Winter Storm*, A.B.A. Com. L. Newsl., Dec. 2003 at 8. In a funds transfer, money or funds do not move from the originator to the beneficiary. Rather a funds transfer is a series of transactions in which each of the parties will have rights to payment from, and an obligation to make payment to, another party. While these rights and obligations are intangible property that is subject to attachment or garnishment, they are not owed to or by remote parties. As the Commentary so ably notes, any bank in a funds transfer is obliged to make payment only to those parties in privity with it: If it accepts the funds transfer, a beneficiary's bank is obliged to make payment only to the beneficiary, U.C.C. § 4A-404(a), and a bank other than the beneficiary's bank is obliged to make payment to the next bank in the funds transfer. *Id.* § 4A-402(c). If the bank does not accept the payment order, or the funds transfer is not completed, the bank must refund any payment received from its sender. *Id.* § 4A-402(d). Thus, an intermediary bank will owe payment to the beneficiary's bank or another intermediary bank or—if it has not accepted its sender's payment order or the funds transfer has not been completed—its sender; it will never be obliged to pay the originator or beneficiary of the funds transfer. Because an intermediary bank is under no obligation to make payment to either the originator or beneficiary, it holds no property of either and is not a proper garnishee for Rule B actions directed against the originator or beneficiary.

Yet the cases applying Rule B to funds transfers have usually adopted a view of the property relationships that arise in the course of these transactions which is at odds with this reality. For example in discussing comment 4 to section 4A-502, the court in *Navalmar (U.K.) Ltd. v. Welspun Gujarat Stahl Rohren, Ltd.*, 485 F. Supp. 2d 399, 408 (S.D.N.Y. 2007), stated

But clearly it is property, for the money belongs to someone, either the originator of the funds transfer, or the beneficiary, directly or through their banks. . . . Indeed the policy position adopted by the drafters departs from common law understanding of property, for certainly the funds, in temporary possession of the intermediary bank, are funds subject to the right of another “to possess, use, and enjoy” those funds. (citation omitted)

But in point of fact, no “funds” of either the originator or beneficiary flow through the intermediary bank. Rather the intermediary bank in *Winter Storm* had an account for the originator’s bank, which was a debt that it owed to the originator’s bank (i.e., property of the originator’s bank) and an account for the beneficiary’s bank (property of the beneficiary’s bank). Had it not interrupted the funds transfer in response to the attachment order, it would have executed the payment order it received from the originator’s bank (its sender) by debiting the sender’s account, crediting the beneficiary’s bank’s account, and sending a corresponding payment order to the beneficiary’s bank. This action would have decreased the debt the intermediary bank owed to the originator’s bank and increased its debt to the beneficiary’s bank, but at no time would the intermediary have any debt to the originator or the beneficiary, and because it has no debt to the originator or beneficiary, it holds no property of either party, and the intermediary bank is thus not a proper garnishee for property of the either of those parties.

In *Winter Storm*, the intermediary bank voluntarily took an action that was at variance with the normal procedure: it debited the amount of the payment order from the originator’s bank’s account, but instead of crediting an identical amount to beneficiary’s bank’s account and sending a payment order to the beneficiary’s bank, it credited the amount of the plaintiff’s claim to a suspense account, credited the balance to beneficiary’s bank’s account, and sent the beneficiary’s bank a payment order for that reduced amount. It was this action on the part of the intermediary bank that created a static fund that the Second Circuit held was the originator’s property and that was subject to attachment when the plaintiff’s process server came calling again.³ But because the intermediary bank’s action ensured that the funds transfer was not completed, the

³ The court made it absolutely clear that the intermediary bank was under no obligation to take the action that it did; indeed, the court left open the possibility that the intermediary bank might be liable to the originator for its action. Under *Grain Traders, Inc. v. Citibank*, 160 F.3d 97 (2d Cir. 1998), liability to the originator would be unlikely, as the originator has no right to payment from an intermediary bank. But the issue of liability to the sender of the payment order under U.C.C. § 4A-402 has not been resolved.

“money-back guarantee” of U.C.C. § 4A-402 required the intermediary bank to refund to its sender the amount of the payment it had obtained from the sender. The amount in the suspense account should therefore have been regarded as the property of the sender (the originator’s bank) and not the originator.

THE PRIVACY STRUCTURE OF ARTICLE 4A. The Committee agrees with the Commentary that Article 4A has a privity structure. *See Grain Traders, Inc. v. Citibank*, 160 F.3d 97 (2d Cir. 1998). This privity is especially important in cross-border funds transfers because the various parties to the funds transfer are in different countries and subject to different legal regimes. Privity is thus vital in ensuring that parties to a funds transfer understand the legal obligations that they undertake and in ensuring that they can manage their risks by limiting the parties they will receive payment orders from or send payment orders to only to those persons who they believe have the financial capacity to meet the obligations they will incur in the course of a funds transfer.

In *Winter Storm* and its progeny this privity structure has been ignored with predictable results. For example, in *Vamvaship Maritime Ltd. v. Shivnath Rai Harnarain (India) Ltd.*, No. 06 Civ. 1849(HB), 2006 WL 1030227 (S.D.N.Y. Apr. 20, 2006), the plaintiff (Vamvaship) and defendant (Shivnath) were involved in a maritime dispute, and an award was issued in favor of Vamvaship. Vamvaship then obtained a Rule B order from the Southern District and served several New York banks. At around this time, Little Rose Trading L.L.C. entered into an agreement with Shivnath for the purchase of rice, with Shivnath to ship the rice upon receipt of 25% of the total purchase price at Shivnath’s bank, with the balance payable later. On March 16, 2006, Little Rose ordered Al Fardan Exchange Co. in Dubai to wire \$290,000 to Shivnath’s account at State Bank of Mysore, New Delhi. Al Fardan sent a payment order to Wachovia Bank, N.A., instructing Wachovia to pay JPMorgan Chase Bank, N.A., for further credit to Shivnath. Wachovia, however, had been served with Vamvaship’s Rule B order and instead of sending a payment order to Chase, deducted the amount of the payment order from Al Fardan’s account and credited the amount to a suspense account.

Little Rose filed a motion to vacate the order with respect to this funds transfer for a number of reasons. In particular, it argued that Shivnath had no interest in the amount

of the funds transfer because it was an advance payment on an executory contract and therefore a “mere expectancy.” The court disagreed.

A contract that remains executory may nonetheless be binding and enforceable. . . . Here, Little Rose commenced performance by tendering advance payment to Shivnath. The fact that this payment was seized by Shivnath’s creditors does not render it a nullity. The payment was directed to Shivnath according to the terms of a binding agreement entered into by Shivnath and Little Rose. If Shivnath’s performance was contingent under the terms of the purchase and sale contract, it became obligatory when Little Rose rendered its performance in the form of payment. Thus, Shivnath’s interest in the attached funds is more than a “mere expectancy.” *Vamvaship*, 2006 WL 1030227, at *2.

What is lost in all of this is that Shivnath is located in India and Little Rose is located in Dubai. Yet the court, citing a New York case on executory contracts, purports to lay out the legal rights and obligations of the parties without any attempt to discover which jurisdiction’s law applies to those parties or what that law would require.⁴ Moreover, the court misstates U.S. law, for under the law of all 50 states, if an originator pays a beneficiary by a funds transfer, the originator’s obligation to the beneficiary is discharged only upon acceptance by the beneficiary’s bank of a payment order in the funds transfer that the originator initiated. U.C.C. § 4A-406. It is true that payment will be considered made to the beneficiary even if the credit is not made available to it because the beneficiary’s bank has applied the amount of the funds transfer to a debt that the beneficiary owed to the beneficiary’s bank, *see id.* § 4A-405(a), or a court restrained the beneficiary’s bank from releasing the funds to the beneficiary, *see id.* § 4A-503, but stopping a funds transfer at an intermediary bank gives the beneficiary no right to payment by any bank in the transfer.

Under the privity regime adopted by Article 4A, these relationships and the rights and obligations that arise from them are clear. Wachovia, as a receiving bank, is subject to the law of the place where it is located. Its obligations are incurred only after it has received a payment order from a sender that it has agreed to receive payment orders from. The Rule B decisions of the New York federal courts depart from this privity and treat

⁴ Under Article 4A, the issue of whether the originator had paid the beneficiary would be governed by the law of the jurisdiction in which the beneficiary’s bank was located. U.C.C. § 4A-507(a)(3).

intermediary banks as bailees of disembodied “funds” belonging simultaneously to the originator and the beneficiary. Such an approach could have a number of unfortunate results, including the proliferation of lawsuits against intermediary banks in cross-border funds transfers. For example, a foreign sender could sue a U.S. receiving bank on the money-back guarantee, using Article 4A, in the foreign jurisdiction’s courts.

Specific Comments.

In a few places the wording should be amended to reflect more closely the actual structure of funds transfers.

Page 2, 1st full para., 2d-last sentence: “If the originator’s bank accepts the originator’s payment order, the originator owes an obligation to the originator’s bank to ~~fund that payment order with sufficient credits to~~ pay the amount of the payment order.”

Page 3, carryover para., 2d-last sentence: “In the event the originator ~~does not have sufficient credits to cover~~ *was not able to pay the amount of its payment order to the originator’s bank*, but the originator’s payment order has been accepted by the intermediary bank, the originator’s bank still owes a payment obligation to the intermediary bank.”

We would also note that the first sentence of the last paragraph of page 2 may need some further explanation. That sentence says that “[i]n 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.” This is often true, but in cross-border funds transfers where the beneficiary is in a time zone outside of North America, or where there is no direct correspondent relationship between the originator’s bank and the beneficiary’s bank, the originator’s bank may split the funds transfer. In these cases, the originator’s bank will send a payment order directly to the beneficiary’s bank. Acceptance by the beneficiary’s bank will require the originator’s bank to pay the amount of the order to the beneficiary’s bank. To satisfy this obligation, the originator’s bank will send a separate funds transfer (referred to as a “cover payment”) through a correspondent bank for further credit to the beneficiary’s bank. *See*

U.C.C. § 4A-403(a)(2)(ii). It should be clear that the cover payment is a separate funds transfer from the underlying funds transfer and is merely an interbank transaction that is intended to pay the originator's bank's obligation to the beneficiary's. Because the first funds transfer has already been completed, any obligation that the originator had to the beneficiary has already been discharged and the beneficiary would already have been paid. Thus, neither the originator nor the beneficiary of the underlying funds transfer has an attachable property interest in the cover payment.

The PEB may wish to include a discussion of cover payments in its Commentary.

* * * * *

We hope these comments are helpful. If you have any questions, please contact Joseph R. Alexander at 212-612-9234 or joe.alexander@theclearinghouse.org.

Respectfully submitted,

COMMITTEE ON COMMERCIAL LAW AND UNIFORM STATE LAWS
ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

David W. Dykhouse, *Chair*
Joseph R. Alexander
Nathaniel Burney
Kristen Campana
Greg Cavanaugh
Penelope Christophorou
Francis Facciolo
Clayton Gillette
Jeffrey E. Glen
Allen S. Joslyn
Jeffrey M. Katz

Kenneth Kettering
Alan Kolod
Richard M. Newman
Daniel J. Paisley
Sandra M. Rocks
Stephen J. Shimshak
Glenn E. Siegel
Ronald J. Silverman
Sandra Stern
Peter J. Wasserman
Sooryun Youn