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World Bank Discussion Papers

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# Towards a Payments System Law for Developing and Transition Economies

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Raj Bhala

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The World Bank  
Washington, D.C.

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## **FOREWORD**

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

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

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

Gary L. Perlin  
Director  
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## **ABSTRACT**

This paper examines the legal foundations of large-value credit transfer systems and the importance of certainty, efficiency, and fairness in funds transfer law. A case study is presented to highlight key terminology and concepts. Thereafter, five particularly noteworthy legal rules are discussed in the context of the case study: (1) a rule defining the scope of the law; (2) a rule establishing when the rights and obligations of parties to a funds transfer are triggered; (3) a receiver finality rule; (4) a rule assigning liability for interloper fraud; and (5) a money-back guarantee rule, coupled with provisions on discharge. Finally, strategic concerns affecting the drafting of a funds transfer law are identified.

## **ACKNOWLEDGEMENT**

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## INTRODUCTION

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

The paper consists of four remaining parts. In **Part I**, the relationship between the legal framework for a large-value credit transfer system and the development of an ideal system is discussed. **Part II** briefly surveys the five foundations of a legal framework for large-value credit transfer systems. **Part III** introduces a case study of a funds transfer and employs essential legal terminology. In **Part IV**, the five foundations of a legal regime governing funds transfer law are discussed in detail using the essential legal terminology. **Part V** considers general principles of drafting a funds transfer law in the special context of developing and transition economies. The countries of the former Soviet Union and Baltic region are considered as examples. Finally, concluding observations are set forth in **Part VI**.



## I. THE IMPORTANCE OF THE GOVERNING LEGAL REGIME

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

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

With so much money transferred "by wire" each day, and with the average value of each transfer so high, the potential for large losses is great. Thus, commercial parties making and receiving such payments require a clear, comprehensible, and sensible legal regime to answer two basic questions. First, how should a funds transfer normally work? Second, what happens if a mishap occurs? There is a third public policy issue of particular concern to central bankers, namely, systemic risk – how can this risk be minimized and contained?

One way to approach these issues is to consider the theoretical underpinnings of an ideal payments system. Arguably, an ideal payments system must have three salient features: it must be certain (i.e., reliable), efficient (i.e., high speed, low cost, and high security), and fair (i.e., equitable in its apportionment of liability).<sup>1/</sup> That is, large amounts of funds must be transmitted at low cost and with high security, and the rights and obligations of parties to the funds transfer must be allocated in a fair manner. A legal framework for a large-value credit transfer system is essential to ensuring that all three features are present in the system.

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<sup>1/</sup> See generally Raj Bhala, *Paying for the Deal: An Analysis of Wire Transfer Law and International Financial Market Interest Groups*, 42 KANSAS LAW REVIEW 667 (spring 1994) and ERNEST T. PATRIKIS, THOMAS C. BAXTER, JR., AND RAJ BHALA, WIRE TRANSFERS 23-5 (1993).

First, burdensome or unclear legal rules raise the costs of a funds transfer, thereby reducing efficiency. In turn, the system becomes less attractive to potential providers of system services, users of those services, or both. For example, suppose an automobile company instructs its bank to make a \$5 million payment to a steel supplier. The payment is made through the Bank of Credit and Commerce International (BCCI), but before the payment transaction is complete BCCI fails. Does the automobile company, the steel company, the creditors of BCCI, or some other party bear the \$5 million loss? If the legal framework fails to provide an unequivocal answer, then uncertainty is generated. In reaction to uncertainty, system providers and users must take precautions – that is, insure against risks – hence, the cost of providing and using the system inevitably will increase.

Second, the lack of rules on authenticity and security reduces reliability. Consequently, the system creates uncertainties and risk for both its providers and users. For example, suppose a U.S. bank that receives a \$500,000 payment instruction from one of its customers discovers – after the payment is made to an offshore bank – that the instruction is unauthorized. What are the rights and obligations of the U.S. bank, its customer, and the offshore bank? If the legal framework does not provide a clear answer, then the system will be viewed as unreliable by prospective users and providers of system services.

Third, an over-allocation of duties to system providers or to system users can be unfair. In addition, it may lead to a non-level playing field. For example, where liabilities are skewed toward non-bank users of a large-value funds transfer system, banks may enjoy a monopoly position. When potential users or providers perceive a system to be unfair, they simply will not use or provide, respectively, system services.

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

## II. AN OVERVIEW OF THE FIVE LEGAL FOUNDATIONS

To appreciate the rules, it is first necessary to master the terminology of funds transfer law and to use applicable terms in the context of a typical funds transfer. (The terms "funds transfers" and "credit transfers" are used interchangeably, as are the terms "funds transfer systems" and "large-value credit transfer systems."<sup>2/</sup>) Accordingly, the five critical elements in the American and international funds transfer laws are set forth in the appropriate legal terminology and context.

The economic and policy justifications for the five legal rules are beyond the scope of this presentation.<sup>3/</sup> Similarly, there is no attempt to argue or prove that the rules discussed herein are the exclusive legal pillars of funds transfer law. By setting forth the important provisions in American funds transfer law, the presentation will serve as a point of departure for the future work and study of the lawyer, banker, or scholar.<sup>4/</sup>

The five rules are set forth in Article 4A of the Uniform Commercial Code (U.C.C.), the principal law in the United States governing funds transfers,<sup>5/</sup> and the United

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

<sup>3/</sup> For theoretical discussions of funds transfer law, see Raj Bhala, *Paying for the Deal: An Analysis of Wire Transfer Law and International Financial Market Interest Groups*, 42 KANSAS LAW REVIEW 667 (spring 1994) and *The Inverted Pyramid of Wire Transfer Law*, 82 KENTUCKY LAW JOURNAL 347 (winter 1993-94) reprinted in JOSEPH J. NORTON, ET AL., EDS., *ELECTRONIC BANKING* (1994). See also Fairfax Leary, Jr. and Patricia B. Fry, A "Systems Approach" to Payment Modes: *Moving Toward a New Payments Code*, 16 UNIFORM COMMERCIAL CODE LAW JOURNAL 283 (1984); and Hal S. Scott, *Corporate Wire Transfers and the Uniform New Payments Code*, 83 COLUMBIA LAW REVIEW 1664 (1983). For a microeconomic analysis of loss allocation rules in consumer payments transactions, see R. Cooter and E. Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEXAS LAW REVIEW 63 (1987) and Hal S. Scott, *THE RISK FIXERS*, 91 HARVARD LAW REVIEW 737 (1978). For this analysis in the funds transfer context, see Judge Richard Posner's opinion in *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951 (7th Cir.), cert. denied, 459 U.S. 1017 (1982).

<sup>4/</sup> This is not to imply that Article 4A is the sole practical alternative or teaching model. Indeed, the recently-approved United Nations Model Law on International Credit Transfers is available for national legislatures to enact in whole or part. U.N. GAOR, 47th Sess., Supp. No. 17, at Annex 1 p. 48, U.N. Doc. A/47/17 (1992). For a discussion of the Model Law, see ERNEST T. PATRIKIS, THOMAS C. BAXTER, JR., AND RAJ BHALA *WIRE TRANSFERS* parts III and V (1993).

<sup>5/</sup> Article 4A does not govern paper-based methods of payments like negotiable instruments or letters of credit (though, of course, payment orders associated with an electronic funds transfer may be issued in writing). The version of Article 4A cited here is the 1989 Official Text with Comments approved by the American Law Institute and National Conference of Commissioners on Uniform State Laws (NCCUSL). States have been quick to incorporate Article 4A into their Uniform Commercial Codes, with over forty states enacting the statute in less than three years. Information on state enactment is provided by NCCUSL. As discussed below, Regulation J, (continued...)

Nations Model Law on International Credit Transfers (U.N. Model Law), the main international legal agreement on funds transfer rules.<sup>§</sup> They are:

- (1) a scope rule to differentiate the parties and payment instructions that are included in the law from those that are not included;
- (2) a trigger event to indicate the moment when the rights and obligations of a party to a funds transfer are manifest;
- (3) a receiver finality rule to establish when credit to an account is irrevocable;
- (4) a money-back guarantee to cover situations where a funds transfer is not completed, coupled with a discharge rule for cases where the transfer is completed; and,
- (5) an anti-fraud rule to allocate liability for fraudulent payments instructions.

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<sup>§</sup>(...continued)

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

Regulation J is codified at 12 C.F.R. Part 210 subpart B (1992). Similarly, the New York Clearing House has selected New York's version of Article 4A as the law applicable to CHIPS. In addition, relevant additional provisions are set forth in Federal Reserve Bank operating circulars and the CHIPS rules. For a discussion of Regulation J and Operating Circular No. 8, and of the CHIPS rules, see ERNEST T. PATRIKIS, THOMAS C. BAXTER, JR., AND RAJ BHALA, WIRE TRANSFERS part III (1993).

<sup>§</sup> Like Article 4A, the Model Law governs electronic transfers and not paper-based methods of payment like negotiable instruments or letters of credit. Hereinafter, references are to U.C.C. Article 4A and certain analogous provisions in the Model Law.

### III. A CASE STUDY

A discussion of the five key rules of U.C.C. Article 4A is aided by reference to a case study of a funds transfer. Consider the following hypothetical:<sup>2/</sup>

- (1) An automobile manufacturer buys steel worth \$100,000 from a steel company to make vehicles. The steel company delivers the steel to the automobile manufacturer, and the manufacturer now seeks to pay the company for the steel by funds transfer.
- (2) The manufacturer and steel company hold their accounts at different banks.
- (3) The manufacturer instructs its bank to pay \$100,000 to the steel company. The instruction contains the name and account number of the steel company and the name and identifying number of the steel company's bank.
- (4) The automobile manufacturer's bank complies with the instruction of its customer by further instructing a second bank to pay \$100,000 to the steel company. This second instruction again contains the relevant information about the steel company and its bank.
- (5) The second bank also complies with the instruction it received. It further instructs the bank at which the steel company has an account to pay \$100,000 to the steel company.
- (6) The steel company's bank complies with the third instruction and pays the company.

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

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<sup>2/</sup> A payments obligation to be discharged by a funds transfer can arise from virtually any sort of underlying contractual relationship between the buyer-payor and seller-payee. While the underlying contractual obligation in this hypothetical involves goods, in reality financial transactions generate the bulk of funds transfers. Most large-value funds transfer activity is associated with securities and foreign exchange trading. See Raj Bhala, *The Inverted Pyramid of Wire Transfer Law*, 82 KENTUCKY LAW JOURNAL 347 (winter 1993-94) and BANK FOR INTERNATIONAL SETTLEMENTS, *PAYMENT SYSTEMS IN ELEVEN DEVELOPED COUNTRIES* 215 (3rd ed. 1989).

Each of these parties, and the actions each undertakes, has a specific legal label in U.C.C. Article 4A. Applying the correct labels is the first step in the process of distilling Article 4A to its essential ingredients. Each payment instruction is a "payment order" if it meets the requirements of the definition of that term. This term is critical in defining the scope of the law.

The automobile manufacturer is the "originator" of the funds transfer, that is, "the sender of the first payment order in a funds transfer."<sup>8/</sup> The bank at which the automobile manufacturer maintains an account and to which the first payment order is addressed is the "originator's bank."<sup>9/</sup> The steel company is the "beneficiary" of the originator's payment order.<sup>10/</sup> Also, it is the beneficiary of each payment order issued in the funds transfer chain that implements the originator's order, i.e., the payment order issued by the originator's bank and the second bank. The "beneficiary" is simply "the person to be paid by the beneficiary's bank."<sup>11/</sup> The bank at which the steel company maintains its account and to which funds are credited is the "beneficiary's bank."<sup>12/</sup> This term is reserved for "the bank identified in a payment order in which an account of the beneficiary is to be credited pursuant to the order or which otherwise is to make payment to the beneficiary if the order does not provide for payment to an account."<sup>13/</sup> The second bank is the "intermediary bank" in that it is "a receiving bank other than the originator's bank or the beneficiary's bank."<sup>14/</sup>

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<sup>8/</sup> U.C.C. Section 4A-104(c).

<sup>9/</sup> U.C.C. Section 4A-104(d). There is no requirement in this definition, or elsewhere in Article 4A, that the originator have a pre-existing account relationship with the originator's bank. There is no definition of "originator's bank" in the Model Law.

<sup>10/</sup> U.C.C. Section 4A-103(a)(2).

<sup>11/</sup> U.C.C. Section 4A-103(a)(3).

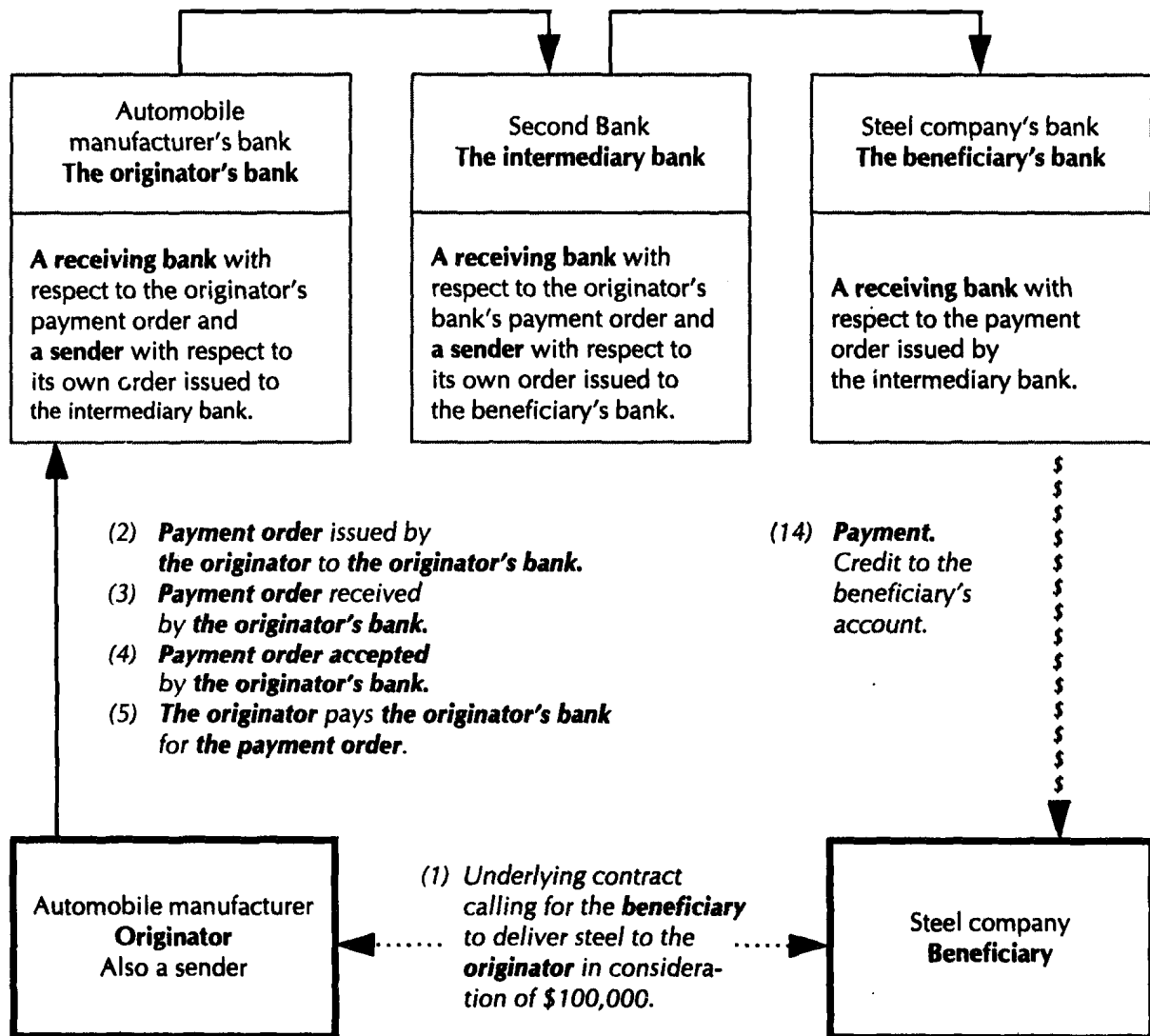
<sup>12/</sup> U.C.C. Section 4A-103(a)(3). Here too, there is no requirement of a pre-existing account relationship. There is no definition of a "beneficiary's bank" in the Model Law.

<sup>13/</sup> U.C.C. Section 4A-103(a)(3).

<sup>14/</sup> U.C.C. Section 4A-104(b). See U.N. Model Law Article 2(g).

## Diagram: Hypothetical example of a funds transfer

- |   |   |
|---|---|
| (6) <i>Payment order issued by the originator's bank</i>                      | (10) <i>Payment order issued by the intermediary bank</i>                       |
| (7) <i>Payment order received by the intermediary bank</i>                    | (11) <i>Payment order received by the beneficiary's bank</i>                    |
| (8) <i>Payment order accepted by the intermediary bank</i>                    | (12) <i>Payment order accepted by the beneficiary's bank</i>                    |
| (9) <i>Settlement between the originator's bank and the intermediary bank</i> | (13) <i>Settlement between the intermediary bank and the beneficiary's bank</i> |



Adjunct to (12). Obligation of the **originator** to pay \$100,000 to the **beneficiary** is **discharged** when the **beneficiary's bank** accepts the payment order.

The terms "sender" and "receiving bank" are generic: a sender is "the person giving the instruction to the receiving bank" and the receiving bank is "the bank to which the sender's instruction is addressed."<sup>15/</sup> The automobile manufacturer (the originator), the bank of the automobile manufacturer (the originator's bank), and the second bank (the intermediary bank) are all senders. The originator's bank, intermediary bank, and beneficiary's bank (the steel company's bank) are receiving banks.

The "funds transfer" is the entire "series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order."<sup>16/</sup> It includes the payment orders issued by the originator's bank and the intermediary bank, because these are "intended to carry out the originator's payment order."<sup>17/</sup> The funds transfer "is completed by acceptance by the beneficiary's bank of a payment order for the benefit of the beneficiary of the originator's payment order."<sup>18/</sup>

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

The concept of discharge is tricky in two senses. First, its legal importance is not always clearly understood. The crucial point is that until the funds transfer is completed, which occurs when the beneficiary's bank accepts a payment order for the beneficiary, the originator is legally liable on this obligation – it is not discharged.<sup>20/</sup> The originator's obligation to pay the beneficiary based on the contract for steel is not discharged until the beneficiary's bank accepts a payment order for the benefit of the beneficiary. Thereafter, the originator cannot be sued by the beneficiary for breach of contract on the grounds of non-payment.

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

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<sup>15/</sup> U.C.C. Section 4A-103(a)(4)-(5). See U.N. Model Law Article 2(f) (defining "receiving bank").

<sup>16/</sup> U.C.C. Section 4A-104(a).

<sup>17/</sup> *Id.*

<sup>18/</sup> *Id.*

<sup>19/</sup> U.C.C. Section 4A-406(b). See U.N. Model Law, Article 19, footnote.

<sup>20/</sup> U.C.C. Sections 4A-104(a) and 4A-406(a)-(b).



obligation of the originator to pay the beneficiary. This obligation arises from the underlying contractual obligation between those two parties. When the obligation is satisfied, it is said to be legally discharged. Each sender whose payment order is accepted by a receiving bank has a payment obligation to that bank, namely, to pay for the accepted order. The terms "settlement" and "settlement obligation" refer to an interbank payment obligation that arises from the acceptance of a payment order. That is, they refer to the payment obligation as between a sending and receiving bank. However, these interpretations are based more on customary and trade usage than specific sections of U.C.C. Article 4A.<sup>21/</sup>

Each receiving bank has a decision to make when it receives a payment order: should it accept or reject the order? The receiving bank is not obligated to accept an order.<sup>22/</sup> A receiving bank may reject an order because the sender does not have sufficient funds in its account to pay for the order. Or, a receiving bank may reject a payment instruction because it states conditions with which the bank is unwilling or unable to comply. A receiving bank other than the beneficiary's bank (*i.e.*, the originator's bank and intermediary bank) accepts a payment order by executing the order.<sup>23/</sup> "Execution" of a payment order means that the bank "issues a payment order intended to carry out the payment order received by the bank."<sup>24/</sup> Thus, the originator's bank accepts the payment order of the originator by issuing an order that conforms with the instructions set forth in the order of the originator. Similarly, the intermediary bank accepts the payment order of the originator's bank by issuing a conforming order designed to implement the originator's bank's order.

A beneficiary's bank, however, does not accept a payment order by execution.<sup>25/</sup> Rather, the beneficiary's bank, if it accepts the order, is required to pay the

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<sup>21/</sup> ERNEST T. PATRIKIS, THOMAS C. BAXTER, JR., AND RAJ BHALA, WIRE TRANSFERS 72-3 (1993).

<sup>22/</sup> U.C.C. Section 4A-209 and official comment 3. See U.N. Model Law, Articles 7(2), 8(2), 9 and 10(1). The receiving bank is free to enter into an account agreement with its sender-customer specifying that the bank will accept all payment orders issued by that customer. In this instance, the bank cannot reject the order. In addition, a receiving bank is unable to reject a payment order transmitted through Fedwire. This is because one of the ways in which a receiving bank accepts a payment order is obtaining payment from its sender. U.C.C. Section 4A-209(b)(2). With a funds transfer through Fedwire, the payment order and payment (*i.e.*, the instruction and value) move simultaneously from sender to originator. ERNEST T. PATRIKIS, THOMAS C. BAXTER, AND RAJ BHALA, WIRE TRANSFERS 174 (1993).

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

<sup>24/</sup> U.C.C. Section 4A-301(a). See U.N. Model Law Article 2(l).

<sup>25/</sup> U.C.C. Section 4A-301(a). The U.N. Model Law does not clarify this point.