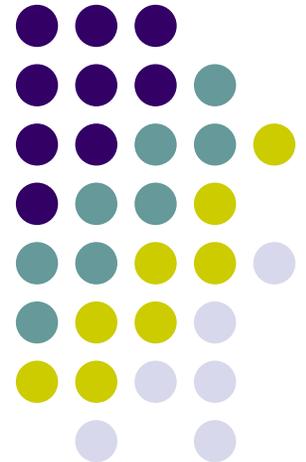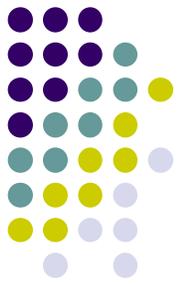# Funds Transfer Law And Unauthorized Payment Liability

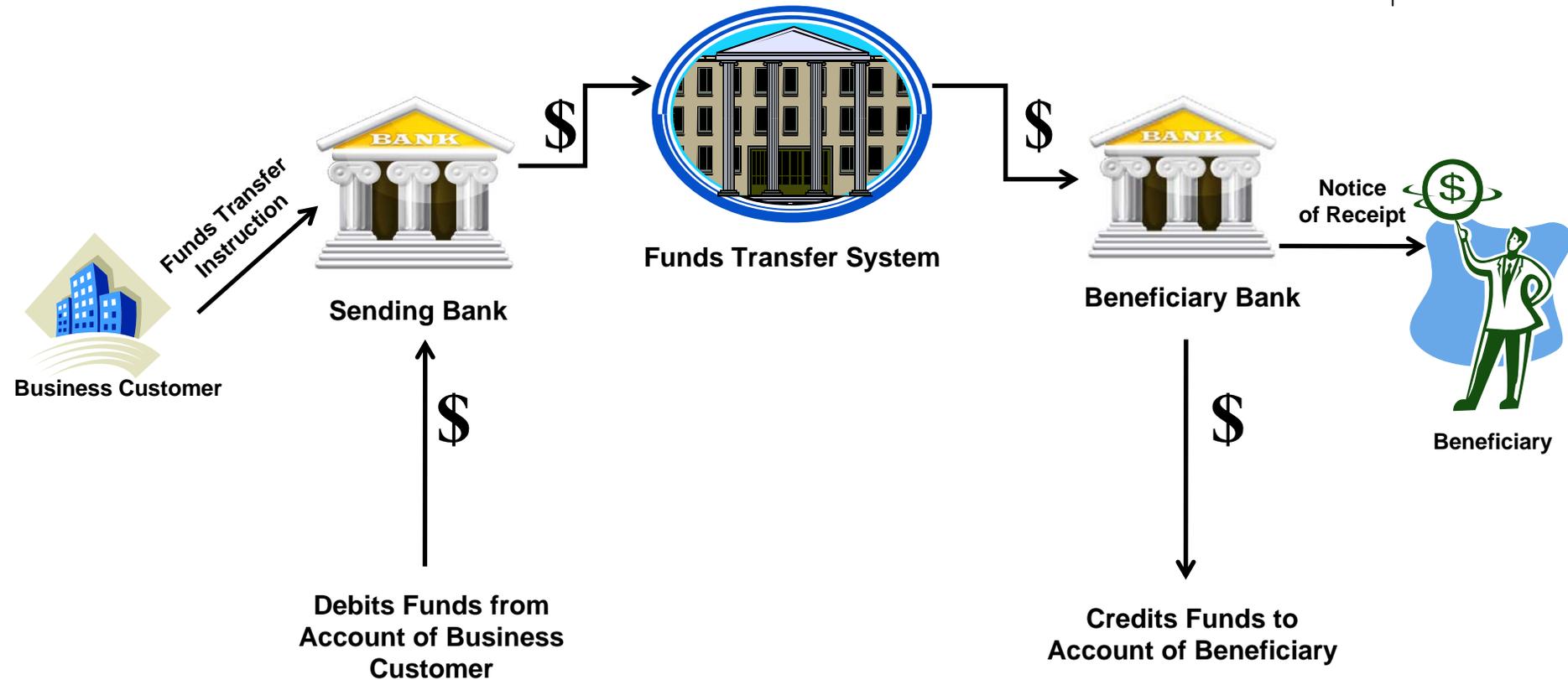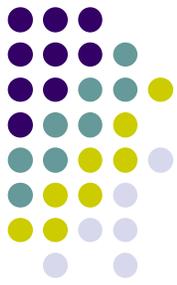Thomas Fox

Schwartz & Ballen LLP

May 11, 2010

# Types of Funds Transfers For Today's Discussion

- Business Initiated Transfers of Funds
  - Business-to-Business Transfers
  - Business-to-Consumer Transfers

- These are "credit" transactions
  - Funds are "pushed" from the originating Sending Customer to the receiving beneficiary Customer
  - Sending Customer is instructing banks to make a credit payment to beneficiary Customer

  - Credit transfers generally not reversible or recallable once accepted by the beneficiary Bank

  - Result in final settled funds for the beneficiary Bank

# Overview of Funds Transfer: Process Flow



**Business Customer**

Funds Transfer Instruction

**Sending Bank**

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**Funds Transfer System**

$

**Beneficiary Bank**

Notice of Receipt

**Beneficiary**

$

**Debits Funds from Account of Business Customer**

$

**Credits Funds to Account of Beneficiary**

# Applicable Law

What laws govern rights of Business Customers and their Banks for Fund Transfers?

Bank - to - Customer Relationship
- Uniform Commercial Code - Article 4A adopted by each of the states
- Account Agreement between Customer and Bank can vary certain provision of UCC Article 4A
- State Tort Law? – UCC Article 4A meant to occupy field

Bank - to - Bank Relationship
- UCC Article 4A
- NACHA Operating Rules (If processed as ACH transaction)
- Federal Reserve Regulation J and Operating Circular (If processed by Federal Reserve through fedwire or ACH system)
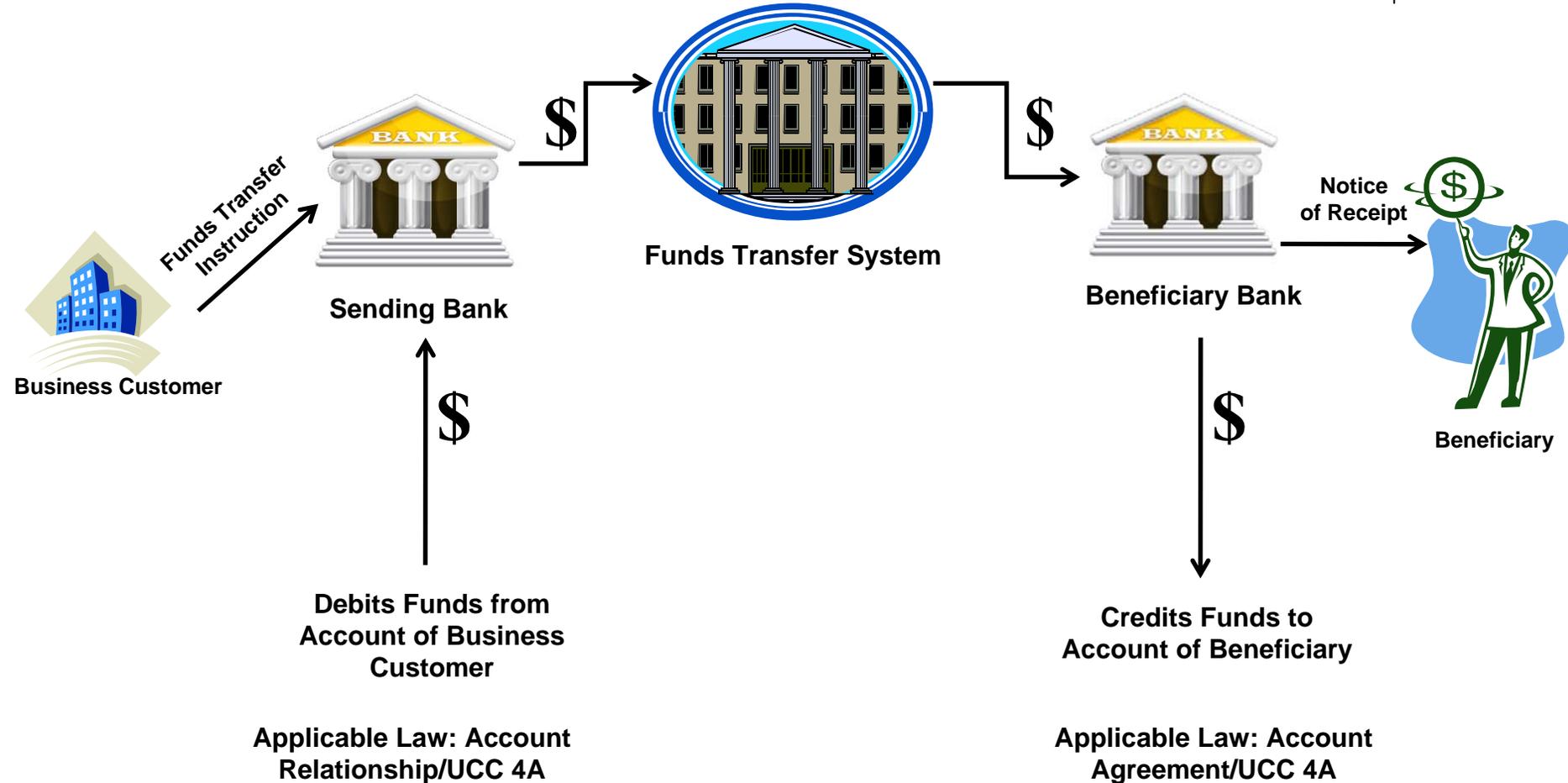
# Overview of Funds Transfer: Rules And Process Flow
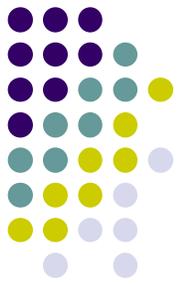
Applicable Law: UCC 4A/ ACH Rules/ Fed System Rules

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**Business Customer**

*Funds Transfer Instruction* →

**Sending Bank**

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**Funds Transfer System**

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**Beneficiary Bank**

**Notice of Receipt** →

**Beneficiary**

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**Debits Funds from Account of Business Customer**

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**Credits Funds to Account of Beneficiary**

**Applicable Law: Account Relationship/UCC 4A**

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**Applicable Law: Account Agreement/UCC 4A**

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# Treatment of Unauthorized Transfers under UCC Article 4A
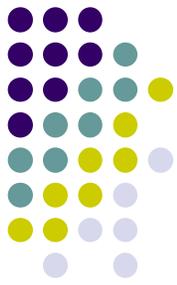
**General Rule**:  Sending Customer is not liable to Sending Bank for a funds transfer if the transfer is not <u>authorized</u> by Customer. UCC 4A-202

**What is Authorized**:  A funds transfer is deemed "authorized" by the Sending Customer if the Sending Bank verified the authenticity of the instruction with a "security procedure".

**Requirements:**

(1)  Security procedure is "commercially reasonable method of providing security against unauthorized entries" <u>and</u>

(2)  Bank acted in "good faith" in compliance with security procedure. "Good faith" means honesty in fact and observance of reasonable commercial standards of fair dealing.

**Security Procedure Obligates Customer**:  A funds transfer validated by Sending Bank with security procedure is deemed authorized, even if Sending Customer did not <u>in</u> <u>fact</u> authorize the funds transfer.

# So what is a Security Procedure?

The following are examples of security procedures:

- Algorithms
- Passcodes
- Encryption devices
- Call back procedures
- Identifying words/ Numbers UCC 4A-201
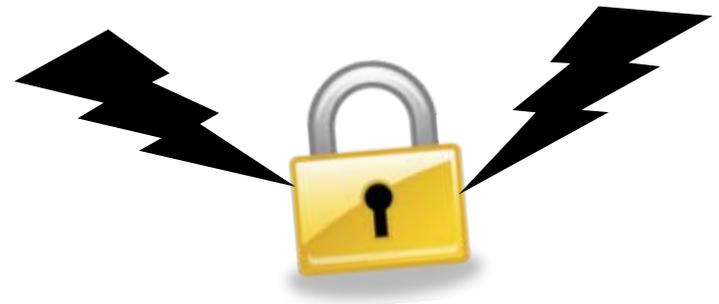
Signature comparison is **NOT** a security procedure

What determines if procedure is "commercially reasonable"?

- Circumstances of the Customer
  - Size, type and frequency of funds transfers
- Security procedure in use by similarly situated Banks/Customers
- Whether alternative security procedures are offered UCC 4A – 202(c)
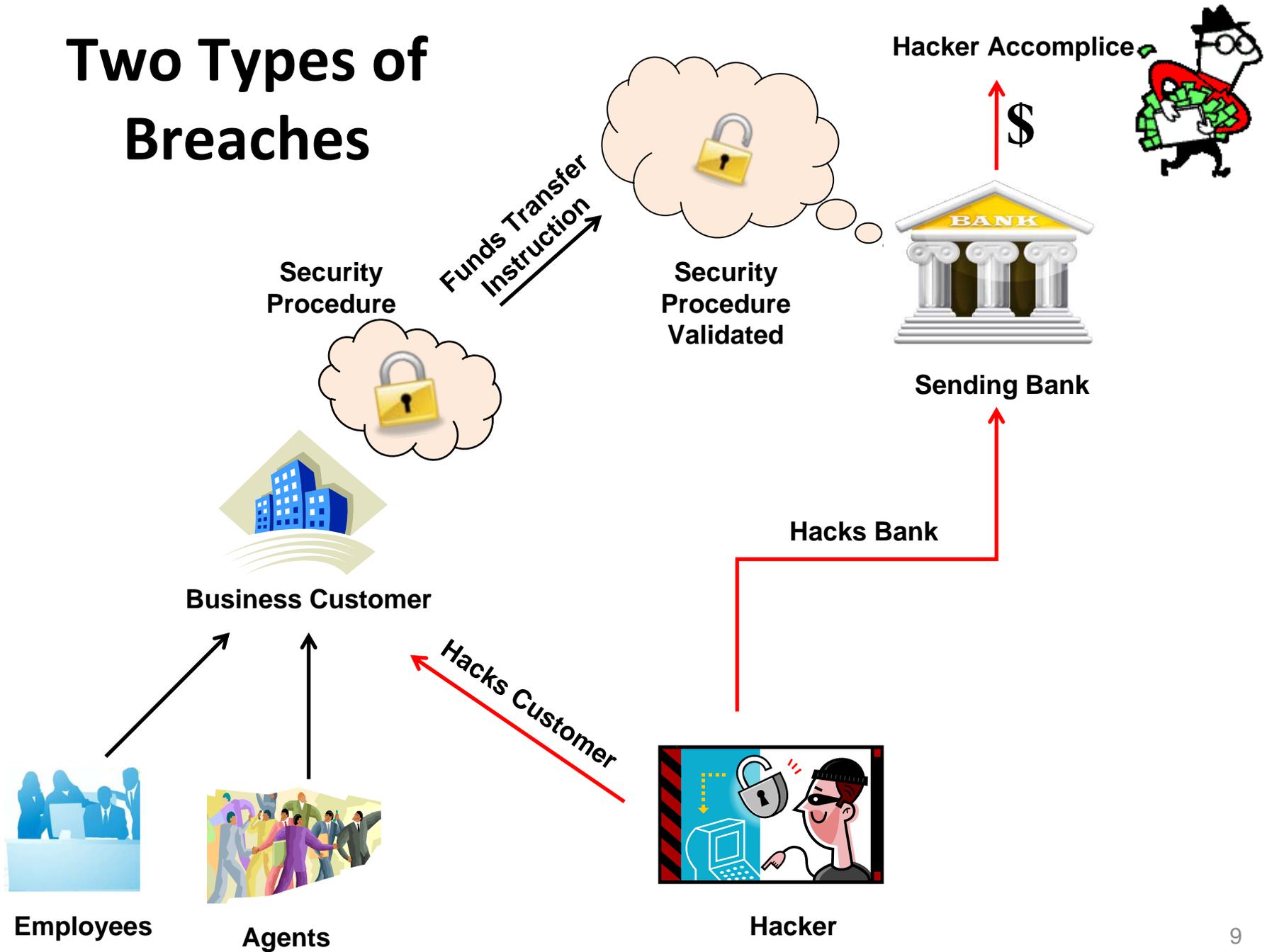
# Exception to UCC 4A's Loss Allocation Rule

There is limited exception to Customer obligation for funds transfer authenticated with security procedure.

Sending Customer is not liable for an unauthorized transfer if Customer proves:

- Transaction was not directly or indirectly caused by:
    - Customer or its employees or agents;
    - A person with access to Customer facilities; or
    - A person who obtained information from source controlled by Customer

    As practical matter, this is very difficult for Customer to prove. For example, Bank will have record of the Customer's security codes/passwords being used.

# Two Types of Breaches

Funds Transfer Instruction

Security Procedure

Security Procedure Validated

Hacker Accomplice

Sending Bank

Business Customer

Hacks Bank

Hacks Customer

Employees

Agents

Hacker

# Comparison to "Debit" Payments

- Debit payments occur when the beneficiary is requesting payment through the banking system

- Examples:
  - Debit/Credit Cards
  - Checks Payments
  - ACH Debit Payments

- Subject to different rules and protections for unauthorized payments

- Not subject to UCC Article 4A

# Comparison to Consumer Payments

- Federal Law provides <u>consumers</u> with protections from fraud/ unauthorized electronic payments
    - Electronic Fund Transfer Act (15 USC §1693)
    - Regulation E of Federal Reserve Board (12 C.F.R. Part 205)

- Consumers are persons that hold bank accounts for "personal, family or household" purposes

- Places responsibility on Bank to determine if payment from a consumer account is authorized

- Limits total liability of consumer for fraudulent electronic payments (subject to prompt notice requirements)

- Consumer protections not applicable to wire transfers or other electronic payments made by Business Customer