

## CHAPTER 4

# DISCHARGE OF THE ORIGINATOR'S OBLIGATION TO THE BENEFICIARY

It is a common commercial fact of life that at the closing of a large financing transaction or corporate acquisition funds are disbursed to the bank account of the borrower or the corporate seller by means of funds transfers. Moreover, corporate trading partners commonly use funds transfers instead of checks to pay for goods and services. In the context of these commercial facts of life, section 4A-406 sets forth a very significant rule of Article 4A: *the underlying obligation of the originator to the beneficiary is discharged when the beneficiary's bank accepts its sender's payment order.*

The discharge of the originator's obligation to the beneficiary occurs simultaneously with the creation of an obligation of the beneficiary's bank to pay the beneficiary, that is, both events occur when the beneficiary's bank accepts its sender's payment order. § 4A-406(a). Thus, if the purpose of the payment is to repay indebtedness, the indebtedness is discharged "to the same extent discharge would result from payment to the beneficiary of the same amount in money." § 4A-406(b). From the point of view of the originator-debtor, the acceptance discharges the debt. From the point of view of the

beneficiary-creditor, the obligation of the originator is replaced with the obligation of the beneficiary's bank.

There is an exception, however, to the Article 4A discharge rule. Discharge of the originator's obligation to pay the beneficiary does not occur if:

- (1) the payment was by a means prohibited by agreement between the originator and the beneficiary;
- (2) the beneficiary, within a reasonable time after receiving notice of the purported payment, gives notice to the originator that it refuses the payment;
- (3) the funds are not withdrawn by the beneficiary or applied to a debt of the beneficiary; and
- (4) the beneficiary would suffer a loss that could reasonably have been avoided if the payment had been by a means that complied with the agreement between the originator and the beneficiary. § 4A-406(b).

The exception to the rule discharging the indebtedness makes the originator bear the risk of the insolvency of the beneficiary's bank when the beneficiary has bargained for the right to receive payment by a means other than the funds transfer (*e.g.*, a tender of cash). If the other means would have eliminated the risk of the insolvency of the beneficiary's bank and the beneficiary's bank has become insolvent, the indebtedness is not discharged despite the acceptance of the payment order, and the originator must bear the risk of the insolvency.

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#### **ILLUSTRATION 1**

Selling Corporation sells a subsidiary to Acquiring Corporation for \$50 million, to be paid at the closing by a Fedwire<sup>®</sup> funds transfer into Selling Corporation's account at Selling Corporation's Bank. Instead of using

the Fedwire<sup>®</sup> system, Acquiring Corporation's Bank sends a payment order for \$50 million to Bank of Malibu, as an intermediary bank. Bank of Malibu executes the order by sending a payment order to Selling Corporation's Bank, which accepts the order. Then Selling Corporation's Bank fails.

Selling Corporation has been "paid," by reason of the acceptance by its bank of the payment order from Bank of Malibu, but it has not received the \$50 million because its bank has failed. Selling Corporation gives timely notice of refusal of payment and asserts the exception to the discharge rule. The facts support the first three conditions to the exception but not the fourth condition:

- 1) The payment was in breach of the contract because the payment order to Selling Corporation's Bank was from Bank of Malibu instead of via the Fedwire<sup>®</sup> system;
- 2) Selling Corporation gave timely notice of refusal of acceptance of the payment; and
- 3) Selling Corporation did not withdraw the \$50 million.

The fourth condition, however, has not been satisfied because Selling Corporation cannot show that the loss would have been avoided if the payment had been carried out in compliance with the contract terms. The insolvency of Selling Corporation's Bank would have occurred in any event, whether or not the funds transfer had been a Fedwire<sup>®</sup> funds transfer. If the payment order had been sent by the Federal Reserve Bank, Selling Corporation would have no more than a claim for \$50 million against Selling Corporation's Bank, only \$100,000 of which would be insured by the FDIC.

## **ILLUSTRATION 2**

As in the previous illustration, Selling Corporation sells a subsidiary to Acquiring Corporation for \$50 million. Instead of a Fedwire<sup>®</sup> funds transfer, however, the agreement stipulates payment of the \$50 million selling price by delivery of a cashier's check to Selling Corporation drawn on Bank of Malibu. Instead of delivering the cashier's check, Acquiring Corporation sends a funds transfer of \$50 million to Selling Corporation's Bank. Selling Corporation's Bank accepts the payment order and then fails.

Selling Corporation has been "paid," by reason of the acceptance by its bank of the payment order, but it has not received the \$50 million because its bank has failed. Selling Corporation gives timely notice of refusal of the payment and asserts the exception to the discharge rule. The facts arguably support all four conditions of the exception to the discharge rule. First, the payment method was in breach of the contract. Second, Selling Corporation gave timely notice of refusal. Third, Selling Corporation did not withdraw the funds. The fourth condition would also likely be satisfied because Selling Corporation would suffer a loss that could reasonably have been avoided if it had a cashier's check from Bank of Malibu as required under the contract. Under these facts, if Selling Corporation gives timely notice of its refusal of the funds transfer, the debt of Acquiring Corporation has not been discharged. Acquiring Corporation bears the risk of the insolvency of the beneficiary's bank and must pay \$50 million to Selling Corporation.

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The deduction of fees from the amount of a funds transfer by a bank in the funds transfer chain is addressed in Article 4A

given the consequences that such a deduction could have on both the originator and the beneficiary. Remember, the originator's debt to the beneficiary is discharged but only for the amount of the payment order accepted by the beneficiary's bank. So, unless instructed by a sender, Article 4A provides that a receiving bank is not permitted to deduct its charges from the amount of the payment order it issues in execution of the sender's orders, and it is not permitted to instruct subsequent banks in the funds transfer chain to do so. § 4A-302(d). When such charges are deducted, whether permitted or not, the beneficiary receives less than the full amount of the payment, and the originator may incur losses as a result of the beneficiary's receipt of less than the full amount.

Suppose, for example, that the originator has an option to purchase a parcel of real property. The property is worth \$10 million, but the purchase price is only \$5 million. To preserve the option, the originator must make a payment of \$1 million by June 1 to the beneficiary. The originator initiates a timely funds transfer, but at the end of the day on June 1, the beneficiary has received only \$999,990 as a result of the deduction by an intermediary bank of \$10 for its charges. The intermediary bank may or may not have been authorized to make the deduction, but as a result of the deduction, the optionor seeks to terminate the option. If the optionor can terminate the option, the originator will sustain a loss of \$5 million.

Under these circumstances, section 4A-406(c) serves to protect the rights of an originator against the beneficiary. If a beneficiary's bank accepts a payment order in an amount that is equal to the originator's order less the charges of one or more receiving banks in the funds transfer chain, for purposes of determining whether discharge of the originator's obligation to the beneficiary occurs, the beneficiary is deemed to have been paid the full amount of the originator's order. § 4A-406(c). If upon demand, however, the originator does not pay the deducted charges to the beneficiary, this special discharge rule does not apply. § 4A-406(c). Instead, Article 4A provides that

the debt of the originator to the beneficiary is discharged only in the amount of the payment order accepted by the beneficiary's bank. § 4A-406(a). Of course, where a receiving bank has deducted fees from a funds transfer without authorization, the originator of the funds transfer would have a claim against the receiving bank for improper execution under section 4A-305 for the expense of the transfer, for incidental expenses, and interest, but not for any additional damages. (See discussion *supra* Chapter 2, Section D.)