

# The Funds Where Wired Where?

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A mortgage banker's warehouse lender wires funds to a closing agent to close a loan.

The funds are redirected from the closing agent (through malfeasance or inadvertence) to a third party bank (the "Bank"). The Bank credits its customer's account with the funds. Then the customer (the mortgage banker) instructs the Bank to apply the funds to pay off a loan owed to the Bank by the customer. The loan is satisfied. Then the warehouse lender weighs in, trying to determine what happened to its money. A lawsuit follows and the court hands down its decision. Guess who owns the funds? According to recent case law, the Bank does.

Wire transfers are central to a mortgage banker's business. They have accelerated the speed of transactions and have enabled the mortgage lending industry to grow at a faster rate than would otherwise have been possible. When a wire transfer flies off into the ether and ends up in the wrong hands, recovering the funds often presents unanticipated challenges, and the source for ultimate recovery may not be the party that received the funds.

With the 1990 adoption by the California Legislature of Article 4A of the Uniform Commercial Code, which specifically deals with funds transfers,

a set of precise and detailed rules were put in place to assign responsibility, allocate risks, and establish limits on liability. A key consideration in the drafting of these rules was to ensure that the various parties to fund transfers would be able to "predict risk with certainty, to insure against risk, to adjust operational and security procedures, and to price funds transfer services appropriately." (Comment, California Commercial Code ("U.C.C."), Section 11102).

All domestic wire transfers are made via the Federal Reserve Wire Transfer Network, or "Fedwire," which is owned and operated by the Federal Reserve Banks. Under Subpart B of Federal Regulation J, 12 C.F.R. Sections 210.25–210.32, the provisions of Article 4A are incorporated into §210.25(b)(1). So, whether drawing on California or federal law, Article 4A applies to funds transfers via the Fedwire system.

California courts have been virtually silent regarding the impact of Article 4A, with the exception of a single case that only hints at the impact of the adoption of this provision on funds transfers. Although that case, *Bank of America v. Sanati* (1992) 11 Cal.App.4th 1079, was decided after the adoption of Article 4A, it wasn't decided using the article's provisions because the wire transfer at issue in the case was made prior to their adoption. The *Sanati* court did, however, make it clear that future

disputes related to funds transfers using the Fedwire system would fall under the rubric of Article 4A.

A recent federal court of appeals case provides a good example of what can happen in cases where wire transfers are misdirected to an entity that believes it has a legitimate right to keep the money. In *Regions Bank v. The Provident Bank, Inc.*, 345 F.3d 1267 (11th Cir. 2003), Morningstar Mortgage Bankers, Inc. ("Morningstar"), a mortgage originator, had an outstanding balance on its line of credit with its warehouse lender, Provident. Provident made a demand for immediate pay off of the credit facility because of Morningstar's questionable business practices.

Morningstar had entered into a second warehouse lending arrangement with Regions Bank. Pursuant to that credit arrangement, Morningstar instructed Regions Bank to transfer funds to a closing agent to fund a number of nonexistent loans. Regions Bank made the wire transfers as requested. Morningstar convinced the closing agent that the funds had been wired in error, and had the closing agent wire the funds to Morningstar's account at Provident. Morningstar then instructed Provident to pay off the outstanding balance on Morningstar's line of credit using the misdirected, wired funds.

After Provident applied the funds to pay down Morningstar's line of credit, both the closing agent's bank

and the FBI contacted Provident regarding these wire transfers and requested that the funds be returned. Provident refused and Regions Bank's lawsuit followed.

When a bank receives instructions to make or receive a funds transfer, these instructions can be transmitted orally, electronically or in writing. Under Article 4A, the beneficiary's bank (Provident) accepts a payment order "when the bank receives payment of the entire amount of the sender's order." U.C.C. §4A-209(b)(2). Provident complied with the relevant provisions of the U.C.C. by accepting the transfer of funds from the closing agent's bank into Morningstar's account, as well as when it followed Morningstar's instructions to apply the funds to credit the debt owed to Provident by Morningstar. Title to the funds passed to Provident upon acceptance of Morningstar's payment order when Provident applied the funds to Morningstar's outstanding balance on its warehouse line of credit.

The *Regions Bank* court noted that the parties did not dispute that Provident had complied with the relevant provisions of the U.C.C. in accepting the transfer and applying the funds to credit the debt owed to Provident by Morningstar. The question was whether a state statute requiring disgorgement of funds would apply. The statute required disgorgement if the beneficiary's bank knew or should have known that the funds were obtained illegally when it accepted the wire transfer. The state statute was not preempted because Article 4A is silent with regard to claims based on

a theory that the beneficiary's bank accepted funds when it knew or should have known the funds were obtained illegally when it accepted the wire transfer.

The court held that Regions Bank had failed to show that Provident knew or should have known that the funds had been obtained illegally. Article 4A therefore applied and Provident's good title to the funds was affirmed.

To minimize exposure to the

dangers of wire transfers, include language in wire transfer instructions that limits the use of the funds to a specific purpose and requires the immediate return of the funds if that purpose is not fulfilled within a specified limited time.

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